[COMMITTEE PRINT]

INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES

JOINT AND SUPPLEMENTAL COMMENTS

OF THE

PRESIDENTS OF THE FEDERAL RESERVE BANKS IN RESPONSE TO THE QUESTIONNAIRE

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

EIGHTY-FIFTH CONGRESS

SECOND SESSION

CHAPTER I

Printed for the use of the Committee on Finance

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INTRODUCTION

The Senate Finance Committee in connection with its investigation of the financial condition of the United States mailed a questionnaire to 104 individuals engaged in various phases of our economic life. Among this 104 were the 12 presidents of the Federal Reserve banks.

The joint comments of the 12 Federal Reserve bank presidents together with their individual supplemental views and comments are included in this chapter.

This is the first of a series of committee prints that will be published. In this manner the verbatim responses to the questionnaire will be made available without delay. Subsequent chapters will include the replies of corporation officials, economists, professors, and the heads of business and trade associations.

The Committee on Finance is deeply appreciative of those who responded to the questionnaire. Their voluntary efforts in helping the committee try to find some of the answers to the perplexing economic problems facing the Nation is a patriotic gesture of significant importance.

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SUPPLEMENTAL COMMENTS OF INDIVIDUAL PRESIDENTS OF THE FEDERAL RESERVE BANKS IN RESPONSE TO THE QUESTIONNAIRE OF THE SENATE FINANCE COMMITTEE

LETTER REQUEST FROM CHAIRMAN, SENATE FINANCE COMMITTEE

UNITED STATES SENATE,
COMMITTEE ON FINANCE,
February 17, 1958.

DEAR MR. BLANK: As you know the Senate Finance Committee has undertaken an inquiry entitled "Investigation of the Financial Condition of the United States." We have had testimony from three witnesses so far: Former Secretary of the Treasury, George M. Humphrey; former Under Secretary of the Treasury, W. Randolph Burgess; and Federal Reserve Board Chairman William McChesney Martin, Jr. Under separate cover I am sending to you a copy of these hearings.

I am anxious that the Finance Committee have available for study and guidance your thoughts and opinions about vital matters affecting our economy. In preparing your reply it is suggested that you use the attached list of questions merely as a guide. Please feel free to answer part or all of the questions and make any further comments you deem desirable or appropriate.

For your information I am also addressing a similar letter to the individuals shown on the attached list. It is my present intention to recommend to the Finance Committee that the answers to this letter be compiled into a compendium for use by the Members of Congress.

We must have a strong and sound economy to undergird our continued progress as a free nation. Your cooperation in answering these questions and adding your further comments will be a valuable contribution. I will appreciate your getting your answers and comments to me by April 1, 1958, if at all possible. In the event you will not be able to furnish your answers by that date, it would be most helpful if you would kindly indicate an approximate date when you could conveniently furnish your answers and comments.

Cordially,

HARRY F. BYRD, *Chairman.*

1. Give a definition in your own words of deflation and inflation.
2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.
3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942 to 1957. (You may wish to divide the period into two parts, 1942–50 prior to the accord, and 1951–57.)
4. Beginning in August 1956 there was an increase in the Consumer Price Index each month through September 1957, thereby causing a

decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

6. (*a*) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policies in the United States:

1. Price stability.
2. Stability of production, demand, and employment.
3. Economic growth in production, demand, and employment.

(*b*) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

7. Give your opinion of the effect on our economy of current Federal State, and local government spending.

8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

9. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy, and then relate them, one to the other. Please discuss these policies, stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

10. (*a*) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank credit.) Also please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

(*b*) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

(*b*) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy?

13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy?

14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

15. Can full employment goals be attained while maintaining a dollar that has relative stable purchasing power?

16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

17. List and briefly discuss what you consider the causes of the present recession, and what should be done to terminate it.

INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES

JOINT COMMENTS IN RESPONSE TO QUESTIONNAIRE OF THE SENATE FINANCE COMMITTEE

FOREWORD

The discussion that follows is intended to cover broadly the questions posed in the questionnaire that accompanied Chairman Byrd's letter of February 17, 1958. As suggested in his letter, the questions have not been answered separately, but have been used as a guide in organizing the discussion.

The questions and the comments have been brought together under five main headings. Part I discusses the meaning of inflation and deflation and their causes, and reviews the experience of recent years. Part II considers the interrelationships of three main objectives of economic policy and the problem of endeavoring to harmonize these objectives. Part III reviews the policies pursued by the Federal Reserve System since 1942, with reference to wartime and postwar developments generally and to the recurrent inflationary tendencies of the period more specifically. Part IV comments on fiscal policies, both at the Federal Government level and at the State and local government level, and also on Federal-debt-management policies. Part V discusses the monetary system of the United States, and the relationships between fiscal and debt management policies and monetary and credit policy.

PART I

ASPECTS OF INFLATION AND DEFLATION

Few concepts in the field of economics have been subject to such a wide variety of interpretations as the terms "inflation" and "deflation." It is common practice to define these concepts in ways that focus upon specific forces as major sources of these problems. Such usage is often dictated by the problem of the moment, and since inflation and deflation in any specific setting have characteristics that are more or less unique, these definitions are not useful under all conditions in selecting for analysis those developments of particular significance under new circumstances.

DEFINING INFLATION AND DEFLATION

The variation in usage is revealed by noting some characteristics of four familiar definitions of inflation, all of which may be found, either explicitly or implicitly, in a wide range of economic writings:

1. Inflation is a general rise in prices produced by expansion of money and credit supplies at a more rapid rate than growth of the economy's output potential.
2. Inflation is a general rise in prices created by excessive Government spending and deficit financing.
3. Inflation is a general rise in prices elicited by an expansion of aggregate demands beyond the capabilities of the economy to supply goods and services at existing price levels.
4. Inflation is a general rise in prices fostered by wage increases in excess of productivity gains.

Each of the above definitions has the property of defining inflation in terms of an alleged cause of rising price levels. The first three find the core of the difficulty in factors affecting total spending, although the precise factors are not necessarily identical, while the fourth points to forces affecting production costs. Each regards inflation as a kind of economic disorder or disturbance, while considering the price movement largely as symptomatic of an underlying problem.

None of the above definitions may be regarded as "correct" or "incorrect." The question may be raised, however, whether a definition couched in terms of a specific cause of rising prices ever is likely to command universal support. It is preferable perhaps to choose a definition of inflation which is entirely neutral as to the source of advancing prices, a solution to which professional usage has turned increasingly. Inflation, in this view, is regarded simply as an upward movement of the general price level, irrespective of the originating forces. Alternatively, inflation may be identified as a reduction in the purchasing power of money, which varies inversely with prices.

This definition leaves unanswered the important questions of causal factors and appropriate remedial actions but, by virtue of that fact, clears the air for meaningful discussion on these critical matters.

Customarily, inflation develops during the expansionary phase of cyclical movements about the growth trend of the economy. On the other hand, an expansion in business activity may create enlarged employment and production without being classified as inflationary.

In similar fashion, construction of a comparably neutral definition of deflation necessitates only that it be associated with the contractive, or readjustment, phase of deviations from long-run growth. Such identification is foreign to much of the early history of formal economic writings. Commonly, for example, if inflation were defined as a rise in prices associated with an excessive growth of money and credit supplies, deflation would be identified with a fall in prices produced by contraction of money and credit supplies. Other phenomena accompanying periods of monetary contraction—such as reductions in employment and production—were given less emphasis.

As the analysis of economic stability problems progressed, periods of depressed employment and production increasingly were called to the attention of observers. In part, this may reflect the fact that as industrialization proceeded in western nations, cyclical fluctuations became more obvious. But at the same time, recognition of these disturbances was enhanced by the accumulation of data on production and employment, which lagged considerably the collection of price statistics. With these developments, the concept of deflation was broadened, and definitions of deflation became more neutral as to causation, reflecting a growing awareness that economic contractions might encompass other variables than prices alone.

A working definition of deflation must recognize that periods of moderate contraction in economic activity need not always be accompanied by a general reduction of prices. It is true that contractionary tendencies in the economy, in the past, nearly always have elicited a downward price readjustment. Nevertheless, it is evident from the behavior of prices during the mild recession of 1953–54—when selective price adjustments had comparatively little impact on the general price level—that moderate contractions in business activity may produce little response in prices.

Before turning to some questions of identifying and measuring inflation and deflation, it may be useful to comment briefly on the concepts of inflationary and deflationary pressures. The suggested definitions of inflation and deflation are essentially descriptive: the words are defined in terms of movements of observable variables. Underlying these movements are economic disturbances creating inflationary or deflationary pressures, and it is well to recall that these forces are not always communicated instantaneously to the general levels of employment, production, incomes, and prices. Inflationary or deflationary tendencies may operate for many months before accumulating sufficient strength to generate open inflation or deflation. And with respect to upward pressures on the price level, it may be noted that inflationary forces, having gathered strength, may be partially repressed over extended periods by conventional industry pricing practices or governmental regulations and controls. In many industries, price adjustments are made at discrete intervals, and a considerable amount of time may elapse before the pressure or rising costs or the pull or rising demands is reflected in pricing decisions. The celebrated inflationary gap of the World War II and immediate postwar years exemplifies the repression of inflationary forces with Government controls.

QUESTIONS OF IDENTIFICATION AND MEASUREMENT

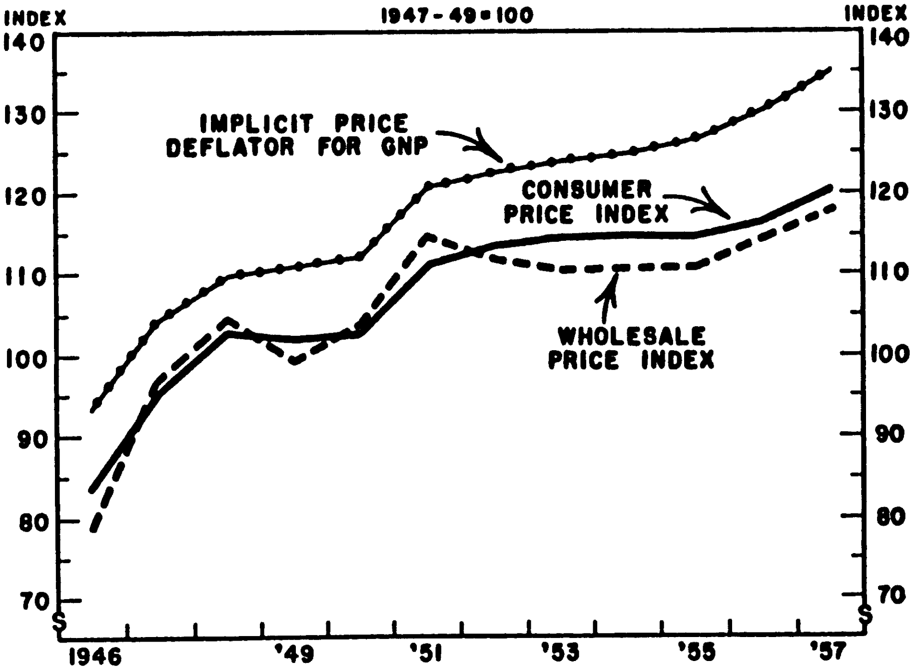
Having adopted general definitions of inflation and deflation expressed in terms of variations in employment, production, incomes, and prices, problems of both a conceptual and a statistical nature are encountered in tying the definitions to specific measures of these variables. It is clear that indexes to gage the movement of these variables should be based on broad aggregates. A price increase in one industry, for example, is not necessarily inflationary, nor is a decline in another industry necessarily deflationary. Alterations in the industrial composition of output and employment occur continuously, and relative price changes perform an important function in guiding the transfer of resources from one sector of the economy to another in accordance with final demand.

Reasonably adequate measures of aggregate employment and personal income are available on a current monthly basis. Production statistics may be obtained on a current monthly basis only for the Nation's factories and mines, but movements of output in these sectors are a fairly sensitive and useful indicator of expansive or contractive tendencies. Each of these measures is comparatively free of serious defects conducive to drastic misinterpretation. Various statistical and analytical refinements—such as seasonal adjustments, distinctions between random and other variations, adjustments of money income for price changes, distinctions between voluntary and involuntary withdrawals from the labor force, and adjustments of employment data for changes in the length of the work week—are essential to a proper interpretation of changes in the magnitude of these variables, but these are, in the main, well known.

Measures of price change raise several difficult conceptual questions. There are available currently two indexes relating to the price behavior of broad groups of goods and services, the consumer and wholesale price indexes. The former is designed to measure price changes of goods and services typically purchased by wage earners and clerical workers living in urban areas; the latter records prices at primary market levels of farm products, processed foods, and industrial commodities at various stages of fabrication. One test of the adequacy of these indexes to represent general price changes is provided by comparing their behavior with that of the implicit price deflator for gross national product. The last-named statistic is constructed by the Department of Commerce in removing price-level variations from dollar gross national product figures, and is, perhaps, the single available measure most closely representing prices of all goods and services.

As is indicated in the chart, the 3 measures show a substantial degree of uniformity over a relatively long period, such as the 12 postwar years. In periods of a few years or less, however, the indexes may depart strikingly in their rate of change. From 1952 to 1957, wholesale prices advanced 5.4 percent and consumer prices 5.9 percent, according to the indexes, while the implicit gross national product deflator shows a rise of 10.2 percent. Part of this divergence is explained by changes in wage rates of Government employees and in the prices of construction and exports and imports, all of which are included in the price deflator. In addition, the price deflator reflects the relative importance of all goods and services, rather than the selected items in the wholesale and consumer price indexes.

MEASURES OF GENERAL PRICE CHANGES



Sources: Bureau of Labor Statistics, Department of Commerce, Council of Economic Advisers.

Recognizing the limited coverage of existing indexes, it is not possible to decide whether consumer or wholesale prices provide the better guide to general price movements in the short run. Both consumer and wholesale prices must be observed and, indeed, supplemented to whatever extent possible by observation of any other available data not covered by these indexes—residential construction costs, for example. When these measures of price move in opposing directions, as they occasionally have in recent years, there may be no clear or simple way of identifying the direction of general price changes.

Further difficulties arise in interpreting movements of a price index. Ideally, a price index measures the average price change of a given bundle of goods and services of constant quality. Practically, improvements in product quality, shifts in the kinds of commodities marketed, and changes in expenditure patterns also are reflected in movements of the price index, despite the employment of highly refined statistical techniques to minimize these influences.

Improvements in product quality can be quite troublesome, for, to the extent that adjustments cannot be made, an inherent upward bias is introduced into the index, overstating the extent of the price increase. An illustrative example which may be cited is the interpretation of the increased cost over the past 20 years of a typical visit to a doctor's office. Part of this increase, clearly, reflects the general upward movement of prices during the period. But it is evident that an office call in 1958 is not the same service as an office call in 1938. Diagnostic techniques have improved immensely; more diseases are cured faster and more completely. These are major quality changes which defy quantification and measurement.

These considerations warn against excessively ambitious use of price indexes. Over a period as long as 20 years or more, the indexes indicate little more than a very rough approximation of the magnitudes of price change on those items included in the index. Month-to-month and year-to-year variations are less subject to serious misinterpretation, but these difficulties, along with the lack of a truly general price index, caution against reading too much into small variations in the consumer and wholesale price statistics.

FACTORS AFFECTING THE PRICE LEVEL

The relative importance of various sources of change in general prices has been a subject of continuing dispute over many years of economic observation and analysis. Manifestly, since the issue cannot be readily resolved, it is the function of this discussion to cite some major elements affecting price levels, to outline broadly the interrelationships among these elements, and to indicate the combined influence of these forces in producing inflation. This section treats these problems with minimal reference to historical experience; subsequent sections apply the analysis to recent price behavior.

It is a matter of general economic intelligence that periods of rapid inflation have been characterized by especially heavy demands for goods and services. Our postwar experience evidences three distinct periods in which the inflation problem has been thrust to the forefront of the economic scene—from about mid-1946 to mid-1948, the year beginning in June 1950, and the period from mid-1955 onward. In the first 2 of these 3 episodes are seen the inevitable aftermath of global war and the reflection of abnormal strains accompanying defense production and mobilization, while the third represents the effects of an extraordinarily vigorous capital-goods boom, following a residential construction and consumer durable-goods boom.

That war periods produce serious inflationary tensions no one seems to question or to regard as unusual. It appears to be understood less readily, on the other hand, that peacetime booms give birth to multiplicity of price-boosting forces. The statement that supplies of goods and services are relatively inflexible in an economy running close to full-capacity production, so that further increases in demand encourage advancing prices, is but a partial expression of the potent inflationary forces inherent in a major industrial boom.

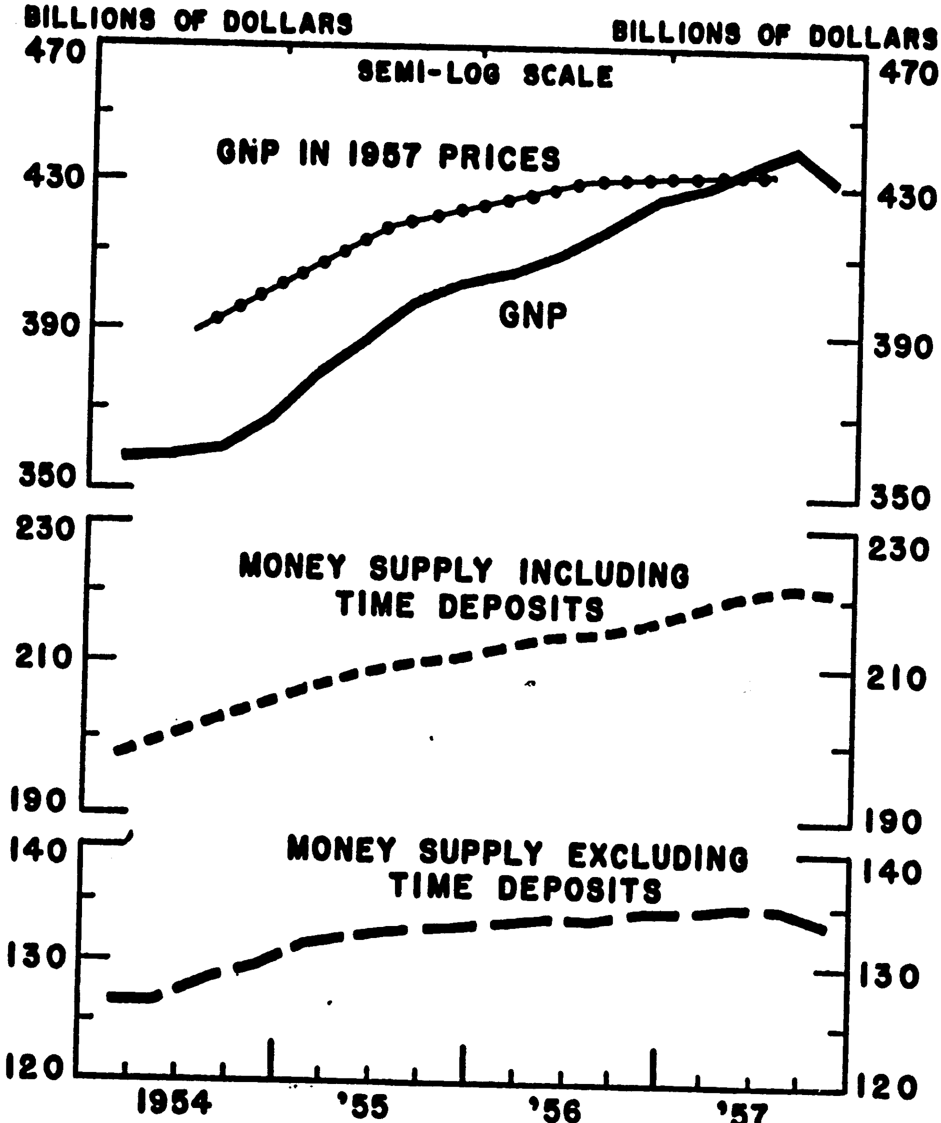
The encouragement of industries to ration short supplies of goods through price increases during boom periods is accompanied by a forceful push from advancing costs. These stem not only from the increased bargaining strength of organized labor as industry profits expand, but from the declining resistance of firms to wage demands as it becomes less difficult to shift cost increases to customers. Competitive bidding for scarce labor resources is another essential ingredient in the growth of money-wage rates, and in the encouragement of of wives, teen-agers, and older workers to offer their services in the labor market. Significantly, these cost pressures are at their maximum when productivity gains are least likely to offer an offsetting influence. During recovery from a condition of underemployed resources, the initial phase of the upswing normally is accompanied by exceptional increases in efficiency, but these gains do not continue with further growth of output in relation to capacity. A well-established feature of our cyclical experience is that productivity increases much less rapidly as the economy moves into the region of full-capacity production. Utilization of standby capacity, lack of experience with newly installed equipment, fewer shutdowns for routine maintenance, and the employment of less skilled and less productive workers are probably among the factors hampering the growth of efficiency in the late stages of industrial expansion.

It is because these cost pressures at the peak of a boom are intimately connected with the strains placed upon the Nation's basic resources that traditional analysis of inflationary pressures has focused upon the growth of aggregate demand in relation to aggregate supply. It should be noted, in this regard, that the expansion of demands need not have its origin in rapidly growing money stocks or in Government spending and deficit financing. The major sources of growth in spending during the recent boom scarcely can be attributed to such factors. Total spending on final output of goods and services advanced 20 percent between 1954 and 1957, while the money supply (demand deposits adjusted plus currency outside banks) rose a little more than 5 percent between these years. If the money supply is defined more broadly to include time deposits at commercial and mutual savings banks, a growth of approximately 10 percent is shown, still less than half the expansion of total spending. And the growth of total output in physical terms between 1954 and 1957, somewhat more than 11 percent, clearly outdistanced the expansion of money stocks. Federal purchases of goods and services, meanwhile, declined from 13.5 percent of gross national product in 1954 to 11.6 percent in 1957. Cash payments to the public by the Federal Government rose $13.6 billion between calendar 1954 and calendar 1957. Although the growth of cash receipts from the public was more than $2 billion larger than the rise in payments, the sharp increase in payments from an already high level may have had a mildly expansive effect on total spending. Such an effect would have been at a minimum in calendar 1956 when a $5.5 billion surplus occurred in the Federal cash budget.

Recognizing the importance of demands in "pulling up" prices, and citing the close relationship between cost pressures and the current state of demand, is not to deny that cost increases—or attempts by producers to widen profit margins—may have an independent "pushing" influence on prices. Although firms necessarily must consider demands in establishing prices, it is evident that there are few areas in the economy in which prices are completely beyond the influence of the individual seller. Thus, a firm faced with rising costs or desiring to expand profit margins per unit of sales may, even in the face of constant demand for its output, elect to increase prices even though that may involve a decline in sales.

In this connection, a few remarks are appropriate concerning the alleged noninflationary character of wage increases which do not exceed productivity gains. It cannot be questioned that if wage increases in every firm were at the same rate as productivity gains in that firm, there should be no upward force on prices arising from this source. But widespread application of this rule is difficult to imagine when there are marked differences in productivity gains among firms in a given industry and among the various industries. Wage concessions

MONEY SUPPLY, SPENDING, AND OUTPUT



NOTE.—Money supply includes currency outside banks plus demand deposits other than interbank and U. S. Government, less cash items reported as in process of collection. Time deposits added to money supply include all time accounts at commercial banks, mutual savings banks, and Postal Savings System. Quarterly figures are averages of end-of-month data.

Sources: Board of Governors of the Federal Reserve System, Department of Commerce, Council of Economic Advisers.

granted to labor in those firms where productivity gains are largest tend to spread quickly to other firms in the industry, and to other industries, a process facilitated by the keen competition among individual labor organizations and by competition among employers. Also, the rule may be difficult to maintain when the structure of demand tends to shift to those industries where productivity gains are comparatively low. Transfers of resources from one industry to another are not costless, and attraction of adequate labor supplies to those industries where demand is rising may necessitate a rise in wage rates beyond that permitted by efficiency increases. In this case, price stability is threatened unless downward price adjustments in industries experiencing slackening demands match upward price movements in industries which are expanding output. Our price structure, however, does not appear to be sufficiently flexible to insure that these offsetting variations always will occur.

Mention of price inflexibilities suggests another line of reasoning whose implications have an important bearing on long-run price trends. For a variety of reasons, downward flexibility of many prices is comparatively small. The resistance of wage earners to wage cuts is only part of the story. Heavy contractual payments clearly undermine the willingness to reduce prices, as do governmental controls—excise taxes, tariffs, minimum wage laws, and regulated prices, for example. Indeed, governmental policies are sometimes designed deliberately to prevent downward adjustments in specific prices. The support of agricultural prices, the elevation of tariff barriers to protect injured industries and retail price maintenance codes are specific examples.

The extent of these downward price rigidities militate against price declines in periods of moderate business contractions. Since inflation in periods of booming economic activity tends to become "built in" to the cost structure, price behavior in periods of cyclical expansion and contraction tends to be asymmetrical. Obviously, it might be possible to break down many of these price rigidities by permitting massive contractions of demands for goods and services, and corollary movements of production and employment, but such a solution is unacceptable, as is recognized in the Employment Act of 1946.

CYCLICAL FLUCTUATIONS AND GROWTH—THE GENERAL POSTWAR EXPERIENCE

During the postwar decade, the total real output of the economy has increased by an average rate of about 3.3 percent a year. Mild fluctuations in the growth rate have occurred, with annual changes ranging from an increase of nearly 10 percent to declines of slightly more than 1 percent. Total industrial production, covering the output of the Nation's factories and mines, has grown more rapidly, averaging 4.5 percent a year. Annual changes in this broad sector of the economy also have been somewhat more pronounced, ranging from a gain of more than 15 percent to declines of nearly 7 percent. In agriculture, the rate of increase has been about 1.5 percent a year. On the whole, these figures indicate more rapid growth in real output during the years since World War II than during the last half century.

Growth in employment over the period has paralleled the expansion in real output. The rate of increase, however, has been much less and has averaged somewhat more than 1 percent a year. With the number of hours worked continuing downward, the rate of increase in man-hours has been even less. For the private sector of the economy, the average annual gain in man-hour employment has been about 1 percent over the period since 1947. In agriculture, both employment and hours of work have declined. The differential rates of growth between real output and man-hours worked point up the enhanced productivity during the period.

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During the postwar contractions, as has been true historically, unemployment increased more than employment declined. This reflects the tendency of the labor force to grow with the increased numbers of persons of working age in the population. Cyclical fluctuations in economic activity and job opportunities, however, do cause the rate of gain to vary over short-run periods.

In dollar terms, the gain in output during the postwar period is more pronounced than the increase in physical production. The corresponding flow of income likewise has risen more rapidly. For example, national income, that is total net income earned in production of goods and services, rose by more than 6.5 percent a year on the average. The differential between the two measures—money and real value—reflects the rising prices of goods, services, and the factors of production.

Prices of the goods and services in the Consumer Price Index have risen about 44 percent since 1946, as has the implicit price deflator for GNP. Meanwhile, annual average prices of wholesale commodities increased nearly 50 percent. Average hourly and weekly earnings of manufacturing production workers, which provide a rough indication of the advance in price of an important kind of labor, have almost doubled over the period.

THREE WAVES OF INFLATION

During the period since the end of World War II, there have been three distinct inflationary movements. In the first, prices reached a peak in the late summer of 1948. Wholesale prices during the interval from the beginning of 1946 to their high point in August 1948 shot up 53 percent and consumer prices rose by more than one third. Prices declined during the recession of 1949, reaching a low point at the beginning of 1950. Wholesale prices declined 8 percent and consumer prices 4 percent during the interval.

A revival in wholesale prices had already started by the time the Korean war broke out in June 1950 but the rise was more rapid thereafter. In the early months of 1951, prices in wholesale markets were 19 percent higher than at the beginning of 1950. During the remainder of 1951 and 1952, wholesale prices declined slightly and subsequently remained stable in 1953, 1954, and the first half of 1955.

During this period—1951 through 1954—wholesale price movements did not parallel general economic activity, which continued to expand until mid-1953. This divergence between the movements of wholesale prices and overall economic performance after early 1951 probably reflected in part a reaction from speculative buying and hoarding in both United States and world commodity markets that followed the outbreak of the Korean war. When supplies of raw materials and other commodities proved to be more than sufficient to meet demands, prices broke. Later, wholesale prices failed to move with general activity in 1953 and 1954, when they held steady in the face of reduced production, employment, and income.

The index of consumer prices also increased rapidly during the early phase of the second postwar inflationary period initiated in 1950. The swift pace of the advance was slowed somewhat during 1951, and after mid-1952 the index leveled off. At its peak, the Consumer Price Index was 15 percent higher than it had been in February 1950.

During the subsequent decline of business, consumer prices held steady with only a minor tendency to decline.

The third postwar wave of price inflation began in mid-1955, when wholesale prices began to advance rapidly. Following its customary timelag, the index of consumer prices started to rise in the spring of 1956. By January of this year, the increase amounted to about 7.5 percent in the wholesale index and about 6.5 percent in consumer prices, with recent advances generally being rather small.

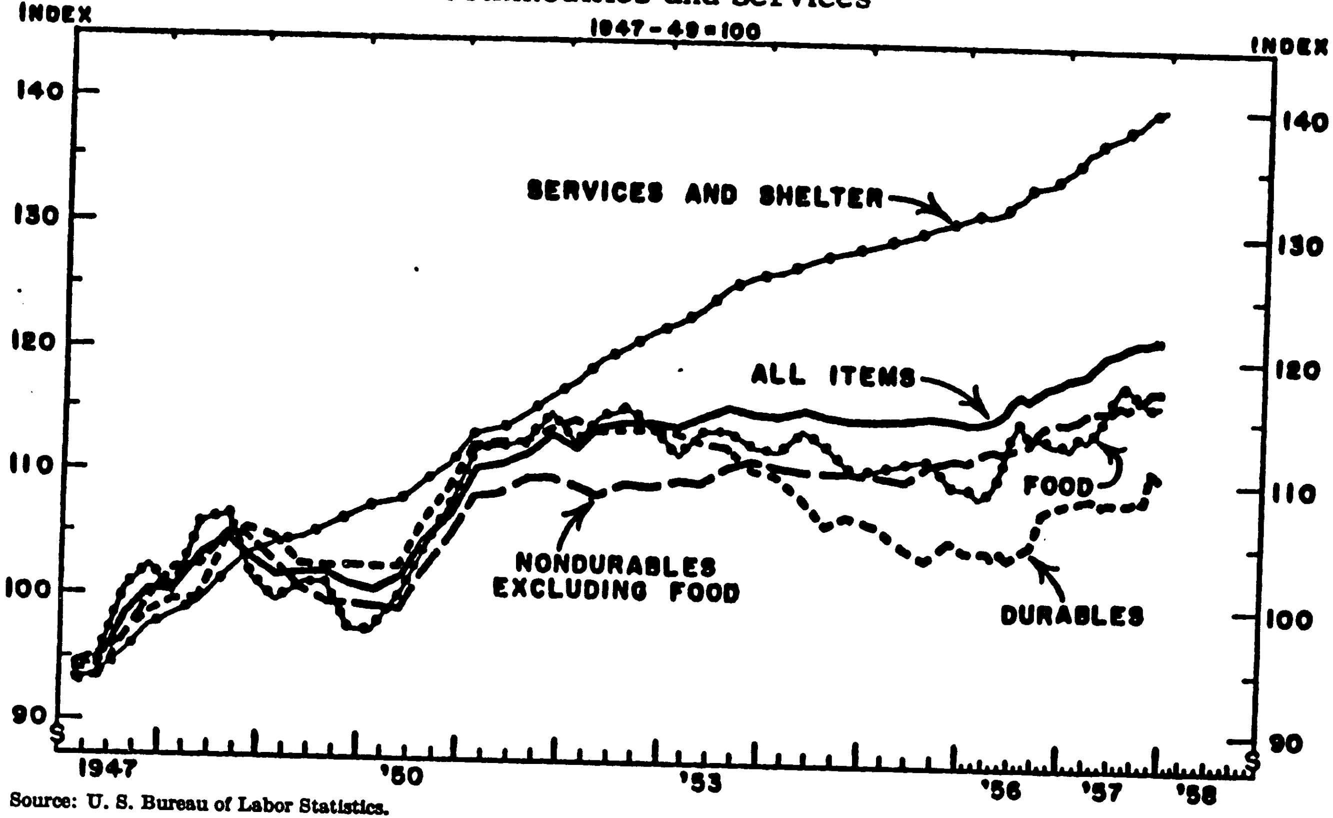
This description of price movements throughout the past 12 years points to a significant conclusion; namely, that inflation has been a major postwar problem. The evidence shows both that periods of rising prices have been longer and that the effects of these advances have been additive in that deflation has failed to reduce prices to the levels preceding inflation. Furthermore, the rate of inflation has been very uneven as prices proceeded on their upward course at an irregular pace.

THE STRUCTURE OF PRICES

Some prices, of course, are more responsive to general economic conditions than others. In wholesale markets, cyclical fluctuations have been largest for raw materials and smallest for finished commodities. In the recession of 1948–49, for example, raw-material prices declined nearly 14 percent; intermediate material prices fell about 4 percent; and finished goods, only 3 percent. During 1954, prices of raw materials dipped only about 1 percent, while intermediate and finished goods prices strengthened slightly.

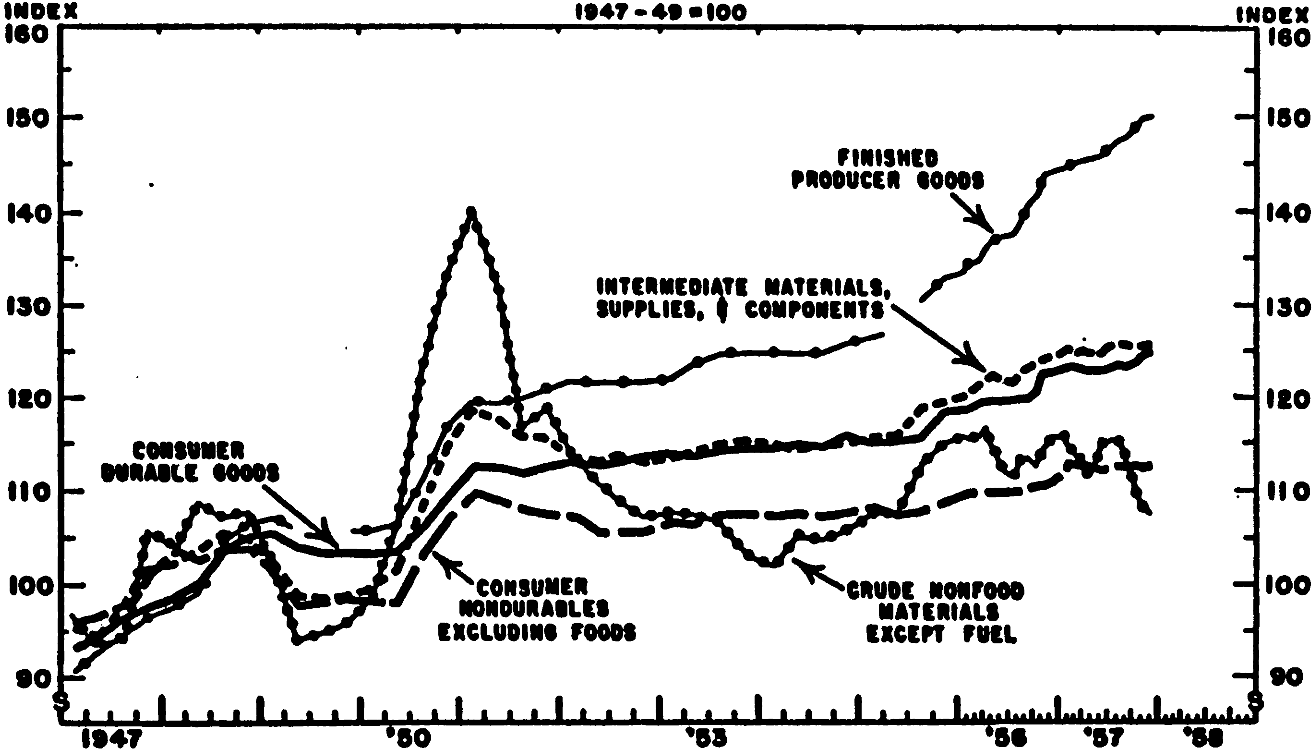
Consumer prices during the postwar period have tended to advance more steadily than wholesale prices. In part, this is due to the continuous rise in service prices, including rent, which lagged behind the rise in commodity prices during the period from 1939 to 1948. Throughout the postwar years, prices of services have advanced steadily, irrespective of the level of economic activity. This is shown by the fact that between 1948 and 1955 prices of services less rent increased about 30 percent and rents advanced more than 29 percent. Meanwhile, the average price of all commodities in the Consumer Price Index rose only 5 percent. During the third and most recent inflation, prices of all major categories in the index increased.

CONSUMER PRICE INDEX
Commodities and Services



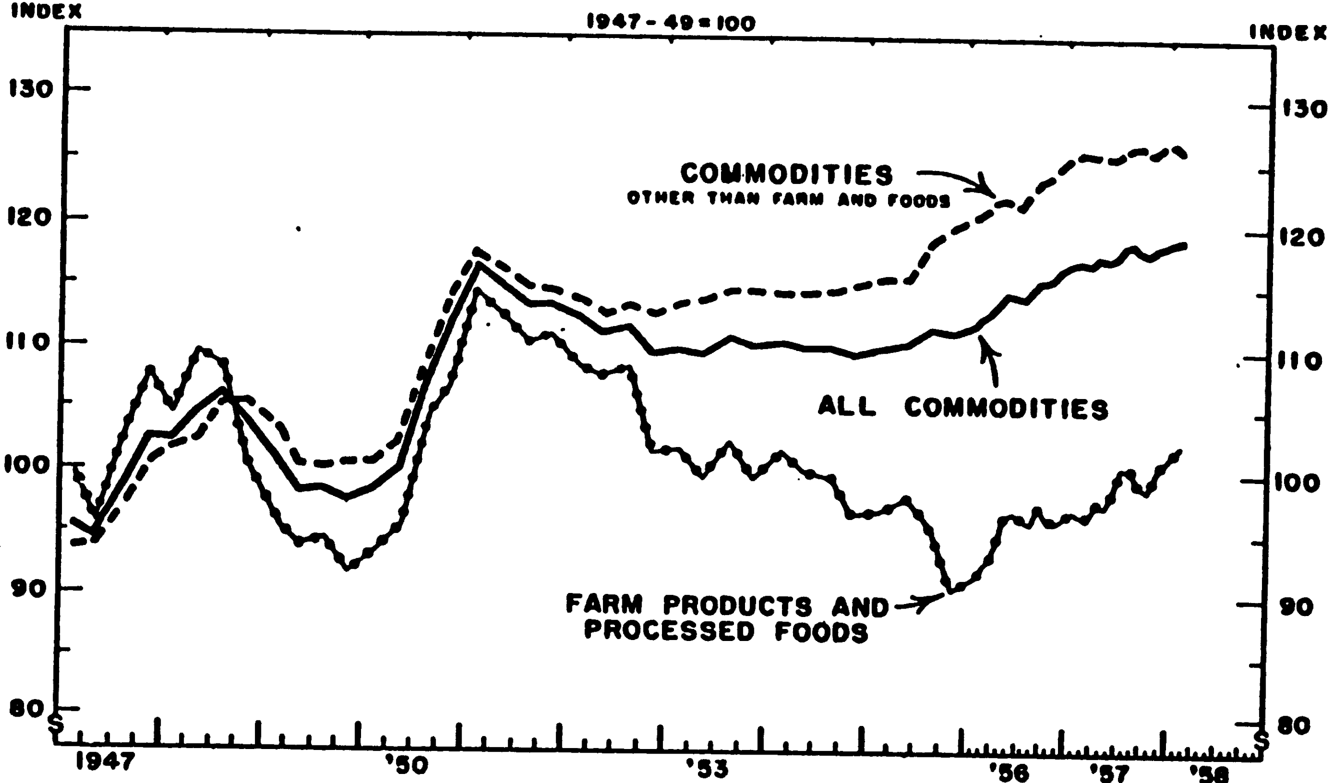
Source: U. S. Bureau of Labor Statistics.

WHOLESALE PRICE INDEX
Selected Economic Sectors



Source: U. S. Bureau of Labor Statistics.

WHOLESALE PRICE INDEX
Major Commodity Groups



Source: U. S. Bureau of Labor Statistics.

INFLATION AND READJUSTMENT, 1946–49

With the return to peacetime conditions following World War II, conditions were favorable to inflationary developments. Accumulated demands for goods that were unavailable or in short supply during the war were large. At the same time, consumers were able to translate their requirements to the market. Although wage and salary incomes were reduced in many industries because of the elimination of overtime, wage rates remained relatively firm and unemployment was low. Thus, current income, augmented by wartime savings and credit extension, gave support to a rapidly rising volume of consumer expenditures for goods, services, and housing. In addition, business multiplied its demands substantially, as is indicated by the growth in business investment from about $9 billion in 1945 to more than $32 billion in 1948. Net foreign investment also rose significantly. The combined impact of this growth in the private sector, even though total Government demand dropped, was excessive in terms of the goods and services available.

Prices began to increase rapidly in the summer of 1946 and, with the end of price controls, continued sharply upward during nearly the whole of the succeeding 2 years. Earnings in manufacturing—on both an average hourly and weekly basis—in this interval lagged behind the advance in prices, after rising considerably more than prices during the war period. For example, during the period from May 1946 to August 1948, average hourly earnings increased 28 percent, compared with gains of 33 percent in the Consumer Price Index and 47 percent in wholesale prices. The relative increase in weekly earnings was little more than that for the hourly figures. In addition, it should be pointed out that other classes of wage and salary earners were even less fortunate in keeping their earnings in pace with price advances.

In the recession which followed, price readjustments accompanied the general deflation. Farm prices, which had risen to new highs in 1948, fell first and declined by nearly one-fifth by the end of 1949. Industrial prices declined also, although at a slower rate. Weakness in prices was quite general as both the indexes of wholesale and consumer prices declined.

Thus the first postwar inflationary period was followed by downward movements in prices. These price adjustments undoubtedly were made possible by the fact that major costs did not advance as much as prices during the 2 years of rising prices following mid-1946. Since the industrial cost structure had lagged behind the price rise, weakness in aggregate demand induced price adjustments and profits were reduced. Corporate profits, for example, fell by more than $6.5 billion, or about 20 percent between 1948 and 1949.

Percent changes in prices and earnings, 1946–49

	Consumer Price Index	Wholesale price index	Manufacturing production workers	
			Average hourly earnings	Average weekly earnings
May 1946–August 1948	+32.8	+47.3	+28.0	+29.5
August 1948–December 1949	−3.6	−8.0	+2.9	+1.8

Wage rates, however, did not decline during the 1949 deflation. Average hourly earnings of factory workers leveled off at about $1.40 an hour and weekly earnings at slightly more than $55. Thus, in the first postwar experience of inflation and deflation, wage rates followed prices up, failed to gain as much as prices, and held firm as prices declined.

INFLATION AND READJUSTMENT, 1950–54

During the second wave of inflation, the early price movements can be traced to the outbreak of the Korean war. Uncertainty concerning the size of the war, the prospect of sharply rising Federal Government demands, and active business and consumer buying contributed to rapid price advances. Wholesale prices by March 1951 had jumped about 17 percent in 10 months, while the Consumer Price Index rose about half that amount. Price and wage controls went into effect in the latter part of January 1951.

Average hourly earnings in manufacturing during the early months of this period increased at nearly the same rate as the Consumer Price Index. Weekly earnings, on the other hand, climbed steeply during the last half of 1950 and by March 1951 were nearly 9 percent above the June 1950 level. During the next year or so—to the summer of 1952—hourly earnings increased somewhat more rapidly than consumer prices. In mid-1952, however, the rate of advance in average hourly earnings increased, and earnings continued to rise throughout 1953. Meanwhile, the level of consumer prices was relatively steady, as were wholesale prices following their decline from early 1951 levels.

In retrospect, it is somewhat surprising that prices held steady. On the demand side, the increase in average earnings had been accompanied by a sharp gain in employment, with the result that personal income advanced rapidly. This purchasing power, in turn, was bolstered by sizable expansions in consumer credit in 1952 and 1953, as had been the case earlier in 1950. And Government, of course, assumed a significant role during the period as Federal Government purchases increased by about 1½ times.

On the cost side, the earnings of labor were advancing. In 1950, these increases were offset by increased productivity as output moved up toward capacity. Starting with 1951, however, the increase in output per man-hour was smaller as the usual shortages and capacity limitations of a wartime period assumed significant proportions. Accordingly, the cost-reducing effects of productivity gains were not so successful in counteracting increased wage costs.

During the mild recession which followed the end of the Korean war, price readjustments were conspicuously absent. At the bottom of the downturn in the summer of 1954, both consumer and wholesale prices were little different from what they had been a year earlier. For 1954 as a whole, both indexes averaged slightly higher than they had in 1953. Meanwhile, average hourly earnings continued to edge upward. At mid-1954, hourly earnings of factory production workers were nearly 2 percent above their level in mid-1953. Weekly earnings were down slightly due to the reduction in hours worked.

Percent changes in prices and earnings, 1950–54

	Consumer Price Index	Wholesale Price Index	Manufacturing production workers	
			Average hourly earnings	Average weekly earnings
January 1950 to July 1953	+14.0	+13.5	+24.6	+26.7
July 1953 to July 1954	+.4	−.5	+1.7	−.6

INFLATION AND READJUSTMENT, 1955–57

The expansion of 1955–57 has been labeled a capital goods boom. In a real sense, this is true. The expansion was initiated by rapidly increasing activity in residential construction and, by the upsurge in demand for new automobiles. Later, massive outlays for new plant and equipment by business, together with heavy inventory accumulation, were primarily responsible for pushing demands strongly upward. These expenditures were supported by rapid credit growth which fully employed available savings and other financial resources. In addition, aggregate demand was bolstered by growing consumer spending for other goods and for services and by substantial increases in Government and foreign trade demands.

As the expansion of this period developed, it very quickly became evident that aggregate supply—resource availability and utilization—as well as aggregate demand held vital keys to an understanding of the economy's growth and to price-cost relationships.

In few periods of our peacetime economic history have labor resources been taxed more heavily than during the boom of 1955–56. Annual increments to the civilian labor force in 1955 and 1956 were well above any year since 1947, even though additions to the adult population were somewhat below the average of the 1948–56 period. Attractive job opportunities and rising wage rates encouraged additional persons to offer their services in the labor market, and the participation rate—the proportion of the adult population in the total labor force—advanced to 59.3 percent in 1956, the highest annual figure of the postwar decade including the Korean war episode.

The point of maximum stringency in the labor market appears to have been reached some time in the latter half of 1956. The overall labor force participation rate reached seasonal peaks in June and July of that year at the highest level for any postwar month. Labor force participation declined seasonally in the fall months, but unemployment was reduced to less than 3 percent of the civilian labor force in September and October—the lowest level in several years—in the wake of advancing production following the summer steel strike.

In addition to labor force and employment developments, the relationships between capacity and output illustrate another dimension of the inelasticity of the aggregate supply of goods and services during late 1955 and most of 1956. Continuous series on capacity-output relationships are available only for specific components of manufacturing where the nature of the product permits a meaningful definition of capacity. Fortunately, these sectors include the major industrial materials—metals, cement, woodpulp, paper, paperboard, petroleum products, coke, textiles, and certain industrial chemicals—whose supply is essential to a broad base of other production activities. In the years 1953 through 1955, major materials producers added about 11 percent to their output capacity through capital expenditures. From the first quarter of 1953 to the first quarter of 1956, however, output of major materials advanced about 14 percent. The materials industries were operating in late 1955 and early 1956 at utilization rates as high or higher than in the opening months of 1953, when production reached peak levels of the Korean period. In some critical segments, such as structural steel, demand outran capacity.

In a very significant sense, these developments in aggregate demand and supply during the most recent expansion help provide an understanding of the inflationary pressures of the period. In contrast with the two earlier waves of rising prices and wages, important external factors were small. Thus, the most recent period of inflation was generated within the economy. The evidence, which has been cited only briefly above, points clearly to the upward pull of demand and the upward push of limited supply on prices, wages, and costs during the period.

Substantial increases in wages—both hourly and weekly earnings of manufacturing production workers—occurred during 1955. By the end of the year, average hourly earnings had advanced 7 percent and weekly earnings by more than 12 percent from the January 1954 level. The rate of increase in the wage series continued high during 1956 and subsequently moderated in 1957. In the early autumn of last year, hourly earnings were about 13 percent higher than they had been in January 1955. In addition, there were substantial increases in fringe benefits.

Prices, on the other hand, followed behind the wage advances. Wholesale prices continued stable through the first half of 1955, marking a 2½-year period during which there was very little movement in the overall index. Consumer prices held steady near the levels of late 1953 throughout 1954, 1955, and on into early months of 1956.

Within the overall stability of the price indexes, however, important movements were taking place. While farm and processed-food prices continued downward in 1954 and 1955, industrial prices in the wholesale index remained firm and began to rise sharply after mid-1955. A similar picture of divergent movements is apparent among the economic sector components of the wholesale price index. Prices of crude nonfood materials except fuel, which had dropped by nearly 40 index points from early 1951 to early 1954, began to increase. Finished producers goods prices held steady through most of 1954, following continued strengthening after 1950. After mid-1955, prices of producers goods spurted sharply upward, reflecting the strong growth in business investment. Prices of consumer durable and nondurable goods except foods in wholesale markets were relatively stable in 1953 and 1954, but they began to advance in the summer of 1955. Prices of intermediate materials, supplies, and components also started upward in mid-1955, following a rather long period of stability.

Percent changes in prices and earnings, 1955–57

	Consumer price index	Wholesale price index	Manufacturing production workers	
			Average hourly earnings	Average weekly earnings
January 1955 to September 1957	+5.9	+7.2	+13.0	+12.2
September 1957 to January 1958	+1.0	+.6	+1.0	−2.1

With most of the major components in the wholesale index turning up in mid-1955, the general level of prices at wholesale began to rise. Early in 1956, the rising components were joined by increasing prices for farm products and processed foods. Between January 1955 and the autumn of 1957, the overall index of wholesale prices rose more than 7 percent. Since then, there has been little net change in the average price level, with most major groups, except crude nonfood materials other than fuel, continuing strong.

The stability of the overall index of consumer prices during late 1953, 1954, and 1955 reflected largely two opposing price movements. Advancing prices of services and shelter were offset to a significant degree by falling prices for consumer durables. The latter development was due primarily to the rapid spread of discounting among retailers. Food prices also tended irregularly downward during the period, while prices of other nondurables were relatively stable.

Early in 1956, consumer food prices increased sharply, following largely the rise in wholesale farm and processed food prices. Later in 1956, the prices of durable goods to consumers rose, reflecting both higher manufacturers' prices and the unwillingness of retailers to cut their margins further. These increases, coupled with the persistent rise in service prices and advancing prices of nondurables excluding food, turned the index of all items upward. From its January 1955 level the index rose about 6 percent by September 1957 and advanced another 1 percent by January 1958.

PRODUCTIVITY, PRICES, AND COSTS

Advancing wage rates have accompanied rising prices during each of the postwar inflationary periods. For the important manufacturing sector of the economy, it has been noted that the rise in earnings of factory production workers was relatively smaller than the price rise during the first period. The reverse condition was true in the second and third periods, as earnings mounted more rapidly than prices. In addition, it was pointed out that during succeeding periods of deflation, wages resisted cuts.

Actual labor costs per unit of output, however, have not gone up as much as earnings. Productivity gains have offset to a substantial degree the increase in average hourly earnings. The gain in output per man-hour in manufacturing holds an important clue to recent price-cost relationships. During 1954, for example, significant improvement in productivity resulted in a decline in production-worker payrolls per unit of output, according to United States Bureau of Labor Statistics data. This decline was a reversal of the upward movement from 1950 to 1953.

This productivity gain and the accompanying improvement in labor cost per unit of output help explain the relative stability of prices during 1954 and 1955. Wholesale prices of finished goods—as well as the overall wholesale and consumer price indexes—held steady during the period. As the pace of economic activity quickened, later on, pressure on resources became more intense and productivity gains smaller. Prices also advanced sharply.

The Nation's economy, however, contains vastly more activities than manufacturing, although it tends to be the pacesetter in wage and productivity gains. Wage increases commonly spread into activities which lack commensurate offsets in productivity. Even within manufacturing this is true as wage advances spread from firms and industries with rapid gains in output per man-hour to those which are characterized by lower productivity. Since these higher wage costs clearly cannot be absorbed by marginal firms, they result in either curtailed operations and unemployment or, when demand is inflexible, in increased prices.

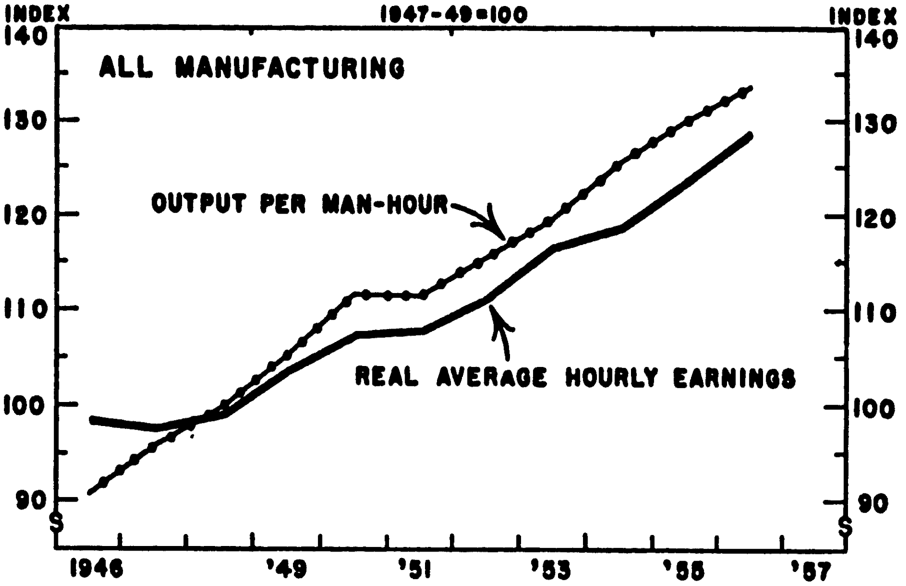
For the private nonfarm economy as a whole—that is, all activities except government and agriculture—productivity gains were greater than the increase in real average hourly earnings during the early years of the postwar period, according to BLS data. Since 1953, however, the opposite situation has prevailed, as increases in real hourly earnings have outstripped productivity gains in the total private nonfarm economy.

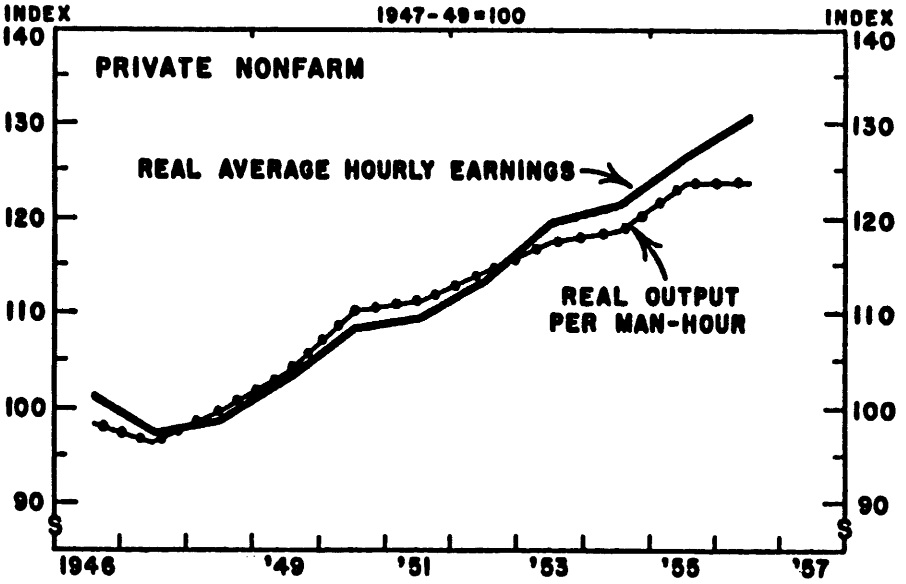
It is often argued that when wage increases are offset by rising productivity, there can be no upward push on prices and costs. This argument is customarily made by those associated with firms and industries in which productivity is high. At the same time, many firms and industries with lower productivity are not able to absorb the increases and are burdened with higher wages as competition among unions, employers, and employees spreads wage increases. The consequence, under conditions of strong demand, is to exert upward pressure on costs and prices.

Such inflationary situations may be further aggravated when demand is expanding for the output of activities which are characterized by low productivity. Prices, under such conditions, are likely to push up strongly as a means of transferring resources to relatively low productivity occupations in the face of rising wage rates in more productive activities.

The trend of labor productivity during the postwar years has been an important factor in the relationship between labor and nonlabor costs per unit of output. Comparisons of the rate of increase in these two costs also have been facilitated by BLS data. Again, for the private nonfarm economy, labor costs per dollar of real product, including both direct and indirect costs of labor, have sometimes lagged behind and sometimes gone ahead of nonlabor costs, a measure including depreciation, interest, taxes, profits, etc. During 1954 and 1955, when labor productivity increased substantially, labor costs again fell behind the rising nonlabor costs. As labor productivity showed little improvement in 1956, unit labor costs increased much more rapidly than did nonlabor costs. At their level in 1956, labor costs per dollar of real output had increased a little more since 1947 than did nonlabor costs.

PRODUCTIVITY AND EARNINGS





Source: U. S. 85th Cong., 1st sess., Joint Economic Committee, Productivity, Prices, and Incomes; materials prepared by the committee staff. Washington, Government Printing Office, 1957.

The relationship of these developments to the last period of inflation seems rather clear. In 1956, for the first time in about 10 years, practically no increase was recorded in real output per man-hour in the private nonfarm economy. In manufacturing, the productivity gains were smaller than in most postwar years. Thus, the failure of productivity to increase further during the year, coupled with rising wages and strong demands for goods and services, provided a strong impetus to the upward movement of prices.

CROSSCURRENTS IN 1957

Total real output during the first three quarters of 1957 was generally stable at the advanced levels attained in late 1956. During the last months of 1957, however, economic growth ceased and business activity began to decline. In an immediate sense, the decline may be related to changes in the volume of demands for goods and services. The rate of inventory accumulation had been reduced early in the year and in the fourth quarter liquidation occurred. The rising level of national security outlays ended in the second quarter and exports fell. Business outlays for new plant and equipment also began to decline in the final quarter of 1957.

Gradually changing supply conditions also were important. Adjustments made in basic resource supplies had significant impacts upon the demand for new business expansion and upon productivity and prices. By early 1957, pressure on the Nation's industrial capacity was eased. Record volumes of spending for new plant and equipment had enlarged industrial facilities significantly. While the output capacity of major industrial materials was increased by an additional 9 percent or more during 1956 and 1957, production rates failed to exceed the levels attained early in 1956. Accordingly, the margins of unused capacity widened during 1957.

Capital expansion programs during the last boom undoubtedly were founded in part upon such considerations as anticipated demands in the 1960's and upon the presumption of continued rise in producers' goods prices, as well as upon current demand. Nevertheless, the lack of continued growth in current production posed a serious deterrent to sustained high levels of capital investment. The adjustment in the capital-output relation in major industries was thus an important factor in the slackening of business investment demand.

In the labor market, conditions changed gradually. As indicated earlier, the tightest period appears to have been during the latter half of 1956. During the first three quarters of 1957, total employment was generally above the level of the previous year, but the margin of gain diminished as 1957 progressed. Labor force participation rates—proportions of the adult population in the labor force—steadily fell under those in 1956. The length of the workweek also declined. These developments indicated that human resources were under considerably less pressure than they had been earlier.

The slowdown in production during 1957 was associated in part with the lack of significant growth in real consumption. Personal consumption in real terms recorded one of the smaller increases of the postwar period. Constant dollar expenditures for durable goods did not grow, while increases in nondurable goods and service consumption were small. The moderate increase in consumer demand apparently was in keeping with the very slight gain in real disposable personal income during the year. After tax deductions and adjustment for rising prices, the relative rise in personal income was the smallest in the postwar period. In addition, the increase in consumer credit outstanding was among the smallest during the last 12 years.

With the pressures on the Nation's resources reduced in 1957, productivity gains were again more favorable. The indicated gain for 1957 was still small, although much larger than the gain in the previous year. In comparison with the increases in wage rates, the small magnitude of productivity gain caused a continuation of the upward pressure on unit costs and on prices during the year, although in reduced magnitude.

Wholesale prices rose much less in 1957 than in 1956. The rise in industrial prices in particular was quite small. The average for the year rose only 1 percent and the increase after February was very slight. Prices of producers finished goods continued to rise but at a slower pace than during the previous year and a half. Similarly, wholesale prices of consumer finished goods increased only slightly, except for new model auto prices. Semifabricated materials and components rose moderately and crude material prices dropped significantly. Farm product and processed food prices continued to increase but at a lesser rate than in 1956.

In general, wholesale prices are more responsive to changes in aggregate demand and supply conditions. The modest gains in such prices last year, particularly in industrial prices, is directly associated with the slackened rate of growth in demand and the generally easier situation in resource supplies.

In the consumer market, on the other hand, several circumstances—unrelated to current production—loomed strongly in the upward trend of prices during 1957. For example, the decline in meat supplies, due primarily to drought and its aftermath in widespread areas of the country, has played an important role in advancing food costs during the last 2 years. More recently, freezing weather has reduced the output of other food items which have resulted in price advances. Many service prices are subject to the approval of public commissions and therefore tend to adjust slowly to changed economic conditions. Much of the increase in rents, after release from control, reflects delayed adjustments to market conditions.

The significance of such special conditions in the consumer market may be realized by noting that service and food prices were primarily responsible for the rise in the Consumer Price Index last year. In no small measure, special circumstances such as those described above—together with the time lag in consumer prices—explain the overlapping of inflation and slackening demands during 1957.

RELATIONSHIP OF GROWTH IN PRIVATE DEBT TO ECONOMIC STABILITY

The growth of private debt as a factor in the stability and vitality of the economy may be considered in at least three ways: (1) The variable rate of growth of debt as a contributing factor; (2) the liquidity of the major institutions dealing in debt; and (3) the ability of debtors to service their debts satisfactorily, thereby avoiding the threat of large-scale delinquencies, foreclosures, and distress sales.

There have been three separate surges in the growth of private debt since the end of World War II. In 1947, the growth was $25.6 billion and was followed by 2 years of less rapid expansion, the low point occurring in 1949 with a rise of $10.8 billion. A new wave developed in 1950 in response to the Korea war and the total rose by $39.2 billion. From 1951 to 1954, the amount of growth declined, reaching $13 billion in the latter year. The last wave began in 1955 with an increase of $43.3 billion and it also has been marked by a declining amount of annual growth since that time. When these variations in debt expansion are examined against the cyclical changes of the decade, it is seen that the slowest growth has occurred in periods of recession, such as 1949 and 1954. The largest absolute increases have occurred in the first year after the recession or in the year of initial recovery. Although there has been some tapering off of the rate of growth in succeeding years of the expansion, the rise has been sufficient to aid in magnifying demands for goods and services that would result from variations in income alone. In each of the postwar expansions, the absolute increase in personal disposable income has been greatest in the year following the peak of debt formation.

The second aspect of debt relates to the liquidity of the institutions which deal in debt. These institutions include commercial banks, savings and loan associations, mutual savings banks, and insurance companies. A number of notable changes have been made over the past 25 years in the characteristics of these institutions. Deposit insurance has contributed much to the prevention of wholesale presentation of claims. Liquidity has been improved by large investments in Treasury securities. General adoption of systematic amortization for real estate credit, Government insurance and guaranties, and reasonable equity standards for conventional mortgages have strengthened the quality of an important part of the assets of these institutions. Moreover, in the realm of corporate debt there is now little of the pyramiding that characterized public utility and commercial real estate financing in the 1920's. Other corporations also have maintained acceptable debt-equity ratios through retention of earnings and issues of equity securities.

Because of the complexity and the numerous ramifications of debtor-creditor relationships, an assessment of the ability of debtors, particularly consumers, to service their debts may be approached by a symptomatic analysis. This procedure consists of a recognition of certain variables as important for the servicing of debt and an examination of recent trends in these variables. Among the more important of these aspects of debtor-creditor relationships are the interest rate, the maturity of debt and the provisions for repayment, the level of income and its distribution, the distribution of liquid asset holdings among debtors and nondebtors. Trends in these variables may indicate that a given level of indebtedness has become less onerous but they manifestly cannot evaluate the importance of debt in any absolute sense.

Turning first to the interest cost of debts, it is apparent that this factor is not significant for short-run comparisons, for most debts will have been contracted on the basis of rates prevailing in the past. But over longer spans of time, the average interest rate on the outstanding debt can change substantially, increasing or reducing the requirement for debt service. As a rough indication of the trend in this aspect of debt, net interest as a component of national income increased from $6.4 billion in 1929 to $12.9 billion in 1957. In the same interval, net private and public debt increased from $190 billion to $708 billion, and private debt alone increased from $162 billion to $437 billion. From this comparison, it appears that the average interest cost on the debt has been reduced materially over the 28-year period, lowering the relative burden of a given volume of debt.

Shifts in the average maturity of debts raise or lower the ability of businesses and individuals to service their debts under conditions of reduced income. During the years from 1929 to 1957, consumer short- and intermediate-term debt increased sevenfold and mortgage debts of individuals and noncorporate businesses increased 4.2 times. But a marked change in financial practices occurred in this period. Most of the residential mortgage debt was placed on systematic amortization schedules and the average maturity was greatly extended. A similar lengthening of term structure occurred in other consumer credit. The period of repayment of installment contracts was gradually lengthened and an increased proportion of consumer debt took the form of such contracts. In 1929 installment credit was 49 percent of consumer short- and intermediate-term indebtedness; by 1939 it had increased to 62 percent, and at the end of 1957 was 76 percent. It is worthy of note that credit in this form that becomes of questionable quality is soon revealed and steps are taken to liquidate it. Moreover, the structure is given support by widespread arrangements for exchanging credit information so as to minimize overcommitments through multiple borrowings.

Still another facet of consumers' capability of servicing debt is the direction of change in the distribution of income. Annual surveys of the financial status of individuals, financed by the Board of Governors and conducted by the University of Michigan, give indications of the recent trend in this area. From early in 1952 to early in 1957, annual incomes of less than $2,000 declined from 28 percent to 21 percent of all incomes. Annual incomes of $2,000 and less than $5,000 fell from 51 percent to 38 percent, and those of more than $5,000 increased from 21 percent to 41 percent of all incomes sampled. These changes may have strengthened the ability of individuals to carry their credit obligations. Further support is evident in the declining percentage of individuals without any reserve of liquid assets. In the 5 years, their number was reduced from 31 percent to 25 percent of all reporting units.

The joint effect of factors affecting income distribution and liquid asset holdings can be brought into focus by data from the same survey. The accompanying table summarizes the information from the survey conducted early in 1957. It is evident from the table that the percentage of spending units having installment debts is greater as the size of income increases except for the highest income group. Furthermore, indebtedness in relation to liquid asset holdings increased with income size and was greatest in the bracket from $7,500 to $9,999. Thus, it appears that these forms of debt have increased most rapidly among units which would have the largest amount of discretionary spending power and the largest amount of liquid assets to support their debts during interruptions of earnings.

These trends which have tended to maintain the viability of the short- and intermediate-term debt structure may be thought to be counterbalanced in whole or in part by the rapid expansion both of absolute volume and its relative magnitude compared with personal disposable income. Repayments on these debts alone increased from 8.9 percent of disposable income in 1950 to 13.4 percent in 1957. Servicing of mortgages represents an additional commitment of income but it is probable that these payments are no higher, and are possibly distinctly lower, than would be absorbed by rent.

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Personal debt-liquid asset relation within income groups, early 1957

[Percentage distribution of spending units]

	1956 money income before taxes—							
	Under $1,000	$1,000-$1,999	$2,000-$2,999	$3,000-$3,999	$4,000-$4,999	$5,000-$7,499	$7,000-$9,999	$10,000 and over
Some debt	29	44	55	65	69	68	70	47
No liquid assets	18	29	25	27	17	8	3	....
Some liquid assets—debt as a percentage of liquid assets:								
Under 61 percent	5	9	8	12	13	19	25	17
61-250 percent	3	2	7	10	14	13	15	13
251 percent and over	2	3	12	13	22	26	23	11

In summary, the major trends of the economy over recent years seem to have strengthened rather than weakened the ability of individuals to service their debts. These trends have been supplemented in the housing area by persistent price increases which have aided the owners in creating a margin of equity. But no debt structure is likely to be impervious to major reductions of income, and reservations therefore must be held as to how present debt volume would perform under conditions of sharply declining income. Weaknesses then would become apparent which were not discernible before.

PART II

OBJECTIVES OF ECONOMIC POLICY

This section deals with the issues raised by the questions relating to the objectives of economic policy. It does not attempt to go into the many ramifications involved, but is directed primarily at the more important problems such as the meaning of objectives, interrelations among them, and the relative importance of the principal objectives.

OBJECTIVES AND ECONOMIC CONDITIONS

Appropriate objectives of economic policy and methods of achieving them have long been subjects of concern and controversy. In the early part of the 19th century, Thomas Malthus was troubled over economic crises brought on, in his view, by general overproduction. Adam Smith was principally concerned with the conditions needed for economic growth, and David Ricardo struggled with the problem of inflation and depreciation of the currency. In 1832, an English banker, considering the problem of unemployment, stated that the Government should expand the currency until there is full employment and general prosperity.

Economic objectives as well as methods of achieving them have undergone significant shifts in emphasis, reflecting changing economic conditions and political and social ideas. The past 40 years illustrate well the nature of these shifts and some of their causes. World War I brought a sharp rise in the price level followed by a sharp decline in the early twenties. The inequities and hardships caused by the wide swing in prices focused attention on the desirability of maintaining a stable price level. Price stability became a widely accepted objective of economic policy in the twenties, but after the depression of 1920–22 increasing emphasis was placed on efforts to combat developments threatening the stability of production and employment. Until the speculative boom and collapse of the late twenties, monetary policy was commonly regarded as an adequate instrument for achieving both objectives.

Economic collapse in the early thirties ushered in a long period of stagnation and unemployment. The obvious hardships inflicted by widespread unemployment and the drastic fall in commodity, property, and security values shifted attention from inflationary dangers to efforts to promote "reflation" and increased employment. Prolonged stagnation also undermined confidence in monetary policy, and many turned to fiscal policy as a more effective method of achieving economic objectives. Although concern over unemployment was temporarily dispelled by World War II, resurgence of the fear led to legislation in 1946, establishing maximum employment along with maximum production and purchasing power as objectives of economic policy. The Employment Act also stated that it was the responsibility of the Federal Government to use all practicable means, consistent with its needs and with fostering and promoting free competitive enterprise, to achieve these objectives. Experience has demonstrated that maximum employment needs to be interpreted as maximum sustainable employment.

Postwar expansion, interrupted thus far by only minor recessions, has brought further shifts. Persistent inflationary pressures tended to restore some of the emphasis on price stability, but with no noticeable diminution in emphasis on employment objectives. An unexpectedly rapid increase in population reinforced the view that maximum employment could be sustained only within the framework of economic growth. Today we have three widely accepted objectives: (*a*) Price stability; (*b*) avoidance of instability in production, employment, and income; and (*c*) sustained economic growth. The last two, however, tend to merge into a single objective, as a static stability persisting for any extended period would be generally regarded as unsatisfactory.

MEANING OF OBJECTIVES

Although the meaning of stable prices, business stability, and economic growth is clear in a general way, these objectives need to be translated into more specific terms to serve as a useful basis for implementing economic policies.

How much variation in the price level is consistent with price stability? What range of fluctuations in production, employment, and income is permissible if we are to have an acceptable degree of economic stability? Is stability at literally maximum levels of production, employment, and income a feasible objective, or would persistent efforts to achieve the highest possible levels be likely to produce such inflationary distortions as to be self-defeating? Does full employment mean that no one should be unemployed involuntarily? Is unemployment involuntary if a workman is unwilling to take a different type of job or somewhat lower pay? In a free-enterprise economy, there will always be some unemployment as manpower and productive facilities shift to meet changing demands and changing technology. What ratio of unemployment is consistent with maximum sustainable employment—2 percent, 5 percent, or some other percentage of the labor force? Since the labor force is a variable quantity, is the percentage of unemployment of varying significance at different times?

Similar questions arise in trying to put economic growth in more specific terms. To be meaningful, growth should be in real terms, not a growth in dollar volume inflated by rising prices. Growth results in a rising standard of living only if it is sufficient to provide an increase in per capita output and real income. Granting that real per capita output is the goal, what rate of growth should be our objective? Is an average annual rate of 1 or 2 percent satisfactory, or should we seek more?

There is no precise definition of objectives that would be appropriate under all circumstances. It should be recognized, however, that the higher we set our goals the more difficult it is to achieve them, individually or in combination.

INTERRELATION OF OBJECTIVES

Price stability, business stability, and economic growth are closely interrelated.

In principle, stable prices, business stability at high levels of production and employment, and economic growth are mutually consistent. In practice, inconsistencies may at times develop. Excessive expansion or contraction in major sectors of the economy tends to be accompanied by inflationary or deflationary tendencies; too much emphasis on one objective may impair ability to achieve the others.

Rising prices usually lead to waste, inefficiency, misdirected use of resources, and, eventually, to a boom which ends in depression. On the other hand, rapidly falling prices are almost invariably accompanied by declining production, idle plants, and unemployed labor. A considerable degree of price stability (or, perhaps, even gradually declining prices), therefore, would appear to be an essential, although not a sufficient, condition for achieving business stability and steady economic growth.

Reasonably full employment is also consistent with achieving sustained long-term growth. Unemployment and idle facilities represent a waste of economic resources On the other hand, attempts to maintain employment at a maximum level without regard to price stability may inhibit economic growth. In a dynamic economy, resources are continually being shifted from declining to expanding industries; improved machinery and techniques replace the old and obsolete. Such changes are essential for increasing efficiency and promoting economic growth, but they may also result in temporary unemployment. Efforts to prop up declining industries or to delay the introduction of improved techniques as a means of preventing unemployment prolong relatively inefficient methods of production and retard the rate of economic growth. Attempts directed primarily toward maintaining employment at a maximum level also create an economic climate which is not conducive to the most efficient use of productive resources. When demand is pressing against capacity, the emphasis is on getting more output. Costs and prices are a secondary consideration.

Inflation, formerly considered predominantly a wartime problem in this country, has become a threat in peacetime. Several developments have contributed toward making inflation a threat in peacetime. Governments have assumed responsibility for maintaining "maximum" employment. Collective bargaining has become a powerful force in determining wage rates. Several important industries are dominated by a few large companies, and the prices of their products do not respond readily to the free play of supply and demand. Fear of "creeping" inflation has led to protective devices such as escalator clauses which, by their nature, tend to perpetuate it.

It is extremely difficult, if not impossible, to keep aggregate demand strong enough to maintain full employment without spilling over into rising prices, especially with the close interrelationship between wages and prices under our present institutional structure. An increase in prices generates intense pressure for higher wage rates. Under conditions of full employment, a wage increase can easily be passed along in the form of higher prices. Thus, an increase in either prices or wage rates tends to initiate a rising price-wage or wage-price spiral. For these reasons, attempting to maintain full employment is like trying to walk a tight rope—there is constant danger of slipping into slowly rising prices and long-run inflation.

Fear of inflation has led to devices to protect real income from the erosion of rising prices. Some wage contracts tie wage rates to the index of consumer prices. Once prices begin to rise, regardless of the initial cause, wage rates increase automatically. If wage increases were limited to cost-of-living adjustments of modest proportions, so that they could readily be absorbed by increased efficiency of production, no further impetus to the price increases should result. And, as further efficiencies were achieved, costs would be lowered, so that real wages could be increased through price reductions. But when cost-of-living wage increases are added to basic wage increases that fully match or exceed increases in productivity, the tendency is to set in motion an upward spiral of costs and prices. In fact, as the experience of a number of countries has demonstrated, escalator provisions in wage arrangements can perpetuate a wage-price spiral of ever-increasing intensity, with the result that the currency approaches worthlessness at an accelerating rate.

Although the wage "escalator" clause is best known, other devices have a similar effect. Some countries have issued "purchasing-power" bonds, the amount of interest and sometimes the principal being tied to the price index. Cost-plus contracts also tie contractual income to prices. With no incentive to cut costs, rising prices are likely to be fully reflected in higher costs and in a larger fee as well. Escalator clauses and similar devices, because of the accelerating effect once prices begin to rise, make it more difficult to achieve price stability. It remains to be seen whether escalator clauses will be retained and, hence, have similar effects in a period of declining prices.

The fact that our present economic environment facilitates operation of the wage-price spiral does not mean that inflation is inevitable. Wage increases are inherently inflationary when in excess of the rise in productivity for the economy as a whole, and it is problematical whether, under all circumstances, action to limit credit and the money supply and, thus, to make more difficult the financing of business at the higher price level can prevent a wage-price spiral from continuing to push prices upward. However, credit restraint, properly timed, can be of great value in minimizing and possibly preventing or halting an upward spiral. The longer a spiral is permitted to continue, the more difficult it becomes to halt it without precipitating a decline in production and employment.

Policies directed toward maintaining maximum employment may result in long-run inflation, even though a continual rise in prices is avoided. Recurrent booms may push prices upward. On the other hand, because of prompt actions to stimulate production and restore full employment, periods of recession may be accompanied by a halt to the rise, but little, if any, decline in prices. With prices moving upward from a higher base following each recession, the long-run trend would be a ratcheting upward movement in the price level. Too much emphasis on full employment may prevent the effective restraint necessary to maintain price stability.

Success in promoting stability of prices and in avoiding wide fluctuations in production, employment, and income, however, will in general provide an economic atmosphere conducive to maximum economic growth—the third objective of economic policy. In a market economy, the forces that promote economic progress on the part of the individual are in general the same forces that foster a rising standard of living for society as a whole. While this view does not deny that Government policies may accelerate economic growth it does recognize that the major impetus for growth stems primarily from the efforts of individuals to promote their own well-being, within the framework of a stable economy, rather than concerted efforts of the Government to elevate growth to a major objective of public policy.

Aside from the promotion of stability in prices and business activity, the contribution of public policy to economic growth lies mainly in fostering competition in the economy. Competition is a strong stimulant to growth. It sharpens interest in reducing costs, in searching out more efficient methods of production, and in discovering and applying new techniques and products. It places a premium on entrepreneurship and skills. It promotes business investment, both as a means of reducing production costs by introducing more efficient equipment and of increasing capacity to capture a larger share of the market. Competition is, in short, the major stimulant to economical use of resources, both human and material, through technological progress and by eliminating waste and inefficiency in productive processes.

Given the pace of technological advance, the rate of economic growth tends to vary directly with the proportion of economic resources devoted to capital formation. While monetary and fiscal policies inevitably affect the pace of capital formation, the precise allocation of resources between production for consumption as opposed to investment is, in a market economy, determined largely by the free choice of consumers and businesses. Experience indicates that the maintenance of reasonable stability in the value of money and prosperous economic conditions provides an atmosphere conducive to a sustained and satisfactory rate of economic growth. If this view is correct, stability of prices and business activity must be accepted as the primary goal of policy, with economic growth as a natural and desirable consequence of their successful attainment.

Moreover, it is important to recognize that, under conditions of relatively full use of our economic resources, a faster rate of growth can be achieved only at the expense of current consumption. Such a choice should generally, in our opinion, be a reflection of individual preferences rather than a Government decision.

These longer-run problems of harmonizing economic policy objectives have their counterpart in the short run. The current situation affords an illustration. The index of consumer prices has continued to rise even though production, employment, and income have been declining for several months, and recently the index of wholesale prices has been rising also. Sole emphasis on price stability would call for continued restraint to check the rise. A restrictive policy, however, would tend to intensify the decline in production and the rise in unemployment. Thus policies directed solely toward price stability would be somewhat inconsistent with maintaining business stability and a full utilization of labor and productive facilities.

When such conflicts occur, monetary and fiscal authorities should reappraise the relative significance of the various objectives and select that combination which is most appropriate under the circumstances.

RELATIVE IMPORTANCE OF OBJECTIVES

The relative importance of economic objectives varies with economic conditions. There is no ranking as to importance that is appropriate under all circumstances. The particular combination that should be pursued at a given time depends on existing conditions and a careful appraisal of the probable consequences of the policies that would be necessary to achieve each objective.

Wide acceptances of the view that inflation is a probability in peacetime appears to be based not on the conclusion that it is desirable per se or that economic instruments for preventing it are inadequate if fully used. Rather it seems to rest primarily on the premise that full employment, even though involving the threat of long-run inflation, is more desirable than the alternatives. One alternative is the use of monetary and fiscal policies with whatever vigor is required to check rising prices and prevent a decline in the purchasing power of the dollar. Another, favored by some, is to rely less on such instruments as monetary and fiscal policies and more on direct controls as a means of achieving both full employment and price stability.

It is important to recognize that pursuing policies to achieve either of these objectives will inflict sacrifices and hardships on someone. Emphasis on the employment objective, even though it results in recurrent inflation, may temporarily minimize unemployment but there is a price for someone to pay. Creeping inflation is like a termite. Working underneath a surface of prosperity, it constantly nibbles away the buying power of the dollar, favors speculative rather than constructive investment, and so undermines the foundations of growth and, eventually, may even lead to runaway inflation.

A price increase of 3 percent annually, although small in itself, would in 20 years reduce the buying power of the dollar by nearly one-half. One effect would be to wipe out a substantial part of the real value of money savings and fixed incomes. It would inflict heavy losses on millions of people with savings deposits in banks, shares in savings and loan associations, and life insurance; and impose a sharp reduction in the standard of living of those with fixed incomes, such as recipients of annuities, pensions, and other forms of retirement income. The hardship is just as real, although not so obvious, as the loss of income resulting from unemployment; and to a large extent the burden falls on those least able to bear it. Secondly, as it became clear that money savings were faced with progressive shrinkage in purchasing power, the flow of savings into savings institutions would tend to decline, there would be a shift from money and fixed-income obligations to equities and real property, speculation and waste would be encouraged, and maladjustments would be created among different types of economic activity. These developments would accelerate the pace of inflation and thus intensify the hardships imposed on much of the population. If carried far enough, it could eventually threaten runaway inflation which could lead to chaotic conditions in the economy. But even in the absence of such a culminating phase, the consequences of substantial inflation are damaging enough to warrant very strong efforts to prevent it.

Effective use of monetary and fiscal policies to help maintain price and business stability cannot be entirely painless. In essence, a restrictive monetary policy, designed to prevent spendable funds from rising more rapidly than the output of goods and services available for people to buy, limits the total quantity of credit available to borrowers. Some would-be borrowers are deprived of credit which otherwise would be available. But the limited supply is allocated among borrowers by market forces instead of by the decisions of some regulatory agency.

It is well to note that using direct controls as a means of maintaining maximum employment without inflation also has its price. Experience demonstrates that a harness of direct controls over prices and wages creates rigidities and distortions, makes adjustment to change slow and more difficult, infringes upon individual freedom, and stifles private initiative. The long-run effect is to inhibit not only the mobility of resources, but growth itself. In addition, direct controls are inconsistent with the principles laid down in the Employment Act that maximum employment, production, and purchasing power should be promoted in ways that would foster and promote free competitive enterprise.

Even more important, perhaps, is the fundamental weakness inherent in direct controls. The fact that they are needed is conclusive evidence that aggregate demand is in excess of the amount which is consistent with price stability. Their purpose is to suppress the effect of excessive purchasing power on prices. With prices controlled and supplies limited, however, money accumulates which cannot be spent for the goods people want to buy. Experience suggests that before long workers may decide that greater satisfaction can be derived from more leisure rather than more work. Inability to convert income into goods dulls the incentive to work, spawns inefficiency, and leads to conditions inimical to economic growth. Furthermore, if long continued, the accumulation of pent-up purchasing power is almost certain to lead to violations, the growth of black markets, and eventual price inflation.

Selecting the most appropriate goals of economic policy is a difficult and complicated task. General economic welfare can best be promoted, it seems, by carefully weighing the advantages and the sacrifices and hardships involved in pursuing policies designed to achieve alternative objectives. The long-run as well as the short-run effects should also be considered. Only in this way can men of judgment reach a sound decision as to the particular combination which seems most appropriate for a particular situation.

Although there is no set of rules or ranking of objectives which can always be followed, certain guides may be helpful in arriving at a decision as to the appropriate combination under given economic conditions. One factor of significance is the nature of the rise in prices or the increase in unemployment. Is the price rise accounted for mainly by temporary conditions such as crop failures and unseasonable weather? In case of an increase in unemployment, does the rise reflect largely such factors as seasonal declines in production or secular declines in industries whose products are gradually being displaced by newer ones? Monetary and fiscal policies are not appropriate remedies for price increases for particular products resulting from unusual supply or demand conditions, such as crop failures.

A second factor, as indicated above, is that when there is a conflict among objectives the advantages and disadvantages of each alternative should be weighed carefully. For example, if prices and unemployment are increasing simultaneously, the relative strength of inflationary forces and of the contractive tendencies in business activity and unemployment should be appraised. Also the loss inflicted by rising prices on those with savings and relatively fixed incomes should be carefully weighed against the more obvious hardships of unemployment.

Despite some tendency toward inconsistency among the objectives, they seem to be attainable within reasonable limits. One of the principal threats to optimum overall achievement is excessive emphasis on one objective without regard to the others. The problem is to strive for that combination which, under existing circumstances, will minimize hardship and maximize general welfare.

PART III

MONETARY POLICY, 1942–57

The goals of relatively full employment and a satisfactory rate of economic growth have been largely attained in the 16-year period ending in 1957. Stability of the price level, the third important objective of public economic policy, has not, however, been achieved. The purchasing power of the dollar approximately halved during the period, as reflected by a doubling in the consumer and wholesale price indexes. While appropriate monetary policies alone cannot be expected to achieve the objectives of economic policy, including price stability, such factors as the cost, availability, and volume of credit are of considerable significance to economic trends in general and to price level movements in particular. The purpose of the following discussion is to review monetary policy since 1942, emphasizing the inflationary characteristic of the period as a whole and the relationship of monetary policy to the rise in prices. For this purpose, the 16 years are divided into 3 periods: (1) December 1941 to mid-1946; (2) mid-1946 to mid-1951; and (3) mid-1951 to 1957.

DECEMBER 1941 TO MID-1946

At the outbreak of war, the Board of Governors of the Federal Reserve System announced that the primary objective of the System during the war would be "to assure that an ample supply of funds is available at all times for financing the war effort and to exert its influence toward maintaining conditions in the * * * Government security market that are satisfactory from the standpoint of the Government's requirements." During 1942 an additional objective attained a major position in Federal Reserve policy. This second objective was to encourage the repayment of debts and the use of increasing amounts of the incomes of individuals for financing of the war, thus helping to counteract inflationary pressures.

This second objective was promoted through the administration of consumer credit controls and efforts to encourage nonbank purchases of Government securities and to avoid unnecessary credit expansion. Nevertheless, the decision to assure an ample supply of funds for war finance, and to finance the war at low and stable rates of interest, in effect relegated control of inflation to a position secondary to the objective of facilitating war finance. While it was recognized that some inflation was inevitable, it was also believed that rationing and direct controls over prices, wages, and output, coupled with selective control of consumer credit through regulation W, would minimize price increases during the war. That this view was substantially correct is indicated by the relatively mild increase of 11 percent in consumer prices between mid-1942, when the machinery of direct control had been largely established, and the end of the war. It is important to note, however, that the increase in the price index under-states the degree of inflation, in view of the growth of black markets and the substitution of nonstandard and inferior products for standard products.

Two major operating policies were adopted early in the war to promote the System's primary objective. They were: (1) an official commitment on the part of the Federal Reserve banks to purchase all United States Treasury bills that might be offered at a rate of three-eighths of 1 percent, coupled with an agreement to resell the bills to the vendor any time before maturity at the same rate; and (2) purchases in the open market to prevent yields on longer term Government securities (certificates, notes, and bonds) from rising above predetermined levels. Successful implementation of these policies resulted in the establishment of a pattern of rates on Government securities, ranging from three-eighths of 1 percent on 91-day Treasury bills to 2½ percent on the longest term bonds (at that time, 30-year maturity). To facilitate further the financing of the war, two additional operating policies were adopted. They were the establishment of a preferential discount rate of one-half of 1 percent for advances secured by short-term Governments, and reductions in Reserve requirements of central Reserve city banks.

Once investors and other market participants became convinced that rates would not be permitted to rise above the levels selected early in the war, the attainment of the primary objective of monetary policy during the war was assured. In effect, the maintenance of a low and stable structure of interest rates (1) encouraged prompt buying of securities by investors, who might otherwise have awaited higher rates; (2) assured a strong and steady market for outstanding securities; (3) kept down the interest cost on the war debt; and (4) limited the growth in bank and other investors' earnings from their public debt holdings.

Unfortunately, the failure to raise a greater proportion of the funds required for financing the war through taxes and sales of securities to genuine nonbank investors, and the resulting rapid expansion of bank credit and the money supply, contributed to inflationary pressures, both current and latent. Only 40 percent of the funds obtained to finance the war were raised through taxation. The war loan drives, while appearing on the surface to have resulted in the sale of large amounts of securities to genuine nonbank investors, actually relied significantly on bank credit expansion for their success. The Treasury offered nothing but short-term securities for subscription by commercial banks after the third war loan, and only limited amounts of longer term securities in the preceding drives. Consequently, the banks subscribed to short-term securities, sold considerable amounts to the Reserve banks, and then bought the longer bank-eligible securities in the market above par, thus permitting speculatively inclined, nonbank subscribers to make a quick profit and again subscribe to large amounts in the next loan. In addition, the relatively low yields on bills and certificates exerted strong pressures on banks and other investors to liquidate these instruments, which the Federal Reserve had to purchase in order to maintain the rate pattern, and to use the funds thus acquired to purchase longer term, higher yielding securities. While most of the reserves supplied in this manner were absorbed by an increase in currency in circulation and an outflow of gold, a substantial volume was used to support the expansion of bank investments and, consequently, promoted inflationary growth of the money supply.

Although the shifting process could have been discouraged and perhaps eliminated by permitting short-term rates to rise relative to longer term yields, Treasury officials were reluctant to agree to any breach of the rate pattern. Even though the shifting process gained momentum in the later stages of the war and did not cease until about mid-1946, it was not until the summer of 1947 that yields on Treasury bills and certificates were permitted to move higher. In the meantime, the overall technique of war finance and the resulting excessive monetary expansion, together with wartime shortages and accumulated demands, laid the basis for a sharp increase in prices of goods and services once price controls and rationing were suspended in 1946.

MID-1946 TO MID-1951

Throughout most of the period from mid-1946 until the consummation of the Treasury-Federal Reserve accord in early 1951, Federal Reserve authorities were confronted with the task of reconciling two conflicting objectives. Briefly stated, these objectives were, on the one hand, to utilize general instruments of credit control in an orthodox manner to restrain inflationary pressures and, on the other hand, to maintain stable and orderly conditions in the Government securities market.

The importance of the first objective is emphasized by the fact that from the beginning of the period until the latter part of 1948, and again in the latter part of 1950 and in early 1951, inflationary pressures were severe. In the earlier period, the pressures resulted primarily from the huge volume of liquid assets built up during the war and the accompanying shortages of goods and deferred demands. In the latter period, the outbreak of fighting in Korea, which followed closely upon recovery from the mild recession of 1948–49, stimulated business and consumer spending in expectation of greatly expanded military expenditures and in fear of renewed shortage of goods. Under each of these circumstances, orthodox principles of central banking would have called for a restrictive credit policy. While some inflation was no doubt inevitable in each instance, an effective restrictive policy would have limited inflation by reducing the attractiveness of liquidating Government securities in order to purchase goods and services or, in the case of banks and other financial institutions, in order to engage in credit extension to private borrowers.

Adoption of an orthodox restrictive policy would, of course, have necessitated the abandonment of the policy of maintaining a stable market for Government securities. Flexible credit policies require flexible interest rates, which in turn mean that prices of debt instruments, including Government securities, must be free to fluctuate with market forces and those emanating from the actions of the central bank. So long as prices of Government securities were supported at relatively high prices, holders of the instruments were in effect invited to liquidate their Governments at attractive prices. In essence, the Federal Reserve acted as a passive buyer of Governments and, in the process, supplied additional reserves to the market on the initiative of holders of Government obligations.

There was, on the other hand, grave concern as to the effect of abandonment of par support on the market for existing Government securities, the Treasury's refunding operations, and the state of business in general. Such action, it was believed, might precipitate disorderly conditions in the Government securities market. Lower and fluctuating prices for Government securities would have complicated Treasury refunding operations, and the higher interest rates that no doubt would have occurred would have increased the cost to the Treasury of servicing the Federal debt. In the early postwar period, it was feared that abandonment of par support might precipitate a crisis in the security markets generally and interfere seriously with the reconversion and expansion of industry. After the initial reconversion phase, there were recurrent fears of a postwar depression.

These latter arguments, while perhaps appearing less convincing today in view of the relative ease with which the par support program was terminated in 1951, were of considerable significance in the early postwar years. It should be recalled that, at the time, large amounts of Government securities were in the hands of more or less impermanent holders—financial institutions and other investors who had purchased the securities for patriotic and other reasons during the war, and who were anxious to liquidate the securities to obtain funds for other purposes. It is, therefore, quite possible that chaotic conditions in the market for Government securities would have developed had the System attempted to abandon the par support program.

In view of these considerations, the System attempted to reconcile the conflicting objectives by combating inflation through actions that did not necessitate the abandonment of the support program. Thus, despite purchases of $10 billion of Treasury bonds in the 12 months ended October 1948, total Federal Reserve holdings of Government securities increased only $1 billion (the $1 billion of net purchases was more than offset by an increase in reserve requirements in September 1948). The difference of $9 billion resulted partly from System sales of shorter-term Governments to investors other than commercial banks, mutual savings banks, and insurance companies, which was made possible by the rise within the pattern of yields on these securities; and partly from the Treasury's program of debt retirement out of surplus funds, which was concentrated in maturing securities held by the Reserve banks.

Other actions taken by the System to limit inflation included (1) an increase in Reserve bank discount rates from 1 to 1¼ percent in January 1948 and to 1½ percent in August; (2) appeals to bankers to exercise caution in lending policies, to curtail speculative loans, and to guard against overextension of consumer credit (regulation W was inoperative from November 1947 to November 1948); and (3) requests for additional powers over member bank reserves, including authority to raise existing requirements to higher levels and to prescribe secondary reserve requirements for member banks. It is doubtful that these actions had much effect. The discount mechanism was in a state of disuse inasmuch as banks could easily adjust reserve positions cheaply and efficiently in the Government securities market. Appeals to bankers had to compete against customer pressure and a strong profit pull toward private credit extension, not to mention the difficulty confronting bankers of distinguishing essential from nonessential credit demands. Requests for additional legislative authority received no action until the summer of 1948, when Congress renewed the authority for regulation W and granted the Board of Governors temporary authority to raise member bank reserve requirements above existing statutory limits. The Board promptly raised reserve requirements and reinstituted consumer credit control. As it turned out, inflationary pressures had begun to subside in the summer of 1948, and thus the additional powers were bestowed too late. The decline in inflationary pressures was, however, not evident at the time.

With the changed economic situation that became apparent in early 1949, System authorities took action to ease credit, including reductions in margin requirements, instalment credit terms, and member bank reserve requirements. However, concern with the stability of prices of Government securities led to substantial System sales of the instruments between January and June 1949 as market demands for Governments increased. In late June, the Federal Open Market Committee announced that, after consultation with the Treasury, it had been decided that purchases, sales, and exchanges of Government securities would be undertaken with primary regard to the general business and credit situation. It was pointed out that the policy of maintaining orderly conditions in the Government-securities market would be continued but that, under conditions existing at the time, "the maintenance of a relatively fixed pattern of rates has the undesirable effect of absorbing reserves from the market at a time when the availability of credit should be increased." The statement was widely hailed as marking the return of the System to flexible monetary policies.

Support operations were again undertaken, however, following the outbreak of fighting in Korea in the summer of 1950. Although the System attempted to restore flexibility to monetary policy in August, when discount rates were raised, the Treasury opposed such action. The necessity for supporting Treasury refunding operations in August and during succeeding months forced the Federal Reserve to absorb large amounts of shorter term securities and to support long-term bond prices. Banks, insurance companies, and other financial institutions began to liquidate Governments in large volume in order to obtain funds to support private credit extension. Later, other holders began to sell Governments, particularly longer term issues, because of fear that their prices would later decline. In supporting the market, the Federal Reserve between August 1950 and the end of the year purchased $8 billion of maturing Governments, $1 billion of restricted bonds, and $1.4 billion of short-term securities. Sales of short-term Governments in the amount of $7 billion partially offset these purchases. In January 1951, as support purchases continued in large amount and as seasonal factors were adding substantially to bank reserves, member bank reserve requirements were increased.

It was clear that the net System purchases were contributing to inflationary pressures by keeping interest rates low and credit readily available, and by adding to the reserves of the banking system. Loans of commercial banks increased $7.5 billion during the latter half of 1950 alone. Prices of goods and services rose rapidly, reflecting heavy buying by individuals and businesses in fear of war-induced shortages. Moreover, there was considerable public discussion of disagreement between the Treasury and the Federal Reserve. The need was imperative for an agreement to restore harmony between the two agencies and to permit the System to pursue flexible monetary policies suited to the general business and credit situation. The result was the Treasury-Federal Reserve accord, announced jointly by the Secretary of the Treasury and the Chairman of the Board of Governors and of the Federal Open Market Committee on March 4, 1951.

The terms of the accord that provided the basis for restoration of flexible monetary policies were as follows:

> (1) In order to remove a substantial portion of the long-term Government bonds that were overhanging the market, the Treasury agreed to offer in exchange for certain long-term marketable issues a long-term, nonmarketable bond that would be convertible at the holder's option into a marketable Treasury note.
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> (2) The Open Market Committee pledged that it would, in effect, support the exchange operation by making limited purchases of any long-term bonds that private holders might try to sell after the terms of the exchange offering were announced. It was specified, however, that "the situation would be assessed daily," that "the market would be kept orderly," and that "open market purchases, if any, would be made on a scaledown of prices."
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> (3) It was agreed that in order to hold to a minimum the reserve-creating purchases of short-term Governments, the Federal Reserve "would immediately reduce or discontinue purchases of short-term securities and permit the short-term market to adjust to a position at which banks would depend upon borrowing at the Federal Reserve to make needed adjustments in their reserves." It was thought that this action would result in renewed use of the "discount window" as an avenue for obtaining Federal Reserve credit and, as a consequence, greater reliance on discount policy as a device of credit control. Short-term interest rates would, it was believed, tend to fluctuate around the discount rate. The Federal Reserve agreed, however, not to raise the discount rate (then 1¾ percent) during the remainder of 1951.
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> (4) Federal Reserve authorities pledged that their operations would be designed "to assure a satisfactory volume of exchanges in the refunding of maturing Treasury issues." The Open Market Committee would, in other words, support Treasury refunding operations to ease the readjustment.

Although the Federal Reserve continued to purchase substantial amounts of Treasury bonds for a time following the accord, the bonds were purchased on a gradually declining scale of prices. The amounts purchased declined and within a few weeks purchases ceased. Following the accord, purchases of short-terms were promptly discontinued. Short-term rates, reflecting the termination of System purchases, rose sharply at first, but thereafter tended to move with market forces. Banks began to use the discount facility to adjust reserve positions. Under these conditions it was possible to pursue flexible monetary policies, even though support for Treasury financing operations was afforded from time to time until late 1952.

In evaluating Federal Reserve credit policies during the years 1946–51, it is important to note that by far the larger portion of the early postwar inflation (in the period 1946–48) occurred before the problem of par support became acute in late 1947. Between early 1946 and the end of 1948 consumer prices rose 32 percent. However, four-fifths of the increase took place before the final quarter of 1947, reflecting the removal of direct controls in 1946, and it was not until late 1947 that the System began large-scale purchases of long-term Governments in order to support their prices. Thus, most of the inflation that occurred in 1946–48 resulted from earlier actions—namely, the manner in which the war was financed, and the resulting monetary expansion—and the huge accumulated demands for goods and services both here and abroad.

Nevertheless, hindsight supports the judgment that earlier return to more flexible monetary policies would have been desirable. Had it not been for the substantial Treasury surpluses in 1947 and 1948, totaling almost $14 billion, and the use of a large portion of the surplus funds to retire maturing securities at the Federal Reserve banks, control over the Reserve position of the banking system would have been much more difficult. The willingness of the System to monetize longer term Government securities by creating Federal Reserve credit at relatively low rates of interest undoubtedly interfered with efforts to restrain inflatioı ry pressures. The success of the offsetting policies should not, however, be underestimated. Despite the support operations, the volume of bank credit and the money supply actually changed little in 1948.

Even more important is the judgment that failure to restore flexible monetary policies earlier in the postwar period led inevitably to reliance on support techniques following the outbreak of fighting in Korea. While much of the earlier postwar inflation was beyond the practicable influence of monetary policy, the same was less true in late 1950 and early 1951. The post-Korean inflation, while resulting partly from a more active use of the money supply as consumers and businesses rushed to buy in expectation of shortages and higher prices, was also supported strongly by credit expansion; and the credit expansion was facilitated by Federal Reserve creation of reserves as an adjunct to the support program.

MID-1951 TO 1957

Monetary policy during most of the period since the accord has been directed primarily toward restraining inflation. Pressures on the supply of labor and other resources, arising from a high level of defense expenditures and strong consumption and investment demands, have tended, except for a brief period in 1953–54 and again recently, to push prices higher. Between mid-1951 and the end of 1957, consumer prices rose 10 percent, with more than half of the increase occurring in 1956 and 1957.

Balance between aggregate demand for and supply of goods and services was reasonably well maintained in 1951 and 1952, even though consumer prices advanced during the period. This increase stemmed primarily from rising rent and transportation costs and largely reflected the culmination of inflationary pressures that had been built up before the establishment of price and wage controls in early 1951 and before the accord.

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Flexible administration of general credit controls, coupled with other important factors, helped promote stable growth in 1951 and 1952. Among the other factors were the various selective and direct controls, including regulation of consumer and real-estate credit, the voluntary credit restraint program, and price ceilings and allocation of scarce commodities; increases in taxes that offset, in part, rising Government expenditures; and, by mid-1952, a retardation in the rate of growth of defense expenditures.

Following the accord, and throughout most of 1951 and 1952, Federal Reserve actions were designed to minimize inflationary credit expansion while at the same time facilitating the readjustment of the Government securities market to termination of support. In addition, and in keeping with the terms of the accord, the System afforded direct support to Treasury refunding operations. Although purchases of Governments during such periods were substantial, the System was able to offset most of the acquisitions by sales or redemptions of short-term Governments. Thus, between mid-April and November 1951, purchases of $300 million of long-term bonds and $1.5 billion of short-term issues were almost wholly offset by liquidation of $1.7 billion of short-term Governments. The same technique, which was possible only because the System was no longer pledged to maintain stable prices for Government securities and could therefore operate flexibly in the market, was used in February, June, August, and September 1952. Reflecting the effects of the termination of the support program, sustained demands for funds in the market, and the generally restrictive monetary policies, interest rates on Government securities, corporate issues, and other debt instruments rose irregularly through 1951. In 1952, bond yields tended to level out, but short-term Government rates continued to increase. By the end of the year, interest rates generally were at the highest levels since the 1930's.

Inflationary pressures began to mount in late 1952 and early 1953, as defense expenditures rose further and consumer and business demand expanded. With credit demands strong and the economy operating close to capacity levels, the System exercised restraint in order to prevent excessive use of bank credit and inflationary expansion of the money supply. Member bank borrowing from the Federal Reserve banks rose, interest rates increased and, in January 1953, the Reserve banks increased their discount rates by one-fourth point, to 2 percent, in confirmation of the rate structure that had developed and to increase the cost of borrowing to member banks.

With the development of strains in the money and capital markets in the late spring of 1953, System credit policy was reversed, as manifested by substantial purchases of Treasury bills in May and June and a reduction in member bank reserve requirements in July. At the same time, business activity leveled out, and then declined, primarily as a result of sharp cutbacks in defense expenditures and an accompanying shift by businesses from accumulation to liquidation of inventories. Throughout the remainder of 1953 and during all of 1954, monetary policy was directed toward ease in order to cushion recessionary tendencies and to provide a monetary and credit atmosphere conducive to recovery.

The recession was both mild and short-lived, partly because basic forces of demand remained strong, and partly because easy availability of credit at low interest rates provided the basis for rising construction activity and, in late 1954 and early 1955, a resurgence of consumer spending for automobiles and other durable items. It is important to note that actions taken by the monetary authorities in 1954, including open market operations designed to make bank reserves freely available, two reductions in discount rates to a level of 1½ percent, and an additional cut in member bank reserve requirements, contributed significantly to the liquidity of the economy generally and of the banking system in particular. Confronted with reduced demands for loans, banks used the additional reserves made available through Federal Reserve action to increase sharply their holdings of Government and other securities. Between May 1953 and November 1954, total investments of commercial banks rose more than $14 billion, with Governments accounting for almost $12 billion of the increase.

As the first signs of economic recovery emerged in late 1954, the System permitted bank reserve positions to firm slightly in response to rising credit demands. Reflecting the widening of the recovery movement, credit demands continued to rise in early 1955. The System permitted bank reserve positions to tighten further and, in April, the Reserve banks raised their discount rates one-fourth point to 1¾ percent, increasing the cost of borrowing to member banks and bringing discount rates into better alinement with market rates. This rate increase was a straightforward indication to the business and financial community that monetary policy had been shifted toward restraint as contrasted with the policy of ease that had been followed in the second half of 1953 and in 1954. Meanwhile, there had been a rapid increase in the use of credit for purchasing and carrying securities, and margin requirements were increased in January and again in April.

By the time of the discount-rate increase in April 1955, most of the slack that had developed in the economy in 1953-54, as reflected in ready availability of labor and other economic resources, had been eliminated. Pressures on costs and prices intensified as aggregate spending continued to rise. The accompanying demands for credit, in the face of inadequate savings and the gradually increasing restrictiveness of monetary policy, forced interest rates higher. The Federal Reserve banks increased their discount rates in 6 steps, reaching a uniform level of 3½ percent in August 1957. Despite these policies, wholesale prices began to rise in the middle of 1955 and consumer prices in early 1956. The rise in consumer prices continued, almost without interruption, through 1957.

Monetary policy was once again shifted toward ease in the final quarter of 1957. With the abatement of inflationary pressures and the accompanying decline in loan demand in the fall, bank reserve positions were allowed to ease slightly in the latter part of October and early November. Then, as additional economic and financial data confirmed that the peak of business activity had been passed and that recessionary forces were developing, the Reserve banks reduced their discount rates by one-half point to a level of 3 percent. Financial markets responded dramatically to this clear signal that monetary policy had been adjusted to the changing business situation and, by the year end, pressures on bank reserves had been eased considerably and yields on Government and other debt obligations had declined markedly from earlier peaks. Easing actions were continued in early 1958, as business continued to decline, as reflected in significant easing in reserve positions of member banks and reductions in margin requirements, discount rates, and member-bank reserve requirements.

The preceding review indicates that monetary policy has been flexibly administered in the 7 years since the accord. A major question of interest, however, is whether the price inflation that occurred in 1956 and 1957 could have been wholly or partly avoided had Federal economic policy, including monetary policy, been administered differently. It is, of course, impossible to know precisely what would have occurred had different policies, in fact, been followed. It is reasonable to assume, however, that fiscal policies resulting in larger cash surpluses in fiscal years 1956 and 1957 would have helped restrain inflationary pressures. These surpluses could have been used in such manner as to limit the spending power of the private sector of the economy. In addition, the Treasury's financing problems would have been reduced, thereby facilitating the administration of a restrictive monetary policy.

In retrospect, there is little doubt that the direction of monetary policy was generally correct through the 7-year period. There is some question, however, whether the policy of ease was carried too far in 1954, when a combination of open-market operations and reductions in discount rates and reserve requirements pushed available reserves of member banks to high levels and short-term interest rates to exceedingly low levels. As noted above, commercial banks utilized a large portion of the available reserves to purchase Government and other securities. While this action cushioned the recession and provided a basis for recovery by promoting growth in the money supply, it also contributed to the growth of liquidity in the banking system. Consequently, when policy was shifted toward restraint in 1955, and gradually became more restrictive through 1955 and in 1956, commercial banks were in a position to meet demands of consumer and business borrowers by liquidating Governments and extending loan credit.

There also is some question whether the System moved fast enough in exercising restraint in the early and intermediate stages of the boom. Granted that a somewhat less easy policy in 1954 would have reduced commercial-bank purchases of securities at that time, even the excessive liquidity existing at the beginning of 1955 might have been absorbed more quickly, and credit expansion thereby restrained further, had policy been tightened faster in 1955.

That the record bank-loan expansion that occurred in 1955 and 1956 was an important factor in the inflationary push is indicated by continued expansion in business activity and rising prices, despite the restrained growth of the money supply during the period. The active-money supply, consisting of adjusted demand deposits and currency outside banks, increased only 3 percent in 1955 and about 1 percent in 1956. The rate of use of the existing money supply, however, increased markedly during the period. The increase in velocity was facilitated by the liquidation of bank investments, particularly Government securities, the concurrent extension of private credit to business and consumer borrowers, and rising market rates of interest. This type of shift, within the framework of a stable or slowly expanding money supply, tended to be accompanied by an increase in money velocity as the recipients of the bank loans used the funds to spend for goods and services. During 1955 and 1956, a more restrictive credit policy might have curtailed the shift from bank investments to loans and restrained total spending.

These judgments, it should be strongly emphasized, are possible only on the basis of hindsight. It should be recalled that, in 1953–54, there was concern lest the recession deepen and lead to large-scale reductions in output and employment. There was, at the time, little protest that monetary policy was being carried too far in the direction of ease. It is even more important to recall developments in late 1954 and in 1955. The recovery from the recession of 1953–54 moved much faster than was generally expected; there were still doubts in early 1955 that the recovery was firmly established, and there was considerable apprehension that a move toward tighter credit at a faster pace might halt the recovery short of its full potential. Much of the economic data available currently in the first two quarters of 1955 seriously understated the extent of the recovery up to that time. It was only later, when revisions of statistics became available, that the rapidity of the upturn became apparent. Moreover, it should be recalled that, at various times during the boom period, forces emerged that seemed to indicate a levelling off in business activity, or even an imminent decline. It is only through hindsight that the need for a more restrictive policy in the early stages of the boom seems clear.

PART IV

FISCAL AND DEBT MANAGEMENT POLICY

The comments that follow are submitted in an effort to be responsive to the committee's questions concerning fiscal and debt management policies, even though such policies are not within the area of responsibility of the Federal Reserve System. The discussion is intended to be theoretical and analytical, rather than to recommend any specific policies or courses of action.

FISCAL POLICY

In principle, the view is widely held that fiscal policy should be conducted in an anticyclical manner, with Government revenues exceeding expenditures in boom periods, and expenditures exceeding revenues in periods of recession, so as to help compensate for major swings in private spending. To some extent this now tends to occur automatically under our present fiscal system, as most of the major types of taxes tend to produce greater revenues in periods of expanding activity, income, and private spending, and considerably smaller revenues in periods of declining activity. Furthermore, under continuing programs some types of expenditures tend to contract in prosperous times and to increase in periods of recession. For example, disbursements from unemployment trust funds, grants-in-aid to the States for public assistance, and to some extent old-age benefits decline in periods of expanding business activity, and increase in periods of recession and rising unemployment.

To be most effective as an anticyclical influence, however, the automatic variability of receipts and expenditures in response to changes in economic conditions may need to be reinforced by active efforts to restrain Government expenditures when private (business and consumer) spending is high and to accelerate governmental projects when private spending is declining. Similarly, to the extent that tax reduction is possible within the framework of a budget balanced (on a cash basis) over the full cycle, the reductions would be most conductive to economic stability if effected when recessionary tendencies prevail. And if increased taxation is required to achieve overall budgetary balance, the tax increases would best be effected in periods when expansive and inflationary tendencies prevail.

Furthermore, different types of expenditures and receipts have different economic effects. Government expenditures that require large amounts of materials and labor, such as public works, public housing, and highway construction, and of course direct or indirect subsidies, would be most useful in promoting steady growth of the economy if they could be concentrated in periods of recession.

In the field of taxation, similarly, some types of taxes are believed to bear more heavily on consumer spending, while others are believed to bear more heavily on saving. For example, broadly based taxes such as excise taxes (especially retail sales taxes) and the "normal" income tax are considered to have greater impact on consumer spending than on saving, whereas the progressive surtaxes are considered to have greater effects on saving. The actual effects of such taxes on spending and saving, however, are not measurable. The economic effects of corporation taxes also are very difficult to measure. The corporation income tax is commonly considered nonregressive. There is generally a strong tendency, when tax reduction is considered desirable to exert a stimulating effect on the economy, to place primary emphasis on reductions in personal income and excise taxes. But it is questionable to what extent the corporation income tax is actually nonregressive. The fact that the average ratio of net income after taxes to invested capital in recent years has been much the same as in earlier periods of high activity, when tax rates were much lower, would seem to suggest that corporations in general have been able in fixing selling prices to treat the tax on profits as an item of cost and so to pass the tax along to customers.[1]

OUR PRESENT FISCAL SYSTEM

The current levels of expenditures and receipts have made the fiscal policy of the Federal Government a far more important influence on the economy than in earlier days. Government receipts have taken between 20 and 25 percent of total national income in recent years, and Government purchase of goods and services have accounted for 11 to 15 percent of total gross national product, in addition to which large amounts have been returned to the public through transfer payments and interest on the public debt. Sizable variations in Government expenditures or in Government receipts, therefore, can have profound effects on the economy. In the recession of 1953–54, for example, the curtailment of Government expenditures following the end of the war in Korea accounted for a much larger part of the decline in gross national product than the net decline in private expenditures. On the other hand, the substantial tax reductions of 1954 undoubtedly helped to promote early recovery from the recession. And in 1949, the increase in Government defense and other expenditures, together with a reduction in tax collections, went far toward offsetting the decline in business inventory and other investment and stimulating consumer spending.

Over the postwar period as a whole, the budgetary positions of the Government—in the sense of the overall balance between total payments and total receipts—does not appear to have been a major inflationary influence. The delayed effects of the huge wartime deficits, together with the shortages of civilian goods that accumulated during the war, were probably the most important inflationary forces in the early postwar years, 1946–48. In fact, the large cash surpluses in calendar years 1947, 1948, and 1956 were helpful in restraining the inflationary tendencies of those years, and the smaller surpluses in 1951 and 1957 were at least on the right side of the line. On the other hand, the deficits of 1952 and 1953 contributed to the inflationary

[1] It is sometimes argued that, to the extent that accelerated depreciation on plant and equipment has been permitted for tax purposes, corporation profits in recent years have been understated. On the other hand, it is argued with at least equal force that far more generally the practice of basing depreciation on historical cost, rather than on reproduction cost, has resulted in serious overstatement of corporation profits.

influence of real or anticipated shortages of goods (actually more anticipated than real) during the Korean war period.

But the net budgetary position, even on a cash basis, does not tell the whole story. The very magnitude of Government expenditures and the levels of taxation required to meet them have effects independent of the balance of receipts or payments. The current high levels of Government expenditures, and their tendency to follow a long-term upward trend, have made them a much more important element in the economy than in earlier years, and a fairly stable one. But even within a fairly steady total volume, shifts among the various types of expenditures can have substantial effects on particular industries or areas of the economy. For example, the shift of emphasis from military aircraft to guided missiles during the past 6 months or so has had a depressing effect on aircraft production and employment, with the eventual effects in terms of manpower and material requirements still uncertain.

Furthermore, even with a balanced budget, Government expenditures and taxes at current high levels can exert inflationary influences. For example, the corporation tax rate is so high that the effect of higher interest rates in restraining borrowing in a boom period is diluted, since it is said that "the Government pays more than half the cost." Also, incentives to efficiency and avoidance of wasteful or unnecessary expenses are greatly weakened, with inflationary effects. Quite aside from such tax aspects, it becomes extremely difficult to achieve economy and avoid inflationary influences in Government operations and procurement when the aggregate volume of expenditures is so huge. Cost-plus contracts to assure performance, unhampered by cost considerations, give Government contractors little incentive to resist cost increases as they would if their profits were at stake, and any resulting inflation of costs tends to spread through the community.

Another major weakness of fiscal policy as an instrument of national economic policy is the difficulty in obtaining timely public support and congressional action for the fiscal measures that would be most conducive to economic stability in the sense of steady, sustainable growth without inflation. It is usually difficult, except in periods of national emergency to get public support for increased taxation, especially of the kinds that would be most effective in restraining inflationary tendencies; and curtailment of Government spending finds more favor in the generality than in the specifics. On the other hand, when tax reduction or accelerated expenditure appears to be appropriate to exert a sustaining influence on production and employment, it is usually a time-consuming process to reach agreement on the types of tax reduction or of increased expenditure that will be most appropriate to the circumstances. And even if the initiation of changes is well timed, the expenditure programs adopted may attain their greatest momentum when they are no longer needed, and so give rise to new unstabilizing forces. Similarly, new taxes levied to meet the needs of a particular situation are frequently retained long after the particular circumstances that led to their adoption have passed; and tax reductions also are hard to reverse except in emergency situations.

One great difficulty is that of appraising the extent of the need for governmental intervention and how long it will be needed. Despite all the improvements that have been made in our economic data, forecasting remains a decidedly imperfect art. The current situation may be used to illustrate the point. Insofar as the current recession represents an inventory adjustment, it should provide its own remedy within a few months. Another and more important factor, especially from the viewpoint of duration, however, is the decline in business investment in plant and equipment, following the development of excess capacity in a number of industries. Planned expansion of national defense expenditures, together with the rising trend of state and local government capital projects and a possible acceleration of residential construction, should go far toward offsetting the decline in business investment, but the relative timing and momentum of the various factors are uncertain.

Meanwhile, major questions are how well consumer spending—the largest single element in the national economy—will be sustained, and how far the curtailment of business investment will go. Recent data on consumer spending have been difficult to interpret because of the complicating influence of unusually severe winter weather in much of the country. Developments in this area, probably more than any other, will determine whether Government intervention, in the form of tax reduction or a large increase in public works, is needed to counteract the recessionary tendencies. If there is a normal seasonal pickup in such things as automobile sales and residential building during the spring months, and consumer spending generally is well sustained, and if the contraction in business investment is not accelerated, quite moderate action on the part of the Federal Government might be sufficient. On the other hand, if it should appear that consumer spending is being substantially curtailed as a result of unemployment and apprehensiveness concerning future prospects—and perhaps also by the burden of existing consumer debts—vigorous steps in the form of prompt-acting governmental measures would be indicated.

In the tax field, probably, a substantial but temporary reduction in broadly based taxes would be most effective and appropriate (temporary, in view of the prospect of a rising trend of Government expenditures and probably sizable deficits ahead). This does not necessarily mean, however, that tax reductions should be limited to personal income and excise taxes. Some forms of corporation tax reduction might also be expected to have stimulating effects on business activity and employment. For example, some countries have used variable depreciation allowances to stimulate business spending on plant and equipment in periods of reduced activity and to restrain such expenditures in periods of high activity.[2] And, in the expenditure field, the preferable emphasis would be on projects that have been started and can readily be accelerated, or on projects that are past the planning stage and can be put into motion rapidly. The great danger in a public-works program is that it will only attain substantial momentum after the greatest need has passed, and may then accentuate inflationary tendencies by competing with other active demands for materials and manpower—especially the latter unless care is taken to select projects that are clearly needed and are of such types and so

[2] In the present situation, with excess capacity in many industries, more liberal depreciation allowance on new investments in plant might not have much effect in inducing acceleration of expansion plans, but might accelerate replacement of inefficient or obsolete equipment with a view to achieving cost savings and relieving the squeeze on profits.

located as to provide employment for the unemployed. At best, public works cannot be expected to make effective use of the particular skills of many of those who are out of work.

STATE AND LOCAL GOVERNMENT FINANCE

Major parts of State and local government expenditures, such as expenditures for education, police and fire protection, maintenance of public institutions, street and highway maintenance, and other public services are not greatly influenced by economic conditions. But there are other parts, such as the construction and improvement of public institutions and highways which ideally might be accelerated or retarded to help compensate for the wider swings in private spending, and thus exert a countercyclical influence on the economy. Practically, however, such countercyclical timing of construction projects appears to be very difficult to achieve, even though it might result in appreciable savings in costs. The principal types of State and local expenditures which tend to rise in periods of recession and to contract in periods of expansion are unemployment benefits and other forms of public assistance to the needy, much of the financing of which is done by the Federal Government. Major capital expenditures of State and local governments are usually financed by the sale of securities, rather than by current taxation, but frequently require the approval of the voters before the additional indebtedness can be assumed. And even though savings might be achieved by moving forward or postponing such projects to periods of recession, the tendency frequently is to delay them until the need is clearly urgent, and then to proceed regardless of economic conditions and costs. In fact, projects involving large expenditures are more likely to be voted down in periods of recession, since taxpayers are particularly reluctant to assume new burdens at such times, although projects previously approved are carried forward. On the other hand, shortages of materials and unfavorable conditions in the capital markets may retard such projects in boom periods. The net result has been a generally rising trend of State and local expenditures through prosperity and recession during the postwar period.

Since the fields of progressive taxation of personal income and taxation of corporation profits are so largely preempted by the Federal Government, State, and local government revenues are derived largely from real property taxes, general and specific sales taxes, and certain basic business taxes which frequently are independent of profits earned. Consequently, while they have shown a generally upward trend, they have varied only to a minor extent in response to changes in business conditions. As a result, they have tended to become more burdensome in periods of business recession, and less burdensome in periods of prosperity.

DEBT MANAGEMENT POLICY

For some years economists rather generally have urged that the management of the public debt be conducted in such a manner as to reenforce countercyclical fiscal and monetary policies. More specifically, the general policy advocated is that the Treasury place particular emphasis on the sale of long-term securities during periods of high activity and inflationary pressures, and on the sale of short-term during periods of recession. A primary purpose would be to divert investment funds from private investment and thus restrain tendencies toward overexpansion in prosperous times, and to avoid competition for the available supply of investment funds in periods of reduced business activity and unemployment.

Furthermore, in a period of expansion the use of the proceeds of sales of long-term securities, together with the surplus revenues which an appropriate fiscal policy should provide, would be used to retire short-term debt held by the banks and others, thus reducing the liquidity of the banking system and helping to make restrictive monetary policies of the central banking system more effective. In a period of recession, the proceeds of Treasury sales of short-term securities (presumably largely to the commercial banks) would be used to meet Government deficits, and perhaps to retire long-term securities. A result could be to offset, or more than offset, the decline in bank loans characteristic of a period of recession, thus maintaining or increasing total bank credit and the money supply, and at the same time increasing bank liquidity and reenforcing an "easy" monetary policy.

The experience of recent years, however, has raised questions concerning the feasibility and, to some extent, the desirability of such a debt-management policy. In the first place, the heavy demands for capital in a period of high activity tend to make the financial markets unreceptive to long-term Treasury securities and to require the Treasury to bid up interest rates progressively if it is to be successful in diverting funds from other uses. The Treasury is likely to be severely criticized by potential borrowers (such as builders and municipalities) who find it most difficult to compete, and by others who object to the increased service charges on the public debt.

Furthermore, the increased liquidity of the banking system that results from large sales of short-term Treasury securities to the banks in a period of recession (such as 1953–54) delays and limits the effectiveness of restrictive monetary policies when inflationary tendencies again become a problem. These difficulties have led some observers to conclude that the Treasury should abandon any attempt to use debt-management policy as an instrument of national economic policy, and should be guided by market conditions in deciding upon the type and maturity of securities to be offered at any given time. In the long run, presumably the Treasury would direct its efforts primarily toward achieving wide diversification in the maturity structure of the public debt, and avoiding excessive concentration in short maturities. This would reduce the amount and frequency of refunding operations required, and thus would reduce to a minimum the interference of debt operations with the execution of monetary policy. The Treasury would not try to force long-term issues on an unreceptive market, but would ordinarily limit its offerings to short or intermediate maturities under tight money-market conditions. That, of course, would mean that the Treasury would have to do most of its long-term financing in periods of easy-money conditions, when funds for long-term investment tend to be more readily available and other demands on the capital markets tend to become less pressing.

A third alternative would be to follow an intermediate course. While avoiding attempts to float large amounts of long-term securities, and thus to withdraw funds from the private capital market in important amounts during periods of expansion, the Treasury might try to sell limited amounts from time to time at competitive rates. If this proved successful, there would be less need for large offerings of long-term securities, designed to maintain satisfactory maturity distribution of the public debt, in periods of reduced business activity and employment. But moderate amounts of long-term financing might be done even then, the amounts perhaps depending upon the general vulnerability of business conditions and the extent of other current demands in the capital market for available savings—although this would not preclude some modest competition for savings by the Treasury against other demands. And to the extent that there was need for the financing of sizable budgetary deficits, securities designed for commercial bank subscription might well be issued in diversified maturities up to 10 years. This would facilitate an appropriate distribution of bank portfolios, and help to avoid the development of excessive liquidity in the banking system which would be likely to result from heavy emphasis on short-term financing during a period of recession. While such a compromise debt management program would be of limited use as an instrument of anticyclical economic policy, it would at least involve a minimum of interference with anticyclical fiscal and monetary policies, and should involve less difficulty than an attempt to carry out a thoroughgoing anticyclical policy—a policy which has not yet been found feasible for any extended period.

PART V

UNITED STATES MONETARY SYSTEM

The American monetary system consists at any one time of the aggregate of the moneys in use; their relationship to one another; the way in which they are created and issued, and retired, redeemed, and extinguished. The system also comprises the mechanism for facilitating and controlling variations in the quantity of money relative to the needs of our economy. The monetary system is determined by law and custom, and the different kinds of money (coin, currency, and demand deposits) are linked to one another in formal as well as substantive ways. Traditionally the monetary system is discussed in a narrow context in terms of the standard of value, the circulating currency forms, their relationship to one another and to the standard, and its equivalence in gold and foreign money. But for many years the term monetary system has been broadened to include the credit structure—demand deposits (money) and loans and investments (credit) provided by a fractional reserve commercial banking system—based upon the standard money. Thus there are at least two ways—although closely interconnected—in which the monetary system can be considered in appraising its adequacy or inadequacy for serving the increasingly specialized and interdependent sectors of our economic system.

FEATURES OF THE MONETARY STANDARD AND CURRENCY FORMS

In the narrow context, our monetary system includes a variety of relatively minor components that have been left behind as changes occurred during the financial history of the United States. It reflects our experiments with different types of monetary standards, and periods during which no metallic standard was in operation. Although the system has been simplified in recent years with the provisions in the 1930's for retiring several types of currency, it continues to be complex.

Since 1933, the Nation has been on a limited international gold bullion standard. The par value of the gold dollar is defined by law as comprising $15\frac{5}{21}$ grains of gold 0.900 fine, but gold coins are no longer issued. The price of gold in terms of the dollar is fixed at $35 a fine ounce. Although gold is not available without restriction for domestic use, the dollar is ultimately convertible to gold in settlement of the country's international obligations. Thus, the entire credit superstructure—reflected in loans and investments—is ultimately linked to the gold base, and international convertibility is assured. The gold standard in its present form provides the general framework within which the credit mechanisms functions. It sets the limits to which monetary expansion can be carried.

The monetary system of the United States with regard to currency and coin has never had a complete review to determine whether all of the various components fill a logical role and whether their conditions and use are consistent with each other.

MONEY SUPPLY AND THE MONETARY SYSTEM

The present monetary system is so organized as to permit unrestricted shiftability from one medium of exchange to another, i. e., currency to deposits, so that in general our customs have become adapted to the most convenient or least expensive methods of effecting payments for business and personal transactions. For some years it has been estimated that at least 90 percent of our total transactions have been settled through the use of checks drawn on demand deposits and the balance through paper currency and coins. An economy like that of the United States, with diversified industry, agriculture, and trade, with specialized and interdependent parts, needs not only an adequate medium of exchange in the narrow sense but also an appropriate volume of credit. Our fractional reserve banking system, by providing for the creation of demand deposits through loans and investments, relates the country's money supply to the availability of credit.

Credit instruments call for the payment of a definite sum of legal tender (which alone has complete authority to discharge the debt at a specified time). Thus, legal tender is the conventional medium through which the community maintains interconvertibility among credit forms and obligations in general. The reserves of the commercial banking system and their exchangeability for currency are the necessary mechanism by which convertibility is maintained, and the extent of expansibility in bank credit is determined. Money, credit, and banking thus become the mechanism whose main purpose is to provide a flexible means of payment to serve the needs of the business process.

GENERAL MEANING OF ADEQUACY OF THE MONETARY SYSTEM

There is probably no unanimity of opinion about what constitutes adequacy of the monetary system, but most observers would include the following criteria in any judgment: Stability of value; efficiency of the mechanism for effecting payments; responsiveness to economic change in accommodating orderly economic growth; allocation of the credit created by the banks in such a way that the Nation's resources are used effectively; and adaptability of the money creation process to control in achieving the objectives of public policy. As a minimum, the monetary system should encourage rather than hinder progress toward the achievement of these objectives.

The term stability of value is generally used to signify some constancy in purchasing power over goods. A complex economic system such as ours would not have been able to develop and function over the years without a monetary system that performed reasonably well as a store of value and means of deferred payments. Failure to perform these functions would in time have destroyed the mechanism for the exchange of goods and services essential to so complex an economy, and seriously hampered economic growth and progress. The limits of tolerance exclude both a rapid and continuous rise of the price level and a severe fall in the price level.

This is not to state that we have not at times experienced some instability in the value of money in terms of price changes, but the severe losses of purchasing power have been confined to periods of adjustment to the consequences (in part financial) of war. The extreme upward surge of the price level like those of 1914–20 and 1946–48, and similarly the violent collapses such as that of 1929–33, in fact, approached intolerable limits. Monetary developments have played a role in economic fluctuations, but since the aftermath of World War II they cannot be said to have been an originating cause in the United States. During an earlier period in our monetary system—the unrestricted gold coin standard years before the Federal Reserve System—the Nation was exposed to about the same range of price fluctuation but was without the same means of flexible adaptation to change. Another connotation of stability of value is constancy of purchasing power in terms of gold and foreign currencies convertible into gold. In this sense, the dollar has been dependable and stable for many years except for a brief period in the early thirties. The United States today provides a fixed point of reference for national currencies, and this reference point is the dollar and the dollar price of gold. Our currency continues to be the most generally acceptable in the world today. The integrity of our money depends in the final analysis on the productive power of the American economy in conjunction with successful handling of our fiscal and monetary problems.

RESPONSIVENESS OF THE MONETARY SYSTEM TO ECONOMIC CHANGE

Congress created the Federal Reserve System with the power to provide the means for a flexible supply of money and credit, recognizing that elasticity in the money supply can facilitate economic change and growth and that a rigid or arbitrarily limited volume can stifle development.

The present financial institutional arrangements within the monetary system facilitate an allocation of resources among different regions, industries, and firms. The system permits funds, and the resources these funds represent, to be channeled to those areas or businesses which are able to use them most efficiently. In this respect, the present monetary system provides mobility of funds in a free market economy. Organized and interrelated as it is, it represents a cohesive whole which makes possible intensive utilization of available funds.

This flexibility has generally worked well and has assured satisfactory handling of the changing-transactions requirements of an economy whose population and labor force have increased [illegible] percent and whose physical volume of production has quadrupled in the 44 years since the Federal Reserve was established. The economy has also greatly altered the types of goods produced, passed through the disruption of three wars, and undergone basic shifts in regional distribution of productive capacity and population.

Over the same period, however, the economy has suffered serious depressions despite the greater flexibility of the monetary system. Each brought to light new needs, which have been recognized by Congress, not only in monetary and credit institutions and in the policy instruments available to the Federal Reserve System but also over a much broader range of public policy and responsibility. The economy, however, has suffered no major period of cumulative contraction in economic activity in the past 20 years.

The adaptability of the monetary system is also generally well illustrated over the 10-year post-World War II period, and especially since the return to a flexible monetary policy beginning in 1951. During the years 1952–57 as a whole, the economy experienced a remarkable rise in economic activity. Physical production over the entire period increased at an average rate of 4 to 5 percent per year—well above the long-term growth trend. Savings and new bank credit facilitated shifts in production and allowed productive capacity to be expanded at a rapid pace. Recurrent inflationary price developments, however, have posed a serious problem.

The ideal role of bank credit is to meet the real needs of the economy without contributing to inflationary developments as competing demands for goods and services tend to press against available resources. By and large, bank credit has filled this role. The postwar decade brought a rapid rate of technological as well as organizational improvement reflected in a high output increment per unit of capital formation. Through this period of major change, with its inherent potential for temporary distortion of the economy and strain on many prices, monetary policy has operated to limit excessive demand in the money market and in the economy in general.

The negative aspects of financial history since 1951 are reflected in the price rises which have occurred in the period since the 1954 recession. The generally strong demands for both consumer and capital goods permitted price advances of sufficient size and persistence as to raise questions as to the future value of our currency, if the recent trends were to continue. The price advances reflected primarily nonmonetary forces rather than excessive expansion of the money supply, however, and raised questions as to the feasibility of restraining them by monetary policy alone.

SIGNIFICANT NATURE OF MONETARY CONTROLS

In the United States, which relies for its vitality and growth upon individual freedom and incentives of private enterprise, the varying force of supply and demand in different sectors of the freely functioning money and capital markets allocates available funds among the sectors in large part through variations within the structure of interest rates. The heart of the allocative process lies, of course, in arrangements that assure each borrower the possibility of access to competing sources of funds, and each investor the possibility of choosing among competing borrowers or types of investment.

The power to limit or influence the total volume of money, and the additions to the total supply of credit that are derived from changes in bank credit and the money supply, is the responsibility of the Federal Reserve System. The use of this credit by specific borrowers and sectors of the economy is influenced by the cost of the credit and the ability and willingness of the commercial banks to extend it. This willingness is influenced by the balance between reserves which are freely available and reserves that must be obtained through borrowing at the Reserve banks at the discount rate. The Federal Reserve banks are the principal suppliers of reserves, and they may add to or subtract from the reserve base as they create or extinguish their own credit through open market purchases and sales of securities or advances to member banks. Changes in the availability of reserves may also be effected through changes in the level of reserve requirements. An increase or decrease in the reserve base exerts pressure toward increased or reduced availability of credit and a larger or smaller money supply, with an accompanying tendency for rates to rise or fall and lending terms to ease or tighten. Changes in interest rates are the means by which market forces effect a balance between supplies of funds and demands for funds at any given time. Since the banking system and the credit and capital markets of the Nation are closely interconnected, interest rate changes quickly affect a wide range of credit instruments.

Furthermore, uncertainty created by changes in rates affects the whole complex of lenders' and borrowers' decisions. And a limited overall availability of credit forces lenders to ration available credit among users, whether the borrowers are willing to pay the higher rates or not.

Federal Reserve monetary policies thus function through the commercial banking system, and regardless of the instrument of policy used to influence credit, the supply of bank reserves is affected. Although nonbank lenders and investors may be affected directly or indirectly by Federal Reserve operations, the most significant result is change in the money supply and corresponding change in the credit structure.

One aspect of developments in the monetary system in recent years has been the relatively faster growth of such financial intermediaries as mutual savings banks, savings and loan associations, and life insurance companies than of commercial banks. The claims on such financial intermediaries (including savings deposits, savings and loan shares, policy reserves, and other financial assets) differ in essential fashion and function from demand deposits.

In contrast to other financial institutions, the commercial banking system can, if additional reserves are made available, expand its deposits by several times the added reserves as the banks make new loans or purchase securities. Bank deposits are expanded as a result of the monetization of the debts of borrowers. In the case of the financial intermediaries, acquisition of debt instruments involves the exchange of one asset (demand deposits in a commercial bank) for another (the investment acquired). Total assets cannot be increased by setting up demand liabilities in favor of the borrowers. Thus, it can be said that commercial banks create the effective money supply in the form of demand deposits, which are an independent variable at the margin of the credit supply.

The financial intermediaries cannot on their own initiative, either individually or as a system, enlarge the money supply of the public by expanding their liabilities. Most of the increases in the total of claims against the financial intermediaries depend upon an act of saving by individuals. The rise in savings, instead of representing an addition to spending power, generally reflects the diversion of a part of personal income from spending on consumer goods to the financing of productive facilities, homes, and other capital uses.

It is true that demand balances in the commercial banks may be activated as funds are recirculated by the intermediaries through their investment operation, and that the velocity of deposits may thus be increased. Many other types of transactions are reflected in changes in the velocity of money, however; during the postwar period velocity has, as in past periods, changed with the business situation, but the

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behavior has, if anything, tended to be more stable. Velocity will undoubtedly continue to reflect the effect of changes in business activity and in interest rates, and will need to be continuously taken into account in assessment of the credit situation. But that is not a new development, and present institutional arrangements in the United States seem adequate to prevent serious interference with credit policy arising from changes in velocity.

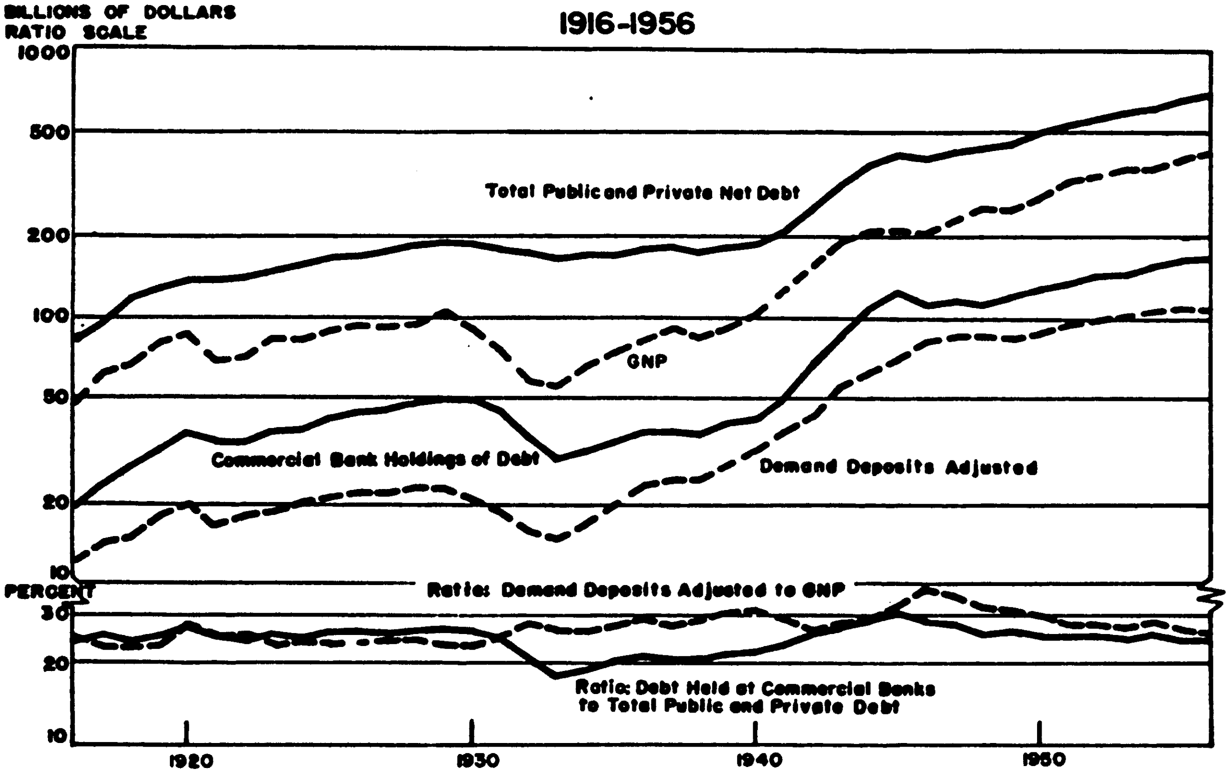
Some of the observers who have questioned the adequacy of monetary controls have suggested that capital rationing may become the critical medium for enforcing financial control of the intermediaries. Presumably, this would ultimately necessitate direction of the whole investment process and involve a significant departure from the philosophy and principles which in the past have governed monetary legislation. This subject, however, goes beyond the proper scope of this discussion; its consideration should await the results of a comprehensive and thorough study of all the financial institutions and practices of the country.

POSITION OF COMMERCIAL BANKS

The data presented in the accompanying chart show that commercial banks now have approximately the same relative position in the economy as before World War I, even though savings institutions and other financial intermediaries have grown more rapidly. The Nation's commercial bank demand deposits were equivalent to about 24 percent of gross national product in 1916 and 1917; currently they amount to about 26 percent. This relative increase has occurred even though the main alternative means of payments to demand deposits, currency in circulation, has grown still faster. Viewed in another way, commercial banks held about 24.5 percent of total net debt in the Nation in 1916 and 1917. They now hold almost exactly the same percentage. Thus, for as long a period as there are reliable statistics, commercial banks have shown no decline in importance. The ratio of the money supply to gross national product declined during the postwar boom, but the decline followed a rapid wartime rise, and the ratio is no lower now than in the 1920's.

TOTAL PUBLIC AND PRIVATE DEBT, GROSS NATIONAL PRODUCT DEBT HELD AT COMMERCIAL BANKS, AND DEMAND DEPOSITS ADJUSTED

1916-1956



INTERRELATIONS OF MONETARY POLICY, FISCAL POLICY, AND DEBT MANAGEMENT

Even as late as the decade prior to the establishment of the Federal Reserve System, predominant attention was directed to money in the form of circulating currency, when considering the monetary and credit relationships to economic activity. During the 20-year period following organization of the Reserve System, emphasis shifted to the regulation of credit. During the depression of the 1930's, the tendency was to turn to fiscal policy as the predominant instrument of economic policy, and during World War II and into the postwar period the operations of the National Government, and at times those of other instrumentalities, became highly important in their effects on economic developments. After the early postwar years, however, there was a widespread tendency here and abroad to turn again to monetary policy as an important instrument of economic policy. Thus, in the last decade, it has become customary to view monetary and credit policy, fiscal policy, and public debt management as essential complementary parts of any program working toward the objectives of economic policy—realization of the potential for growth, avoidance of serious instability of production and employment, and price stability.

Monetary policy deals most directly with the sources of changes in the money supply. Fiscal and debt management policies cannot of themselves create or extinguish money. They can only initiate action which may lead to such results with the cooperation of the banking system or, in effect, shift funds from relatively inactive deposits to more active balances. Since changes in credit and capital markets have a disproportionately large influence on the general state of expectations of business and consumers, it is important that balance be maintained between the supply of reserves and bank credit, and the physical growth of the economy. Fiscal policy, which concerns Government expenditures and receipts, can have direct effects upon demands for goods and services and on spendable incomes.

Effective coordination of monetary policy, fiscal policy, and debt management depends upon sympathetic comprehension and treatment of mutual problems by the Federal Reserve and the executive branch of the Government. Fiscal policy as determined by Congress must be based on many considerations, but one important factor should be its impact on economic stability. The real problem is not a selection of one of these instruments of economic policy in preference to another, but to coordinate them in such a way as to gain the particular advantages and mutually reinforcing action of each in pursuit of economic policy objectives.

Monetary policy has the advantage of being an impersonal, flexible, and adaptable instrument. The Federal Reserve can take prompt action and graduate the degree of immediate effect of its actions, and it can make reasonable adjustments quickly to changes currently visible. The instruments used in policy decisions make possible continuous contact with the banking system and the money market. Open market operations may be undertaken at the initiative of the Federal Reserve and discounting is done at the initiative of individual member banks. The Federal Reserve, because of the interrelationship of these two instruments, is able to retain control of the reserve position of member banks and thus influence their credit policies.

Both fiscal policies and debt management are less flexible and adaptable, but may have more direct effects on demands for goods and services. Fiscal policy, like monetary policy, suffers from the difficulty of foreseeing clearly the economic conditions to be dealt with. In addition, it entails a sizable lag between the considerations of measures to be taken, definite decisions, and their execution; and by its nature involves rigidities. These factors hamper satisfactory design of the revenue structure so that tax revenues at given rates increase or decrease in a higher proportion than fluctuating national income, thus tending to produce budget balance over the cycle of economic activity with alternating deficits and surplus.

The automatic features which have been incorporated in postwar budgets, however, exert a stabilizing influence. It should be noted that the force of them may affect both upward and downward movements of business since revenues rise or fall in a greater proportion than output, so that spendable private income rises or falls less than output. This effect, however, would be offset as a restraining influence in periods of prosperity, if surpluses at such times were used to finance additional or expanded programs rather than to retire debt. Avoidance of a continuously rising debt and resulting inflationary pressure calls for fiscal discipline of a high order.

As long as the budget is dominated by defense and related expenditures, and as long as obligations of earlier wars and transfer payments are relatively large, it will continue to be difficult to distribute Federal expenditures on the basis of positive goals and to vary the size of the Federal budget in relation to private spending.

In depression, fiscal and debt management policies have certain advantages over some Federal Reserve actions. Monetary policy, however, can be more quickly effective and during a minor recession may be sufficient. It counters declining business activity through lowering the cost of credit and increasing its availability as well as reducing pressures for forced liquidation of inventories or other goods. Given a strong underlying demand, growing population, expanding wants, and rapidly changing technology, an increased availability and lower cost of funds tend to induce increased expenditures by individuals, State and local units, and eventually business. Terms and conditions for the purchase of a wide range of goods are brought within reach of an increased number of credit users. Many types of business capital expenditures react to lower interest costs and a ready availability of funds for financing, as do many types of revenue-producing public expenditures. This situation will be encouraged if the banking system is strong and liquid. When the overriding problem is one of inflation, monetary policy may play a more active and central role than in a recession.

On the other hand, under conditions like those which prevailed during the great depression as a result of financial collapse, reduced population growth, and disrupted international relations, monetary policy would be less likely to stimulate private demands for goods and services. In a depression of this kind, action which only increases reserves is not sufficient to stimulate spending. Credit risks increase and individuals and business tend to be reluctant to incur avoidable indebtedness. Someone must borrow if more deposits are to be created. If the Government spends through borrowing from the commercial banks, it adds to bank deposits, and funds are placed in circulation by Government purchases of goods and services. In such a situation fiscal and debt management policies complement and supplement the improvement in atmosphere which monetary ease has developed and help to make it effective.

The large public debt in the postwar period has emphasized the need for a close cooperation between debt management and monetary policy. The Federal Reserve must take greater account of fiscal and debt problems in effecting credit policy and the Treasury must take account of credit policy in managing the debt. At times, the debt operations have tended to interfere with the execution of restrictive monetary policies as well as fiscal policy. Largely, this has come about through the influence of the maturity structure of the debt—on interest rates and in altering the liquidity of the banking system and the economy at large. Debt management decisions as they affect the maturity structure of assets held by private investors including the commercial banks and nonbank financial intermediaries have a pervasive effect. The significance of liquidity is found partly in its effect on the willingness and ability of individuals and business to dispose of assets for the purpose of acquiring other assets or to incur debt for the same purpose. A holder of cash or short-term marketable debt which may be sold or easily redeemed with little cost is able to generate a demand for goods by spending or lending.

In the absence of continuous effort and some leadership of the market, the simple effect of the passage of time will lead to a large floating debt and consequently to excessive liquidity in the economy. This factor also bears upon the technical problem of management of the debt and the latitude for effective monetary policy. If it were practicable to establish and equalize quarterly maturities, with a relatively small floating debt, and thereby develop a roughly uniform term structure of the debt, administrative and technical problems would be greatly simplified and monetary policy probably made more effective. Liquidity needs in a significant sense could then be better adjusted by the Federal Reserve. This general framework seems best to provide a successful operating atmosphere in which the joint obligations of debt management and monetary policy can be absorbed with the best results.

AREAS OF MUTUAL RESPONSIBILITY

Conflicts between fiscal action and monetary policy may occur because of differing objectives or because of technical factors. However, during the recent past Federal fiscal action and monetary policy have generally been complementary. While it is true that there were cash deficits in 1952 and 1955, 2 years when economic conditions called for a cash surplus, the 1952 deficit reflected Korean war expenditures while the 1955 deficit resulted chiefly from the lag in corporate tax receipts.

Policies designed to deal satisfactorily with inflation and deflation must continue to evolve programs for action which will produce the best end product. The question of what regulates the relationship between goods and money causing prices to rise and fall is one of fundamental importance in any society and becomes increasingly significant in the degree to which the division of labor and capitalistic organization of production separate producer from consumer. In pursuing various economic objectives, monetary policy must be accompanied by other appropriate measures of public policy. Prof. Alfred Marshall, writing toward the end of the last century, stated that money and banking was the "center around which all economic science clusters." If this is true, caution should be taken in attempting to classify its operations rigidly as a division of economic action. The monetary system and monetary policy are conditioning factors upon which other economic actions more or less depend.

SUPPLEMENTAL COMMENTS OF INDIVIDUAL PRESIDENTS OF THE FEDERAL RESERVE BANKS

FEDERAL RESERVE BANK OF BOSTON,
April 3, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: This letter and the material herewith furnish my answers to the questionnaire enclosed with your letter of February 17, 1958.

Following earlier practice the presidents of the Federal Reserve banks have worked out joint replies where our thinking has been along similar lines, and with the understanding that each president will enlarge on some of the replies if he so wishes. The joint reply "Comments in response to questionnaire of the Senate Finance Committee" is enclosed. Although all the principles and the issues under question—inflation and deflation, objectives and guides of public policy, nature and causes of business fluctuations, the use of monetary policy and its interrelation with fiscal policy and debt management, and the adequacy and the inadequacy of monetary system and financial institutions—are under continuous discussion, the questions have stimulated careful reconsideration and review of the main points as they have evolved in recent years.

Our board of directors has long been very much concerned with the matters raised in your inquiry and in 1951 directed the research committee of our board in conjunction with our staff to prepare a booklet which would stimulate public discussion and understanding. The response to this booklet was such that our directors suggested that the research committee and the staff revise the booklet in 1956, in the light of subsequent experience. Maintaining Economic Growth and Stability (copy enclosed) was issued in October 1956, and we have since filled requests for over 25,000 copies from business and educational institutions. May I call your attention to a few of the sections: What is Economic Stability? What is Economic Instability? Fighting Inflation, and Fighting Deflation. These sections discuss some of your questions in briefer form than does the joint reply.

PROBLEMS OF BUSINESS FLUCTUATIONS

One of the most interesting issues raised by your questions has to do with reasons for business fluctuations. It seems to me that the causes of fluctuations at any given time involve a combination of factors. Each period of business fluctuation also seems to be unique in its particulars, but it may have general similarities with those which have occurred in the past. The cause is found in the interaction of the following factors—temporary exhaustion of investment opportunities in one or another line of business activity, the necessity for shifting resources from one field of activity to another in response to changing the structure of production as a result of public or private stimulus, and monetary forces. Some of the developments which have characterized downturns in business activity in the past do not seem likely to repeat themselves because of changes in the monetary system as well as in the role of Government.

In the future, however, it is likely that the movement of business will not be smooth and at least two types of fluctuation will occur—change arising from inventory expansion or contraction, and change arising from variations in rates of investment in capital goods by both consumers and producers. Investment in capital goods was a key force over the recent 3-year upward movement of business. Both the upward and downward force of this factor seems to me to gain in importance with the growth in the proportion of income spent on automobiles, appliances, and other durable goods which have a useful life of several years. This force will also be increased with the introduction of further automatic processes or appliances in industry as well as the household. The demand for new supplies of durable goods tends to fluctuate more widely than the demand for the current services which these goods render. This kind of development underscores the need for coordinating the use of all instruments of public policy in attempting to maintain orderly economic growth.

EMPLOYMENT STABILITY AND ECONOMIC GROWTH

Several of your questions have as their central theme the relationship between employment stability and economic growth. A thorough analysis of stability and growth in a country as large as the United States must include consideration of the various types and stages of development illustrated by the different geographic regions. New England, for example, has many unique characteristics that highlight important aspects of growth and stability in a well-developed economy.

Three broad problems have hindered the rate of New England's economic growth. The problem that has received the most recognition has been the severe contraction in what was the region's largest industry—textiles. During the recent general boom years of 1955–57, for example, it has been necessary to absorb about 40,000 workers released by that industry. A second problem has been the increasing pressure of competition from manufacturers located in other regions. A combination of small moves in several factors of production costs such as transportation, fuel costs, materials costs, and others have intensified the problems of a New England manufacturer's reaching into the national market with his products. On a broader scale in time and generality, the absence of a large farm population in New England has somewhat restricted the region's ability to upgrade its labor force by shifting into manufacturing and service employment.

Taken together, these factors explain some of the apparent contradictions in the regional economy. They explain why we have pools of unemployed workers in some cities while neighboring cities may have a worker shortage. They explain why total manufacturing employment has not gained in the past 6 years, even though this Reserve bank's index of manufacturing output for New England had risen by 21 percent to its peak in 1957. Workers in the expanding industries had higher productivity than the average for the contracting industries.

The extensive structural shifts in our regional economy have been an important factor in holding per capita income above the national average. But these shifts have also increased the vulnerability to employment fluctuations. During the period 1919–39, New England manufacturing employment tended to be more stable than that of the United States. This greater stability was attributed to the predominance in the region of such nondurable goods manufacturing as textiles, both cotton and wool, and shoes and leather.

Since 1939, however, New England has steadily increased its durable goods manufacturing, with an apparent reduction in the stability of its factory employment. In the 1947–49 recession, after adjustment for seasonal and long-term trends, total manufacturing employment in the Nation showed a drop of about 13 percent, while the drop in New England was 14.5 percent. In the 1953–54 recession, employment in New England industries fluctuated about the same as that of their national counterparts, except for textiles, which dropped nearly twice as much in the region as in the Nation.

As it devotes an increasing share of its manufacturing effort to durable goods production, New England is, of course, moving into an area in which employment is traditionally less stable. In the recessions since World War II, the Nation's durable goods makers have reduced employment about two and one-half times as much as have nondurable goods producers.

New Englanders have long recognized that the greater maturity of their economy sometimes means that problems of redevelopment must be faced somewhat earlier than in the more recently industrialized regions. In this sense the area serves as a testing ground for new development techniques. The annual reports of this bank for the past 4 years have analyzed in considerable detail the progress of New England's economic development. The most recent report (copy enclosed) verifies that diversification on the part of New England communities provides a measure of insulation from sharp and prolonged employment declines and indicates a continuing need for diversification efforts.

As New England works out of the tragic loss of its major industry, it faces the possibility of other losses due to current dependence on defense production. The largest source of new jobs in the past decade is the production of defense materials—aircraft engines and components in Connecticut and electronic guidance systems and missiles in Massachusetts. Alertness in developing the peacetime applications of discoveries and experience arising from the defense effort is greatly needed.

Your question concerning the adequacy of the monetary system prompts me to mention an innovation in the monetary system that is proving itself. Although this area is exceptionally well served by a wide range of financing institutions, experience with the financing needs of the region led to the identification of a gap in the Nation's financing system. New and growing enterprises need more equity financing if their growth is to be accelerated. In absence of equity funds, these entrepreneurs seek long-term credit from sources willing to assume a greater than normal risk. This is the credit need that is being met by a new financing device, development credit corporations. The general structure of these statewide, privately financed credit corporations was established in Maine in 1949 and has been the pattern for a rapid adoption throughout New England and several other States.

IMPACTS OF TAXING AND SPENDING

Your questions about the effects of Federal, State, and local tax and spending policies call for comments about the variations in their impact on different regions. All too often these impacts are ignored or buried under the weight of other considerations.

The Federal 3 percent tax on transportation is an example. Inaugurated during the war for revenue purposes, its continuance has weighed heavily on railroads whose deficits may foretell bankruptcies. The tax bears most heavily on those resource-deficient areas such as New England that must ship materials in and transport finished products to the consuming markets. The transportation tax likewise places a penalty on those areas that have the longest transportation lines in gathering materials and delivering products. Thus the difference in cents-per-pound delivered price caused by the tax makes it that much more difficult for the distant shipper to compete. The transportation tax is merely one of the Federal excise taxes that restrict trade and investment and are continued largely for reasons of revenue. The broader impact of excise taxes should be reviewed in a thorough study.

The full impact of Federal tax and spending policies on a single region is not easily measurable. It is apparent that some programs have a developmental effect in some regions while their effect in others may be disadvantageous. Both national and regional interests require that each Federal program be considered both in terms of gains for the supported areas and burdens on other areas. Programs adopted for national interests should not ignore problems of adjustment if they are concentrated in specific geographic areas.

The actions of State and local governments frequently have an influence on economic growth that is not sufficiently appreciated. Trends of private investment set the pace of economic growth. Investment decisions as to location of facilities often hinge on small differences. State and local tax and spending policies provide a climate that may be conducive or hostile to private investment.

PRIVATE DEBT

During the recent period of economic expansion, the increased expenditures, particularly for capital goods, supported the strong demand for credit as well as the rapid expansion of private debt. It is interesting to note that business debt increased less, percentagewise than consumer indebtedness or the debt of State or local government units. In connection with consumer debt, the record shows that during the recession in 1949 there was no net reduction in installment credit. Outstandings rose steadily throughout the year. During 1954, installment-debt repayments exceeded new credit in the early part of the year by a small amount, but by late spring the volume had begun to rise again and rose at an unprecedented rate in 1955. In both these recession periods, consumer debt represented a sustaining force part of which undoubtedly reflected long-term growth of this type of credit. I believe that outstandings will grow somewhat less rapidly in the years immediately ahead. Most of the long-term growth of consumer debt may be past. If this is true, then consumer debt can be expected to fluctuate to a greater extent in future expansions and contractions of business activity. It thus may become either an expansionary or a contractive force which will have to be reckoned with in business fluctuations. Favorable features of consumer debt in the last 10 years have been the rapid rate of turn over and the excellent experience with repayments.

MONETARY AND FISCAL POLICIES

The joint answer in section III has dealt at length with the change in monetary policy during the postwar period. I would like to stress that during the period since 1951, which began with the accord, monetary policy has had an influence in producing what might be described as orderly turning points in economic activity. We have been fortunate in that at the upper turning points in the spring of 1953 in the fall of 1957 there was no strong speculative activity, forced liquidation, panic, or severe strain in the capital or money markets. Thus, a contribution of monetary policy has been its performance during its restrictive phase which resulted not only in lengthening the upward movement of business but also limiting the force which would promote acceleration of a downturn. Too frequently, the general observer tends to isolate policy steps and consider them to be abrupt and sharp. They should always be viewed as being part of a continuous process. Continuity of monetary policy provides part of its quality. I would like to emphasize here, as, I am sure, my associates have, that monetary policy works to restrain the force of inflation from causes arising from the monetary side. But it is limited in its performance, and for maximum effectiveness must be supported by other measures of public policy. Monetary policy, however, is an important conditioning factor for all economic activity.

As compared with some earlier periods, public interest, attitudes, and philosophy as regards economic developments have undergone substantial change, and the Government is now generally expected to accept a much larger measure of responsibility for economic policy. This requires careful weighing of the various purposes to be fulfilled and of decisions about the most suitable measures to achieve proper balance in the economic system in all circumstances. Decisions here involve the relation between spending and saving and consumption and investment, as the joint answer points out in several places. A variety of suggestions have recently been advanced for correcting the present recession. Most of these involve direct action on the part of the Congress—cutting taxes temporarily and authorizing large-scale public expenditures for work of one kind or another. It seems to me to be too early to launch steps along this line. If the business decline accelerates, then action of this type will be appropriate. In the meantime, action already taken by monetary policy in developing sufficiently easy credit, and action taken by the Government in speeding up defense expenditures and other projects already in progress may be sufficient.

The course of the recession to date would suggest that if substantial deficit financing were undertaken, either through temporary tax cuts or increased expenditures, inflationary pressures might soon reassert themselves. Restoration of full employment by means of fiscal policy could lead to the resumption of pressures toward higher wages, and they might again rise more rapidly than output per man-hour. Business might also make commitments in anticipation of continuous price increases. We do not now seem to face a long period of extensive underutilization of resources.

It is significant that Congress has made several inquiries about postwar financial developments, as well as searching and useful reviews of the conduct of monetary policy by the Federal Reserve during the last 10 years. Your committee is continuing this work, and has also paid more attention to debt management with its role in relation to monetary policy. I think that inquiry and thought along this line is important. It seems to me that debt management will continue to be of great importance in the future, and we should make every effort to use it in conjunction with monetary policy and fiscal policy as an active instrument.

These and other problems in the monetary and the entire financial areas—private as well as governmental—need, as I have recommended on other occasions, study and review by nonpartisan, professional, or otherwise qualified persons drawn from both public and private life. Such a group could have a membership similar to the National Monetary Commission in 1910 or of the Commission on Foreign Economic Policy in 1954, and would continue and build upon the work of your committee. I cite these Commissions because their membership has commanded respect and their work has been judged of superior quality.

During my career in banking, which dates back to 1920, and particularly since my association with the Federal Reserve System during the postwar period, I have been impressed with the fact that the development of our financial institutions has been logical and evolutionary. Some persons tend to consider the Federal Reserve System as if it were created in 1913 and imposed upon or injected into the middle of our financial arrangements. Actually, the System evolved from what had gone before, and represented a rounding out of our banking structure providing a necessary federation of our independent unit banking systems. In accord with American practice, the System reflects the use of checks and balances of the democratic process, and its decisions reflect opinions of both public and private representative groups. It has also shown an adaptability to change along with changes in our institutions over the years, working toward developing a more effective and efficient monetary system. Whatever arrangements may be developed in the future, it is my strong conviction that sound judgments, rather than automatic formulas, will continue to be necessary in determining public policy. Development of informed understanding and opinion will help to make policy decisions effective.

Sincerely yours,

JOSEPH A. ERICKSON, *President.*

FEDERAL RESERVE BANK OF NEW YORK,
New York, N. Y., March 28, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: I am writing in response to your letter of February 17, 1958, asking for my thoughts and opinions on various matters affecting our economy. Since the presidents of the other Federal Reserve banks also received such a letter, they and I thought at the outset that there might be much benefit to all concerned, including your committee, if we were to work out answers in cooperation with each other to the extent that our thinking was likely to run along parallel lines. This seemed especially desirable in the light of your wish to obtain a prompt reply. We thought that such a mutual discussion of the matters in question would undoubtedly stimulate a cross-fertilization of ideas and would lead to a more thorough and useful response to the difficult questions you had posed. Accordingly, comments have been prepared by the presidents of the Federal Reserve banks, jointly, and a copy of these comments is submitted with this letter.

Since you suggest that the list of questions enclosed with your letter might be used as a guide, and that it was not necessary to follow the list rigidly, it seemed desirable to group our comments under 5 principal headings, representing the 5 principal areas touched upon by your questions.

The comments begin with a discussion of inflation and deflation and a description of economic developments since the outbreak of World War II. That is followed by a discussion of the objectives of monetary policy, and then by a description of the way in which monetary policy has actually been carried out over the period since 1941. The fourth main area is that of fiscal policy and debt management, and in the final section some aspects of the monetary system and some problems of coordination between monetary and fiscal policy are discussed. This concluding area is, however, one in which there is wide room for individual judgment in weighing various factors. It seemed to me desirable in this and other areas to add a personal expression of views. My reply to your letter thus consists of two parts; first, the enclosed set of joint comments prepared by all of the presidents, and second, this letter, setting forth some of the points on which I would like to place special emphasis, or which were not covered in the joint reply.

The first of the five topics focuses attention on the contrast highlighted by your first question, that between inflation and deflation. It seems to me that the term or concept of deflation should not be used as an exact opposite or counterpart of inflation. To me, deflation has always implied a severe decline in prices, accompanying a major economic depression, and usually involving widespread credit liquidation. Inflation, on the other hand, means to me any condition in which the general level of prices is rising, or the purchasing power of the dollar deteriorating—apart from relatively short-lived and moderate price increases that may for brief periods accompany a phase of general economic expansion. To put it simply, I am disturbed, and I think public policy should be concerned, whenever the general level of prices rises for more than a few months at a stretch. Yet it seems to me that public policy should welcome conditions in which the general level of prices might gradually decline, so long as such a decline represented the gradual spreading of the benefits of increased productivity to the general consuming public in the form of lower prices.

More specifically, with respect to the joint answer itself, I would like to supplement the discussion relating to the two charts (p. 28) on productivity and earnings. The discussion of real hourly earnings and productivity should, I would think, be enlarged by some reference to the more usual comparisons between money-wage rates and productivity. It seems to me that a part of the causal force to which much of the price increases of the past 2 or 3 years may partly be attributed is obscured by a simple comparison between real wages and productivity. It may well be that money wages have advanced fast enough to keep the average hourly wageworker receiving a proportionate share of the real output per man-hour. But there is also a question as to whether the repeated increases in money wages through which this has been brought about may not have exerted upward pressures on costs of such intensity that they contributed to a spread of inflationary price developments, which, in turn, played some part in causing the turn from expansion to contraction that occurred in the latter part of 1957.

On the second subject, the objectives of economic policy, it has seemed to me that, as a practical matter, the objective of stability of production and employment is inseparable from the objective of promoting the long-run growth of the economy. Stability, in a static sense, is unacceptable as an objective for, if it persisted for any extended period, it would, in fact, mean retrogression. On the other hand, while some fluctuations must be expected, and may even be desirable in the interest of efficiency and progress, instability, in the form either of substantial overexpansion or serious contraction in major areas of the economy, is inimical to sustained growth. The need for combating cumulative contraction of production and employment is obvious. Yet the invariable tendency for recession to follow attempts to expand too rapidly in too short a period of time seems to be a lesson which, historically, has had to be relearned repeatedly; policies designed to restrain booms have frequently been unpopular and have usually been vigorously opposed by those most directly affected, even though their best interests were likely to be well served by such policies in the long run.

I am convinced, also, that the objective of overall price stability is in harmony with the objective of sustained growth. Fluctuations in prices of particular commodities and services in response to changes in supply and demand are necessary and desirable to promote the proper allocation of resources. But substantial changes in the general level of prices in response to general forces, whether monetary or other, serve no such useful purpose and are, in fact, likely to be inimical to sustained growth. It would be unreasonable, however, to expect complete stability in the general price level so long as there are appreciable fluctuations in business activity. In past periods of rapidly expanding activity, the price level has usually risen, and in periods of recession prices have usually fallen. Consequently, monetary and other economic policies designed to restrain price advances served at the same time to restrain tendencies toward overexpansion in major areas of business activity, and policies designed to check recession also served to prevent any serious deflationary tendencies in prices.

The most disturbing economic development of recent years has been the indication that this symmetry between expanding business activity and price advances, on the one hand, and declining business activity and price reductions, on the other, has been impaired if not destroyed, so that there has been a tendency toward progressive depreciation of the value of the currency and of money savings. With the exception of basic commodities, costs and prices seem to have become subject to increasing rigidity, so far as downward adjustments are concerned, while showing no lessened responsiveness to upward pressures. This development is the basis for fears of recurrent and cumulative erosion of the purchasing power of the dollar, and poses a serious problem for national economic policy generally. Governmental action to maintain, or to restore, high-level production and employment runs the risk of accentuating or renewing the inflationary trend, while there is serious question whether the upward price trend can be stopped without causing or at least permitting substantial curtailment of production and employment. Yet acceptance of progressive inflation would place a premium on speculative activities at the expense of constructive investment and so interfere with sustained and balanced growth, quite aside from the inequities involved.

It is with that kind of dilemma that the Federal Reserve System has been faced during the past 3 years. It has been, and is still, our hope that high—and rising—levels of production and employment can be reconciled with stability in the value of money, and our efforts have been directed toward that combined objective. But we have neither claimed nor thought that monetary policy alone could achieve complete success in its pursuit.

Nonetheless, in my opinion, the monetary policies that have been followed in recent years have had some real success, on balance. Business activity and employment generally have held at high levels for a considerable period; price advances have at least been no greater or more rapid than in some earlier periods of expansion; and, by historical standards, recessions of the postwar period have been mild and of relatively short duration. Admittedly, however, any successes we may have had have been only partial. It is sometimes said that restrictive monetary policies have been unsuccessful in stopping inflation, but at the same time have been responsible for a contraction in business activity and employment. Yet it seems clear that the sectors of the economy that have shown the most pronounced declines in recent months are those that had previously shown the greatest expansion, such as business capital investment and inventory accumulation—not the areas, such as residential building and state and municipal projects, that were said to have been most affected by tight money conditions. And there are grounds for believing that the "capital goods boom" and the inventory accumulation would have gone farther, with consequent likelihood of more drastic curtailment now, if it had not been for the greater difficulties and costs of financing them during 1956 and much of 1957.

But, even though we recognize that monetary policy alone cannot be expected to assume full responsibility for preventing inflation and for combating unstabilizing forces in the economy, and even though we believe that the policies of the Federal Reserve System in recent years have on the whole been the correct ones, we still feel that we should give serious thought to how our performance could be improved and made more effective. One question to be considered is whether the presently available instruments of monetary policy are all that are needed for appropriate and effective action. Another is whether there are organizational or other improvements that might result in better use of available policy instruments. Perhaps the most basic and most difficult question of all is one which applies to all aspects of national economic policy—how can we improve our ability to appraise current and prospective economic developments more accurately? If we could foresee more clearly impending developments, the chances of success in efforts to minimize booms and recessions presumably would be considerably increased.

With respect to instruments, it now seems clear that the general instruments of credit policy—those that affect the availability and cost of credit broadly—must be the backbone of an effective credit or monetary policy. Without the support of general credit restriction, attempts to limit the use of credit for specific purposes tend to break down. Still, it may be worthwhile to consider whether the recent tendency to minimize the utility of selective credit controls may not have been overdone. Undoubtedly they have their undesirable features. Even the most generally approved type—the regulation of security loan margins—has the disadvantage of tending to narrow the market for securities. Yet the absence of a huge volume of indebtedness for securities carried on margin accounts, such as existed in 1929, is one of the important grounds for confidence that we need have no fear now of a repetition of the experience of the early thirties.

But it is at least conceivable that the capital goods boom since 1955 would not have been of the same magnitude, that inflationary pressures would have been less strong, and that there would now be less need for readjustment, if it had been possible to take direct measures to restrain the expansion of consumer credit and mortgage credit, and thereby restrain the housing and consumer durable goods boom of that year. Despite the voluminous and exhaustive study of consumer credit controls that was completed only a year ago, and the vociferous objections from interested parties to such controls, perhaps the issue should not be considered closed if we are really serious about minimizing economic instability. I can assure you, however, that there exists in the Federal Reserve System no bureaucratic urge to administer such controls—quite the contrary. Perhaps if consideration should again be given the question of giving the System standby authority to apply such controls in the future, it might be worthwhile to study the experience of other countries, where enforcement, as distinguished from policy formulation, is in many cases administered by an agency other than the central bank. I do not question the usefulness of consumer credit in facilitating the purchase of items of substantial cost, nor am I disposed to pass judgment on the question of whether the absolute level of consumer indebtedness at any given time is too high. My concern, rather, is with the effects of rapid acceleration or deceleration of the growth of consumer credit on the stability of production and employment.

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Similarly, the experience of recent years suggests that if greater stability in residential building is to be achieved, it may be necessary to consider granting the appropriate agency standby authority to vary the terms of Government insured or guarantied mortgages, and interest rates on such mortgages as well, to keep them competitive with alternative investments. I am not suggesting that such authority be assigned to the Federal Reserve System.

There have also been suggestions in recent years that the rapid growth of the various types of savings institutions and other credit-granting organizations (financial intermediaries), not subject to regulation by the Federal Reserve System, has weakened the effectiveness of monetary policy, and that such institutions should, therefore, be made subject to some form of governmental regulation. I agree with the statement in the joint reply that this is a matter on which conclusions should await comprehensive and thorough study of all the financial institutions and practices of the country. I have long felt that such a thorough study should be undertaken by a highly competent and impartial group, either with or without governmental sponsorship. Consequently, I am hopeful that the present studies of the Senate Finance Committee, considered in conjunction with those announced by the Committee for Economic Development, will provide the broad basis for the kind of exhaustive analysis that we need.

The question in the list enclosed with your letter concerning the adequacy of the monetary system might be interpreted to include not only the deposit banking and currency system and the instruments of monetary policy, but also the organizational structure of the Federal Reserve System, especially as it concerns participation in policy decisions. I believe that the organization and assignment of responsibilities that has evolved over the years is well adapted to the purposes and functions of the Federal Reserve System. Authority over the various policy instruments is assigned to various groups within the System—the Board of Governors, the Federal Open Market Committee, and the boards of directors of the Federal Reserve banks—. but I see considerable advantage and no serious disadvantage to this dispersion of responsibility. It affords opportunity for participation by all parts of the System, representing a wide range of experience, in the consideration of policy problems, and at the same time there is assurance of effective coordination of policies through the frequent meetings of the Federal Open Market Committee. Some years ago the presidents of the Reserve banks suggested to a congressional committee that it might be desirable to concentrate authority over all the principal instruments of credit control in the Federal Open Market Committee. While I have reached no firm conclusion on this matter, I think it may be worth consideration.

The presidents of the Federal Reserve banks come to the meetings of the Federal Open Market Committee, not as instructed delegates of their boards of directors—and certainly not of the member banks—but as professional central bankers engaged in a career of public service, and motivated by the desire to serve the public interest broadly to the best of their ability. They come prepared with information on current regional and national economic developments and trends obtained from their directors, technical staffs, and others, and after consultation with their staff advisers. And it has been my observation that Reserve bank directors approach their duties from the viewpoint of an opportunity and a responsibility for public service.

With respect to the problem of improving the economic analyses on which our policy decisions must be based, I have no suggestion other than unremitting effort to attract and hold in career service the most competent staffs we can obtain, and to make the best use of all available information.

Turning to the subject of fiscal policy, the joint reply comments on the difficulty of using tax reduction or an increase in Government expenditures to exert a sustaining influence on production and employment, in view of the time lags involved in reaching decisions and in putting them into effect. My own feeling is that there is a greater possibility of effective action than this would suggest, especially in the area of tax cuts. It seems to me that while the time needed to reach a decision on tax rates is undoubtedly greater than that required for monetary policy decisions, the effect of a tax decision, once taken, could conceivably be fairly prompt. All things considered, I would think that a carefully designed tax cut is likely to be a considerably more prompt and flexible instrument for combating a recession than is an increase of comparable magnitude in Government spending. This is not to deny in any sense the usefulness, under such circumstances, of speeding up existing sound Government spending programs as much as possible. I would stress, however, that no fiscal measures to combat recession should be taken, with all that they may imply in the way of future inflationary problems and difficulty in reversing such moves, unless it seems reasonably clear that failure to use them involves a real risk of more serious recession.

As for the use of debt management as a positive instrument to reinforce countercyclical fiscal and monetary policies, the enclosed report suggests three alternatives, of which the third embodies a compromise approach, with the Treasury generally avoiding the floating of large-scale issues of long-term securities, and instead doing any long-term financing from time to time on a modest scale, in both good times and bad. While the report avoids specific recommendations in this field, the implication is that this may be the best of the three alternatives, and with that conclusion I have no quarrel. It seems to me, however, that there is considerable room for experimentation in this area—that there may be other equally sound or sounder methods of compromising between the two extreme positions—and that there may be periods in which large-scale long-term issues would be highly desirable, and other periods when the Treasury might well wish to concentrate on short-term issues. In other words, I am reluctant to concede, without further experimenting, that debt management is of limited use as an instrument of anticyclical economic policy.

One question in the list that accompanied your letter relates to the possible need for changes in present monetary and banking laws or for new laws. In this area I would first like to express the hope that the Financial Institutions Act already passed by the Senate and now under consideration in the House will soon become law. While this act does not attempt to deal with some of the larger policy questions pertaining to monetary and credit control, it would perform a highly useful function in providing a number of much-needed changes and in generally bringing about a clearer and more systematic statement of existing laws.

There has been much discussion during recent years on the merits of inserting a clause in the declaration of policy in the Employment Act of 1946 making the maintenance of price stability a stated objective of Government economic policy. The closing phrase of the declaration, which refers to promoting "maximum employment, production, and purchasing power," has been interpreted as meaning maximum sustainable levels, and we believe that requires avoidance of either inflation or deflation in any marked degree. I would, therefore, favor the proposal that the declaration of policy be amended to include explicitly stability of the value of the dollar among the objectives of national economic policy.

Yours sincerely,

ALFRED HAYES, *President.*

FEDERAL RESERVE BANK OF PHILADELPHIA,
March 31, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate,
Washington, D. C.

DEAR SENATOR BYRD: Since Mr. Alfred H. Williams retired from the presidency of the Federal Reserve Bank of Philadelphia on February 28, 1958, I am responding as his successor to the questions you addressed to him in his official capacity.

I share the view of the presidents of the other Reserve banks that we will make our maximum contribution to your extremely important inquiry if we follow generally the procedure established in responding to the inquiries received from Senator Douglas in 1949 and from Representative Patman in 1951. This procedure has the great advantage of assuring that the whole area of your interest will be covered while enabling each president to concentrate on those aspects that concern him or that have occupied his particular attenton over the years and on which his judgment may be of some value. My complete response, therefore, consists of the enclosed document "Comments in Response to Questionnaire of the Senate Finance Committee," which was prepared by our staff committee, and this covering letter.

I am sure you appreciate that discharge of imperative but unique time-consuming duties during my first month in office has made it impossible to devote as much time to the inquiry as its importance requires or as much time as I desired to give. My available time, therefore, was spent on a discussion of a few basic ideas. It has not been possible to develop necessary qualifications or to polish the phraseology.

The discussion is directed to three questions, as follows:

1. Has the rapid development of financial intermediaries changed the essential role of general monetary policy?

2. Has market structure been the source of uneven impact of credit restraint?

3. Should the monetary authorities direct their policies toward achieving a predetermined rate of growth of the economy?

1. Has the rapid development of financial intermediaries changed the essential role of general monetray policy?

A view that has gained considerable support in recent years is that the rapid development of financial institutions other than commercial banks has weakened seriously the influence of central banks and the role of general monetary policy. Stripped of qualifications, the reasoning that leads to this conclusion runs about as follows:

The monetary authorities regulate the amount of reserves available to the commercial banks. Commercial banks adjust their lending and investing activities to their reserve positions and thus influence the amount of deposit money. When reserves are tight in a period of restraint, banks will limit their lending by charging more and by screening applications more rigorously. If banks are the only source of credit open to borrowers, the restraining monetary policy can be effective. If, on the other hand, borrowers can turn to other sources, the influence of the monetary authorities is dissipated.

My own view is that the essential ingredient of general monetary policy is the power of the monetary authorities to influence significantly the terms and conditions under which the public can secure the amount of cash balance that it needs. This judgment in turn is based on the belief that the attractiveness of cash relative to debt assets on the one hand and real assets on the other influence the flow of expenditures and thus the general level of economic activity.

The power of the Federal Reserve System to tighten credit may be measured in dollar terms by its portfolio of earning assets plus the amount by which existing member bank reserve requirements fall short of the legal maximum. The order of magnitude at present is in excess of $25 billion. The power of the System to ease credit is limited by the requirement that the Reserve banks maintain a gold certificate reserve equal to at least 25 percent of their note and deposit liabilities and by the extent to which existing member bank reserve requirements exceed the legal minimum. The dollar amount at present exceeds $40 billion. The magnitudes are obviously adequate in both directions.

I do not wish to create the impression that it is easy to decide the terms and conditions that are appropriate at any given time to produce the desired results. On the contrary, I have found this an extremely difficult and not always successful undertaking. But that is the basic decision on which attention should be focused.

As far as financial intermediaries are concerned, it should be remembered that they do not operate in a vacuum. They operate in organized and in customers' money and capital markets which are influenced by monetary policy. In fact, one consequence of the institutional developments of recent decades is that both borrowers and lenders have more options. A man who wishes to finance the purchase of a house or of an automobile can apply at several different types of institutions. Alternatively, one who wishes to save in liquid forms has numerous options. Banks and other institutional lenders in turn may lend to consumers, to homeowners, to business firms, and others. Is it not reasonable to suppose that as the number of options increases—as the network of credit contacts becomes more elaborate—the influence of the monetary authorities permeates the economy more thoroughly and more quickly? Incidentally, doesn't the widespread ownership of the Federal debt operate in the same direction? Doesn't the credit market become more fluid and doesn't the burden of distributing credit fall more on price and less on administration or rationing?

Nevertheless, the allocation of credit among competing users is an area of recent financial developments that merits much more study. So, also, does the question of competitive relationships among various financial institutions.

My judgment as to the nature of the problem that confronts us is reinforced by an analysis of two earlier instances in which some observers also concluded that central banks were losing their effectiveness.

Although the two episodes differ in detail from current developments in the United States, the basic issue is the same. It is that growing competition of other lenders who presumably escape control can nullify the effects of actions by the central bank. At times the complaint was directed against competition from other banks with limited powers of issue and at times against competition of commercial banks with the central bank rather than between nonbank and bank lenders, but the essential core of the problem has been the same.

The first episode concerns the operations of the Reichsbank from 1876 to 1914. During the first half of the period the complaint was that the banks with limited powers to issue notes were nullifying the powers of the Reichsbank and during the second half it was that the commercial banks were doing so.

The case of the Reichsbank is particularly relevant because the mechanism of control, when viewed from today, was so loose-jointed. The facts are that: (1) before the First World War the Reichsbank paid virtually no attention to reserve balances and ordinarily did not even know what their magnitude was; (2) it did not try to establish their amount at predetermined levels; (3) it was not in a position to do so quite apart from the question of controlling its own assets because of the magnitude of the variations in its other accounts; and (4) German commercial banks did not maintain either their reserve deposits at the Reichsbank or their total primary reserves at any customary relationship to deposits.

The argument was that any pressure the Reichsbank tried to exert could be absorbed by the other banks through the simple expedient of allowing their own reserve ratios to decline. In fact, by allowing their ratios to decline sufficiently, they could move in the opposite direction from that desired by the Reichsbank. Similarly, they could absorb any ease the Reichsbank was trying to create by allowing their reserve ratios to rise.

There is, of course, something to this argument. By allowing their reserve ratios to vary, the other banks could absorb or release some of the reserves the Reichsbank was creating or destroying. It does not follow, however, that they could defeat the Reichbsbank's intentions. What the variable reserve ratios meant was that the Reichsbank had to conduct operations on a larger scale in order to achieve a given result because it had to offset the effects of the actions of the other banks.

The fact is that the Reichsbank had sufficient power at all times to do this. Whatever reserves the commercial banks wished to keep had to be secured from the Reichsbank whose earning assets were always much larger than the total cash assets of the commercial banks. The Reichsbank was also able to influence directly the terms and conditions under which certain other borrowers acquired cash because it was a large commercial bank as well as the central bank. A conclusive demonstration of the Reichsbank's power is that it was able, despite all these impediments, to achieve throughout this period its overriding objective, which was to maintain convertibility of the mark.

The second episode concerns the Bank of England in the 19th century. Prof. Elmer Wood, of the University of Missouri, has made an exhaustive study of the experience. The question at that time was whether the so-called country banks which had authority to issue redeemable notes could escape the control of the Bank of England by reducing their reserve proportions. Professor Wood concludes that they could not do so because, as he puts it, "at no time down to 1913 were the total private securities of the bank unmanageably small in relation to total bankers cash. Whether the banks, therefore, chose to adjust their reserve proportion at 8 percent or 15 percent, the terms of the bank had to be met."

I have cited these two experiences because they contain elements that are relevant to our own problem. Indeed, the conditions that presumably impeded the Reichsbank and the Bank of England were stronger than the conditions now confronting the Federal Reserve System. They were dealing with money-creating institutions whereas we are concerned with financial intermediaries. These latter can influence the flow of purchases, which is what really concerns us, only by affecting the efficiency in the use of money, or velocity of circulation as it is called technically, whereas the former could influence not only velocity but the actual quantity as well.

2. Has market structure been the source of uneven impact of credit restraint?

An area of general monetary policy that needs much more study than it has yet received is the precise impact of that policy on various sectors of the economy. My immediate concern about this problem is that some observers are tempted to reach firm conclusions on what seems to me to be limited analysis and evidence.

We must begin by recognizing that if credit restraint is to be effective it must result in postponing some spending that would otherwise have taken place. It is obvious that these postponements will not be proportional to the actual expenditures of all spending units. The impact will not be uniform.

I shall analyze briefly one theory that has been advanced to describe the differential impacts. This is not a field in which I have specialized and the analysis is tentative. My sole purpose is to indicate that we should not rush to adopt solutions before we understand the problems that confront us.

The particular theory is that general credit restraint sorely handicaps competitive-price industries and leaves virtually untouched the administered-price industries. In some versions, the conclusion seems to result from a rather unusual classification of industries between the two categories, with housing and "other industries where firms are small and numerous" classified as competitive-price industries.

The inclusion of housing is particularly interesting. Since housing starts fell from about 1.3 million in 1955 to 1.1 million in 1956 and to

1.0 million in 1957, it is tempting to some to include home building among competitive industries.

It seems to me that prices of new houses are administered prices; just as administered as, say, the price of an automobile at the dealer's showroom. There are many thousands of home builders in this Nation. But housing sells in a local market. Housing starts in Los Angeles have little or no effect on house prices in Philadelphia. Each home builder erects individualized houses. His price is determined by his costs, the home's location, and what he thinks the market will pay. But he sets the price. It is no more subject to fluctuation than most other administered prices. (In this connection it is interesting to note that housing prices were 7 or 8 percent higher in 1957 than in 1955, despite a decline of one-fifth in starts.)

Perhaps it would be profitable to debate whether home building is a competitive-price industry. Certainly, there is room for some argument. But there is widespread agreement as to why credit restraint had an unusually severe impact on housing in 1956 and 1957. And the answer has nothing to do with market structure. The figures below pretty much tell the story.

Private starts

[In thousands]

	FHA	VA	Conventional
1955	276.7	392.9	630.9
1956	189.3	270.7	633.9
1957	168.4	128.3	694.4

Housing starts slumped off in the Government guaranteed and insured sector. There was an actual increase in houses started under conventional financing. (No one would want to argue that home building of conventionally financed housing is characterized by administered prices and that Government-insured starts are competitively priced.) The "sticky" interest rates on FHA and VA mortgages unquestionably had a great deal to do with this disparity. Interest yields for lenders on Government-insured mortgages were not attractive. Funds went elsewhere.

Housing starts vere dramatically affected by tight money, not because home building is a competitive-price industry but mainly because FHA and VA interest rates did not slide freely with general interest rates.

Some of those who emphasize market structure classify "other industries where firms are small and numerous" as competitive-price industries. Not all small businesses, however, fall neatly into this category. For example, there are smaller manufacturers of appliances, of steel, of automobiles.

The question of whether credit restraint handicaps small business unduly is now being studied extensively by the Federal Reserve System. My own judgment will be deferred until that study is completed. At this point I certainly am not convinced that small businesses in administered-price industries escape the effects of credit restraint while those in competitive-price industries feel the effects unduly.

Agriculture is another industry on which credit restraint is alleged to have had undue impact because it is a competitive industry. We should recognize at the outset that not all of agriculture is competitive. We may admit that we do not know the answer.

We do know, however, that we had a farm problem before we had tight money. We also know that even with tight money our farmers were able to grow more farm products than the market would take. It seems likely that difficulties in the farm sector arose not primarily because it was a competitive price industry; but rather because the industry has been undergoing a basic readjustment. It was a weak industry before, during, and after tight money.

The general idea that monetary policy might have an uneven impact is not new. Few individuals would assume that a very broad-based, general control of credit must have an exactly proportionate impact on the various firms and industries within our economy. Obviously, there are times when certain sectors will be more responsive to monetary actions. The reasons for this uneven impact are not difficult to understand. A restrictive monetary policy, stripped to its bare essentials, is supposed to bring current investment spending into line with the current volume of savings.

Investment spending pretty much depends on current sales and profit margins and on an evaluation of future sales and profit potentialities. If firms are enjoying high levels of demand pressing on current capacities, and if it appears demand will grow as the economy expands, these firms probably will be inclined to increase spending for inventory and to enlarge productive capacity. This is especially the case if current price levels are enabling good profit margins. Firms with less buoyant demand, somewhat dimmer prospects, and poorer profit positions are not so strongly inclined toward freewheeling spending on inventory and new plant capacity.

A policy of credit restraint probably will seem to have a much more immediate and drastic impact on the latter firms. The firms themselves will be more readily discouraged by the increased cost of borrowing. In addition, lenders will tend to screen out these firms as less creditworthy than some others. These seemingly obvious points must be pressed to show that these differing demand and profit positions, which explain the uneven impact of monetary policy among firms, can also explain its uneven impact among industries.

Surely, during any boom period the demand for the products of some industries is stronger than that for others. Investment spending of these industries will seem less affected by credit restraint than others where demand pressures and profit positions are not so strong.

I have presented this analysis to indicate why I am not convinced that market structure was responsible for such uneven impact as the credit restraint in 1956 and 1957 may have had. This, of course, is not the same thing as saying that administered-price industries respond to credit restraint in the same way as competitive-price industries. They probably do not.

Prices in administered-price industries very possibly respond somewhat slowly to changes in demand. In these industries the initial responses to a decline in demand are likely to occur in cutbacks in production and employment. Competitive-price industries probably respond in a different manner. Prices in these industries are more likely to be immediately sensitive to changes in demand. Changes in production and employment would come about somewhat more slowly.

If this likely sequence of responses is accurate, it has implications for monetary policy. Since a large fraction of our measured prices are set by administrative action, it may mean, for example, that the Consumer Price Index is a tardy indicator of the impact of monetary policy.

3. Should the monetary authorities direct their policies toward achieving a predetermined rate of growth of the economy?

A rising standard of living in the sense of more goods and services to consume is made possible only by an increase in real output per capita. Let us admit that growth is desirable; it does not follow that monetary policy should be directed toward achieving a predetermined rate of growth each year. It is possible that policies directed toward that goal could actually inhibit long-term growth.

Economic growth is compounded from many ingredients. One of the most important is that some individuals are motivated by an insatiable desire to comprehend the universe of which we are a part and devote their lives to what has been called basic research. It is the men of genius in basic research who have contributed most to our progress. I believe such individuals flourish most in an environment of freedom. In the interest of growth, I would promote such an environment rather than place on it the limits that might be necessary to achieve a specified rate of growth in the short run.

Related to basic research in achieving growth is technological progress. Technology embraces the application of a wide range of human knowledge to the productive process. It includes scientific discoveries as well as the invention of new machines and new processes of production. The development of new seeds and improved breeds of livestock has contributed significantly to the increase in agricultural output. It was the work of scientists which led to such significant discoveries as synthetic fibers, plastics, electronic products and processes, and atomic energy. Restless minds and scientific research are the sources of innovation—in materials, in productive processes, in machines, and in managerial skills.

New discoveries and new inventions in themselves, however, add little to our total output of goods and services. There remains the problem of fashioning an efficient process for producing the product, building a plant and equipping it with the necessary machinery, and developing a market in order that the product may be produced in volume. This is the work of the entrepreneur. For scientific discoveries and innovations to be fruitful, substantial sums are usually required for investment in plant, new machinery, and equipment.

Another ingredient of economic growth, therefore, is saving and investment. If we are to have the investment that technological progress requires, we cannot consume all of our current output. There must be saving—abstaining from current consumption—to release resources for the capital goods needed in expanding our productive capacity. The more we consume, the higher our current standard of living but the slower our rate of economic growth. The more we save and invest the lower our current standard of living, but the more rapid our rate of growth.

Productive capacity is determined by the character as well as the total volume of investment. Some types of investment contribute to productive capacity more than others. Investment in houses and durable consumers goods, for example, usually adds less to productive capacity than investment in manufacturing plant and equipment and in mining.

Mobility of resources is another ingredient of economic growth. Technological progress means change. Change is the essence of a dynamic growing economy. As industries producing new products expand, those producing products rendered obsolete decline. Growth will tend to be more rapid, the more promptly labor and capital shift to meet changing demands. Attempts to support or prop up declining industries, by postponing the shifting of resources, retard the rate of economic growth.

Another ingredient of growth is the intensity and nature of the desires of the public. People work because they want something—more food, better clothing, an automobile, a home, better education for their children, more security. In this country a strong desire for such things has been a powerful force in stimulating demand for goods and services, and in providing the human and material resources necessary to produce them. With a lesser desire for material things our rate of economic growth would undoubtedly have been slower.

The rate of growth thus depends largely on choosing among alternatives—choices that involve basic social as well as economic values. In the present state of international tension, adequate defense is essential for our security, and to protect our freedom. If we are to preserve our way of life, defense needs must have priority in the allocation of our resources. The large volume of expenditures required for adequate defense provides strong support for a high level of total output. It also provides a strong tendency toward instability. As new weapons are discovered, old ones are rendered obsolete. Labor, plant, and equipment must be shifted from the old to production of the newer type weapons. The recent shift in emphasis from aircraft to missiles is a case in point. Even though total defense expenditures remain the same, a shift in the pattern of expenditures may result in declining production and employment in some industries and an increase in others.

Another choice that has a significant influence on our rate of economic growth is the division of current output between consumption and saving and investment. This raises a baffling question, particularly with a standard of living as high as that which now prevails in the United States. To what extent should we abstain from consumption and reduce our current material standard of living in order that posterity, which, barring a nuclear war, will almost certainly have a higher standard in any event, may have an even higher standard of living? What is the optimum blend of consumption and saving, in terms of human welfare—social and spiritual as well as economic?

Growth also depends in part on our relative preference for progress and security. Technological advances open up new opportunities but they also inflict losses and hardships. Some of our existing investments are rendered obsolete and workers trained and experienced in the older technology may find that their services are no longer in demand. Temporary unemployment and losses on existing investments are a part of the price we pay for changes which contribute to growth. The desire to protect existing investments and jobs frequently leads to attempts to delay the introduction of new and improved technology. The price of such temporary security, however, is a slower rate of economic growth.

Another factor influencing the rate of growth is the proportion of our population employed and the number of hours worked per week. The larger the proportion of the population employed and, within limits, the longer the hours worked per week, the higher output per capita will be. Should the labor force be enlarged by encouraging youths, women, and older people to take jobs? Would the additional output thereby achieved be worth the sacrifices involved in terms of the education and training of youth and life in the home? Which would provide greater satisfaction—more leisure or having the larger amount of goods which might be produced by working longer hours?

Directing monetary policy toward the attainment of a predetermined annual rate of growth involves some basic difficulties. One is that a decision as to specific rate of growth to be used as a target involves appraising a whole range of intangible human values. How does one determine whether it is economically and socially desirable to consume less now in order to have more in the future? To undergo temporary hardships and insecurity to promote progress? To have substantial inequality in income which would provide a stronger incentive for individual effort and initiative? Or to use more of our time for work and less for leisure? Choices such as these have a significant influence on the welfare of the individual as well as that of society as a whole.

A second difficulty is that monetary policy has little direct influence on the principal ingredients of economic growth. It is not an effective means for directly influencing research and the rate of technological progress; promoting individual freedom and initiative; or encouraging people to work more rather than to enjoy more leisure. It is for this reason that undue emphasis on growth as such would tempt the authorities to search for more effective weapons. Directing the flow of credit to "preferred" uses is an obvious possibility. Should we elect to go down that road, I fear we would discover in due course that we had created more problems than we had solved and that our actual rate of growth or our current standard of living would be less.

My conclusion is that monetary policy can make a significant contribution to growth. It can make its maximum contribution, however, by promoting an economic environment favorable to growth not be seeking to achieve a predetermined rate of growth.

Monetary policy will make its maximum contribution by promoting a reasonably full use of resources at a reasonably stable level of prices. An appropriate supply of credit and money should be made available to foster rather than inhibit growth. Beyond that, however, the factors determining the precise rate of economic growth can best be left to the decisions of individuals rather than to the monetary authorities or any central agency.

In conclusion, I appreciate your invitation to express my views on the vital matters before you. I have done my best within the time limit that you mentioned in your letter of February 17, 1958, to Mr. Williams.

Sincerely,

KARL R. BOPP, *President.*

FEDERAL RESERVE BANK OF CLEVELAND,
April 14, 1958.

Mr. SAMUEL D. MCILWAIN,
Counsel, Senate Finance Committee
Washington, D. C.

DEAR MR. MCILWAIN: This is in response to your telephone request of April 10, regarding the printing of the central document of the Reserve banks presidents' answers to Senator Byrd's 17 questions.

I am pleased to provide you with two copies of the following material which has been lifted out of my report:

1. Monetary Policies Since 1941: (a) Graphic summarization (17 pages, plus 8 sheets (1 set only) of original art work).
2. Objectives of Economic Policy (1 page).

The first item above represents pages 3–19 of my report; the second consists of most of the contents of page 53 of my report.

I should like to emphasize that my report did not incorporate all of the text of the central document. In fact, a considerable portion was omitted in order to avoid an undue amount of repetition. The omissions, however, did not, in my opinion, alter the general sense of the central document.

Sincerely,

W. D. FULTON.

PART I. MONETARY POLICY SINCE 1941

(A) GRAPHIC SUMMARIZATION

Monetary history from 1942 to 1957 falls readily into 8 successive phases, each of which differed quite significantly from its predecessor in terms of the prevailing economic environment.

The 8 phases are discussed in chronological order in the following 8 pairs of pages. On the *left* page there is indicated the type of monetary action which was *theoretically* appropriate in view of the concurrent behavior of average prices and of the general trend of economic activity. On the *right* page there is a review of the developments which *actually* occurred in the realm of monetary affairs.

It will be noted that the type of monetary policy suggested by the movement of *prices* was not always compatible with that suggested by contemporary trends in *economic activity* (production and employment).

1942

JAN	FEB	MAR	APR	MAY	JUN
JUL	AUG	SEP	OCT	NOV	DEC

1943

JAN	FEB	MAR	APR	MAY	JUN
JUL	AUG	SEP	OCT	NOV	DEC

1944

JAN	FEB	MAR	APR	MAY	JUN
JUL	AUG	SEP	OCT	NOV	DEC

1945

JAN	FEB	MAR	APR	MAY	JUN
JUL	AUG	SEP			

Period covered: 1942 to mid-1945.
Appropriate monetary policy suggested by—

Trend of prices	*Trend of economic activity*
RESTRAINT	RESTRAINT
(In the face of rapidly rising incomes, prices were relentlessly moving upward, either by reluctant sanction, or by threat of black markets.)	(Pressure of demand was almost continuously in excess of capacity to produce.)

THE HISTORICAL RECORD

Monetary restraint, however desirable theoretically throughout the war period, was almost totally foreclosed by the following announcement shortly after Pearl Harbor:

> The Federal Reserve System is prepared to use its powers to assure that *an ample supply of funds is available at all times for financing the war effort*, and to exert its influence toward maintaining conditions in the United States Government security market that are *satisfactory from the standpoint of the Government's requirements.*

In the face of the national emergency, a commitment of this type seemed almost inescapable. It proved unfortunate, however, that so large a part of the war's cost was financed by means of an inflationary expansion of bank credit.

Pursuant to the foregoing commitment, over the period the Federal Reserve System purchased $19 billion of United States Government securities. It is true that most of this acquisition ($18 billion) served merely to offset the concurrent drain on member-bank reserves caused by the outflow of currency (into circulation) and gold. Nevertheless, in view of the $3½ billion excess reserves already in existence at the time of Pearl Harbor, combined with some further additions of new central bank credit during the war, member banks were able to expand their holdings of United States Government securities by nearly $53 billion. Accordingly, the Nation's money supply (checking account balances and currency) more than doubled during the 3½-year period.

Period covered: Mid-1945 to mid-1946.
Appropriate monetary policy suggested by—

Trend of prices

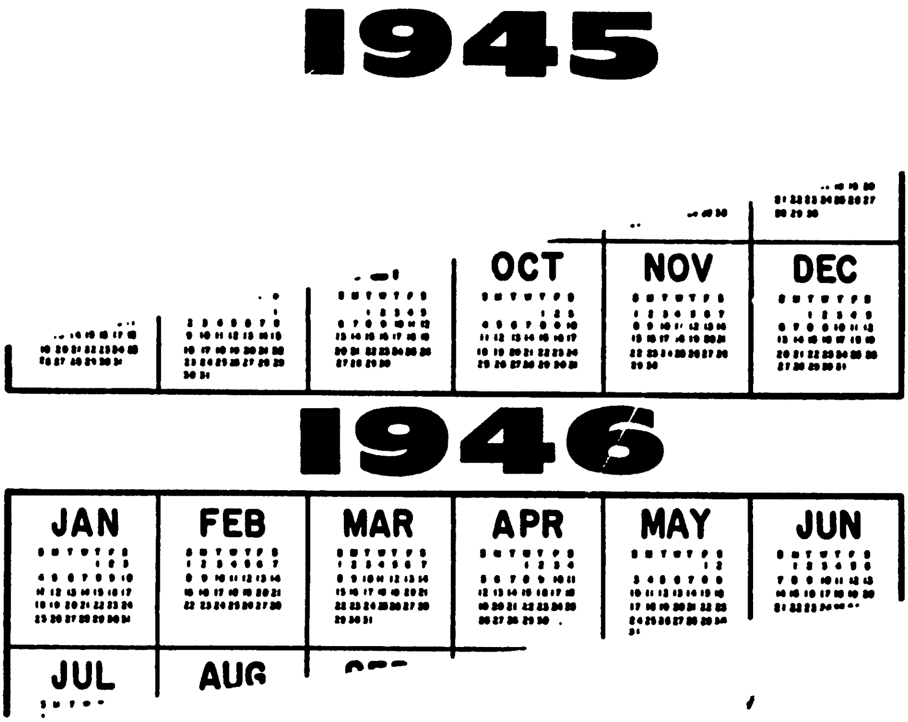
RESTRAINT

(Prices rose sharply as war-accumulated purchasing power pushed against a continuing shortage of many civilian goods.)

Trend of economic activity

EASE

(Considerable unemployment developed while readjustment to civilian economy was taking place.)



THE HISTORICAL RECORD

In view of the subsequent boom it is a matter of some curiosity that bank credit expanded only very moderately during the reconversion phase. The expansion occurred in the form of bank loans (not investments), where a 10 percent expansion presumably expedited conversion to civilian production.

The wartime commitment regarding interest rates on United States Government securities presented no problem to the System during this 12-month period. Long-term money rates in particular reached record low levels without active intervention by the System. System purchases of United States Government securities ($1.9 billion, net) were only enough to offset a concurrent further outflow of currency.

During this interval margin requirements on stock-exchange collateral were increased in 2 steps from 50 percent to 100 percent. Also, somewhat later, the one-half of 1 percent preferential discount rate on short-term Government securities was discontinued.

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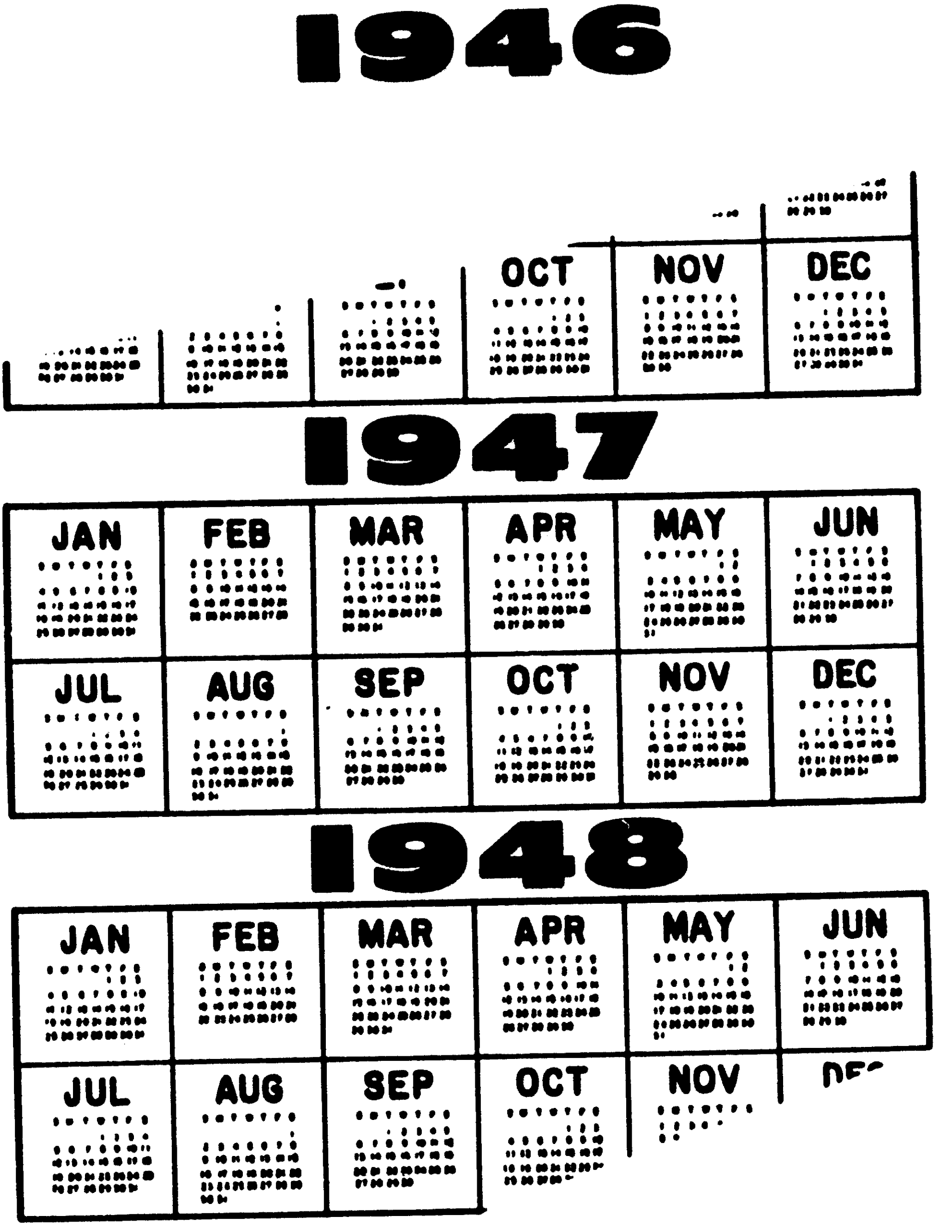
Period covered: Mid-1946 to late 1948.
Appropriate monetary policy suggested by—

Trend of prices	*Trend of economic activity*
RESTRAINT	RESTRAINT
(Removal of wartime controls permitted the full force of war-accumulated purchasing power to push prices to record high levels.)	(Under conditions of relatively full utilization of all economic resources, enlargement of the credit base merely accentuated upward pressure on prices.)



THE HISTORICAL RECORD

The System was virtually powerless to counteract the inflationary potential of a $4 billion influx of gold, because it was still committed to support the pattern of interest rates established in 1942. The money supply increased only moderately (albeit to a new alltime high), but a significant expansion (55 percent) occurred in bank loans. This active use of bank credit contributed greatly to inflationary pressures. Fortunately (in view of the inflexibility of monetary policy), inflationary influences were being dampened by the continuously large cash surplus of the United States Treasury.

During this interval, the discount rate was raised from 1 to 1½ percent, in 2 steps. The System also was freed from the wartime commitment of having to peg the 91-day Treasury bill rate at three-eighths percent. Likewise, war-loan accounts (at member banks) were made subject to reserve requirements. Finally, the percentage of required legal reserves was raised by approximately $3 billion by action of the Board of Governors. The potentially restrictive effect of this last-named action was largely neutralized, however, by concurrent purchases of an almost equivalent quantity of United States Government securities.

The cost of money and credit did rise appreciably (from a low level) during this interval, but not enough to exercise any significant restraint on credit expansion. The Treasury surpluses exerted some restrictive influence, but the System itself was limited to fringe action by the pattern-of-rates commitment.

In terminating the 100-percent margin requirements in January 1947 (to 75 percent) after a sharp reaction in stock prices, the System recognized that the boom was no longer being supplemented by speculative activity in securities.

Period covered: Late 1948 to early 1950.
Appropriate monetary policy suggested by—

Trend of prices

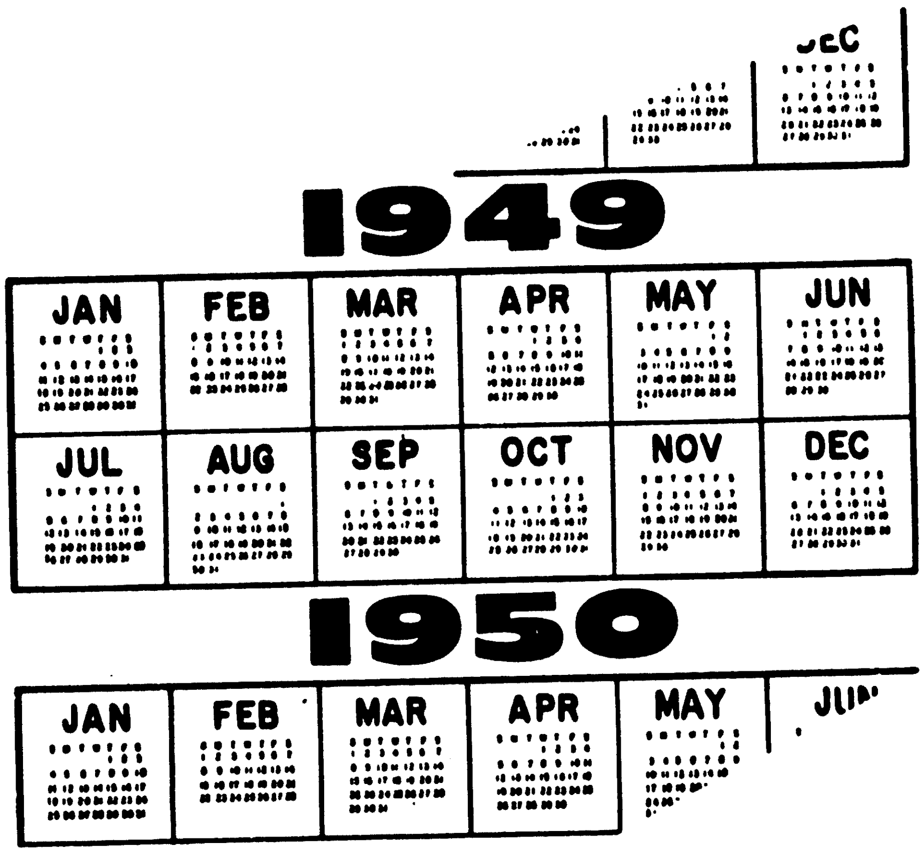
EASE

(Average prices began to recede after mid-1948. By late 1949, wholesale commodity prices reached a 2-year low.)

Trend of economic activity

EASE

(The unemployment situation indicated the existence of considerable unused capacity and idle resources which might be activated by easier credit conditions.)



THE HISTORICAL RECORD

In response to the softening of commodity prices and the diminished rate of industrial activity, the System pursued a policy of monetary ease throughout 1949.

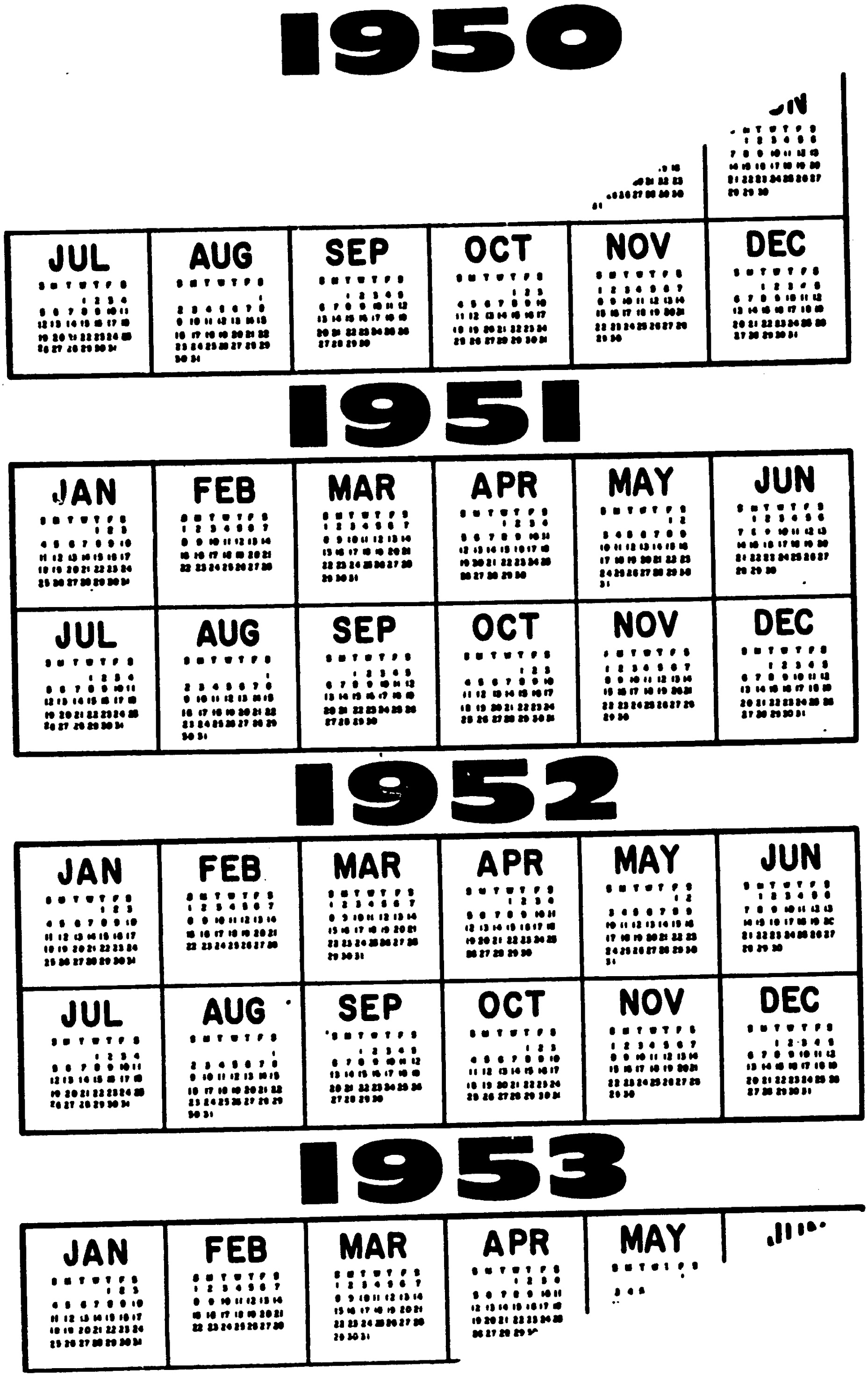
The major move was represented by 2 series of reductions in the percentage of required reserves of all 3 classes of member banks, and covering time as well as demand deposits. The reduction in requirements was equivalent to the creation of nearly $4 billion of excess reserves.

Since, in the absence of any contravening measures, that reduction could have become the base for an excessive expansion of the money supply, the System concurrently undertook to reduce its record-size portfolio of Government securities to the lowest level in the postwar period—in fact, since 1944. Enough liquidity was permitted to remain in the banking system, however, to accommodate a $6 billion expansion in member-bank holdings of United States Government securities.

Quantitatively, the supply of money did not change much on balance during 1949, but the cost of money declined noticeably, not only in the capital markets but also with respect to bank loans to business. The wartime commitment to support prices of United States Government securities presented no immediate problem while the bull market in such securities lasted.

The discount rate remained unchanged at the comparatively low level of 1½ percent.

In March, margin requirements for stock-exchange collateral were reduced to 50 percent (from 75 percent).



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Period covered: Early 1950 to mid-1953.
Appropriate monetary policy suggested by—

Trend of prices

RESTRAINT

(A vigorous upthrust in prices was precipitated by the Korean war. The Consumer Price Index shortly broke into new high ground and was nudging upward during most of this 2½-year period, despite some retreat of wholesale prices from speculative peaks reached early in the war.)

Trend of economic activity

RESTRAINT

(In terms of industrial production, recovery from the 1949 contraction was full and complete before the Korean invasion. Except for some months of hesitation during late 1951 and early 1952, there was no cushion of idle resources or capacity. Inflation of bank credit would merely accentuate the upward pressure on prices.)

THE HISTORICAL RECORD

Upon the outbreak of the Korean war, the still-standing commitment to support Government security prices (which had been of only nominal significance in the recessionary year 1949) suddenly reemerged as a roadblock to the application of effective monetary restraint against a surging inflationary wave. During the first 8 months of the Korean outbreak, the System created $6 billion of member-bank reserves in the course of purchasing Government securities from sellers who wished to obtain funds for other purposes.

During those 8 months, the System had at its disposal (to combat inflation) only such measures as increasing the discount rate (to 1¾ percent), invoking controls over consumer installment credit, and promulgating the new regulation X to curb real-estate credit expansion. Margin requirements were upped to 75 percent (from 50 percent). Reserve requirements also were increased $2 billion (January 1951).

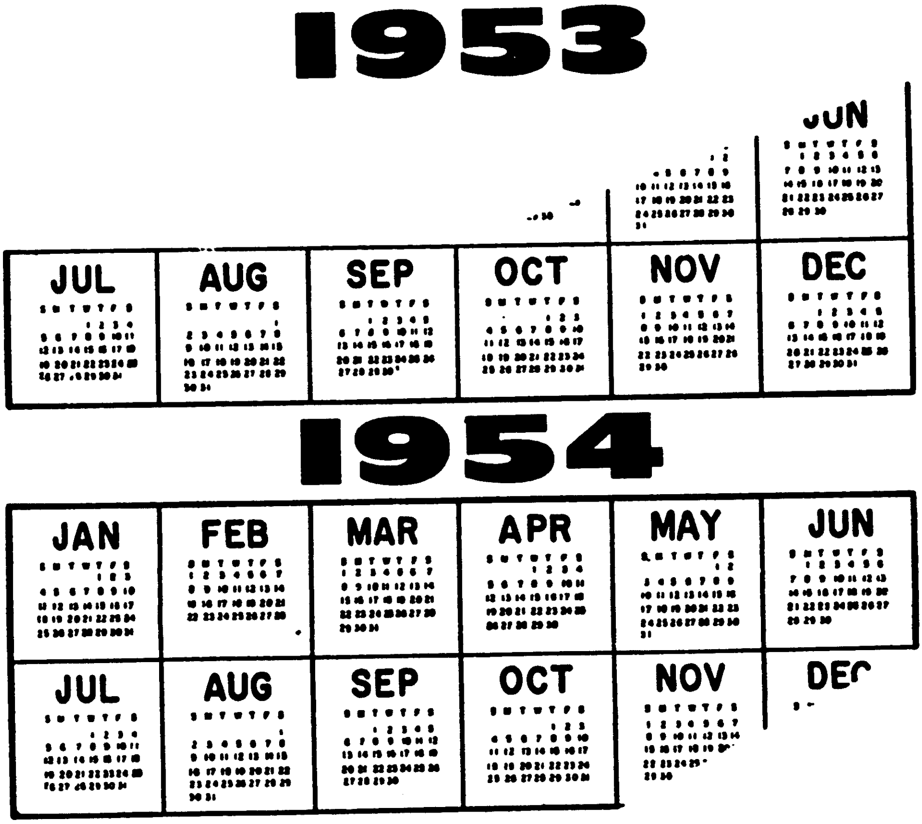
All of these measures combined, however, were relatively powerless in the face of the rapid rate at which new central-bank credits were being created. Fortunately, from the point of view of monetary management, a considerable portion of these credits were being offset by a strong outflow of gold.

Following the accord between the Treasury and the Federal Reserve System (March 1951), credit policy was designed "to limit bank-credit expansion to amounts consistent with the requirements of a growing economy at a high level without inflation."

The continuing demand for long-term capital as well as bank credit eventually pushed money rates to a 20-year high (May–June 1953). The discount rate had been upped to 2 percent in January of that year. In February, margin requirements were reduced to 50 percent, since no substantial increase had occurred in the use of credit in the stock market.

Period covered: Mid-1953—late 1954.
Appropriate monetary policy suggested by—

Trend of prices	*Trend of economic activity*
NEUTRALITY	EASE
(Prices did not decline but remained relatively stable—at virtually the alltime high.)	(Official end of hostilities in Korea was followed by a substantial cut in defense requirements. Readjustment from "war economy" was accompanied by contraction in employment and production.)

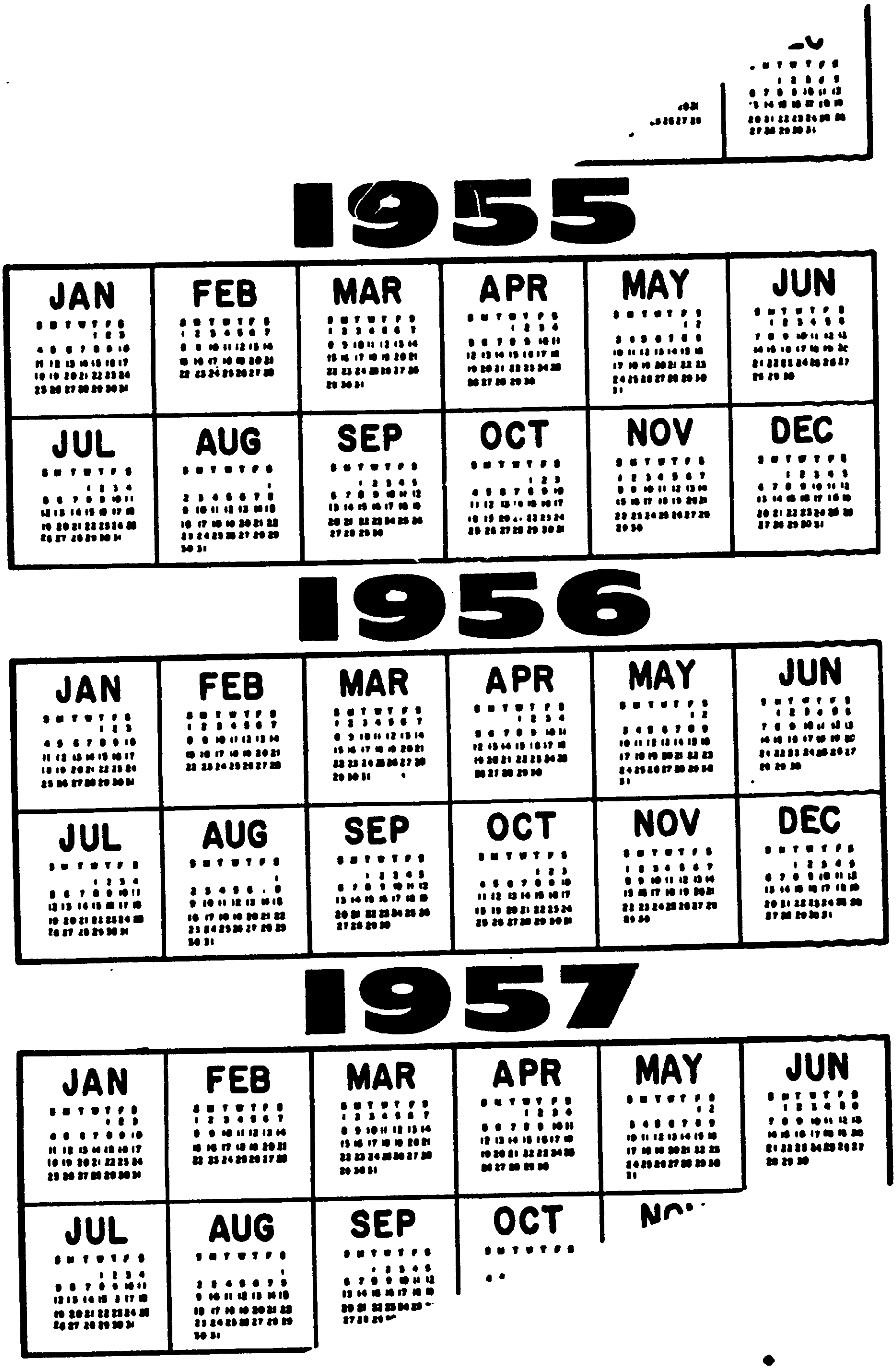


THE HISTORICAL RECORD

Beginning in May 1953, the System embarked first on a policy of relieving the tension in the money markets and then of actively promoting credit ease.

Reserve requirements were reduced in July 1953 and again about a year later. The amount of excess reserves created in the 2 actions was estimated at $2.8 billion. The striking consequence of the reductions was a record increase in the loans and investments of member banks. The $16 billion expansion (in 18 months) caused the Nation's money supply to expand by a record peacetime amount and induced a high degree of liquidity in the economy as a means of stimulating industrial recovery.

The cost of short-term money fell to a 7-year low in 1954. Early that year the discount rate was lowered in 2 steps to 1½ percent (from 2 percent). The cost of long-term funds also declined to the lowest in several years.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Period covered: Late 1954 to late 1957.
Appropriate monetary policy suggested by—

Trend of prices	*Trend of economic activity*
RESTRAINT	RESTRAINT
(Early in 1956, consumer prices began to break out on the upside into new alltime high ground. Wholesale prices had begun a renewed climb almost a year earlier.)	(By late 1954, the economy was back on an "overtime" basis. Many materials also seemed to be in short supply. Any undue expansion of the credit base would merely have aggravated the upward pressure in prices, and would not have resulted in any more employment or production.)

THE HISTORICAL RECORD

Fairly early in 1955 it became the policy of the System to permit no further cyclical expansion of member bank reserves. Temporary additions for normal seasonal purposes were not allowed to become a permanent part of the credit base but were largely withdrawn after each need had passed.

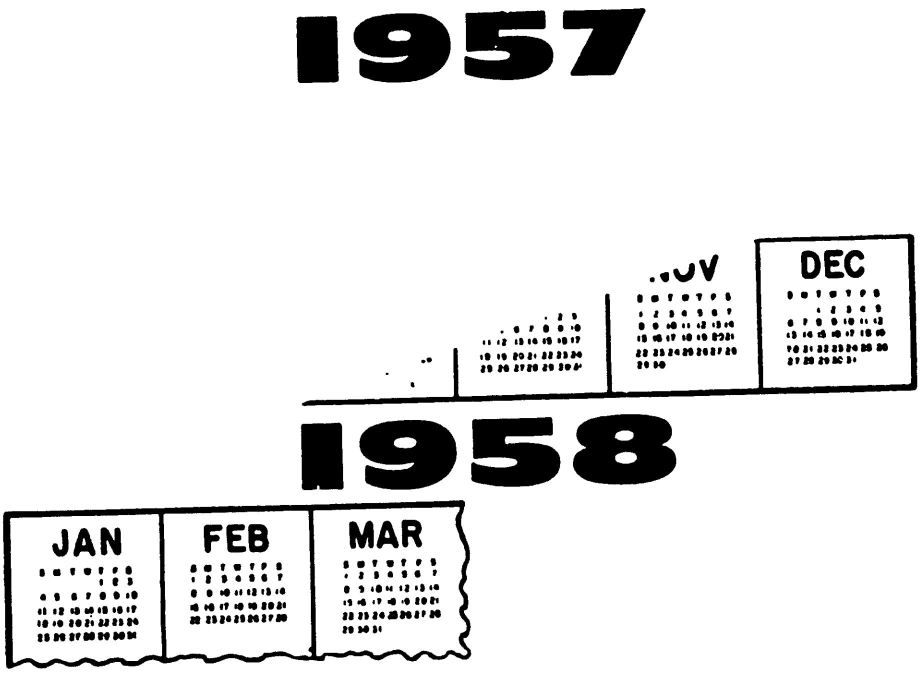
As a consequence of this policy, the $20 billion increase in member bank loans was financed largely by a concurrent liquidation of member bank holdings of United States Government securities—at almost constantly declining prices. (Member banks also increased their borrowings somewhat in order to meet the extraordinary demand for business, installment, real-estate, and other loans.) Accordingly, the contemporary expansion in demand deposits was held to the smallest proportions recorded in any business boom for at least 30 years. Only the less volatile time deposits expanded appreciably.

The continuing strong demand for credit and capital, in the face of a nearly static credit base, produced a steady rise in the cost of money. In order to keep the discount rate in reasonable relationship with open-market money rates, the rate was increased from 1½ percent to 3½ percent in a series of steps beginning in April 1955 and ending in August 1957. Margin requirements against stock-exchange collateral also were increased (from 50 percent to 70 percent) during the early months of this period.

Comment: If the System had capitulated to all of the pleas for "more credit," the boom presumably would have risen to greater and more untenable heights, and the ensuing readjustment might have been much more drastic and difficult.

Period covered: Late 1957 to date (March 31, 1958).
Appropriate monetary policy suggested by—

Trend of prices	*Trend of economic activity*
RESTRAINT	EASE
(Despite the industrial recession, prices continued to creep upward thereby further depreciating the purchasing power of current income as well as of savings.)	(Industrial activity declined sharply in the fall of 1957. Thus, without reference to the price situation, a policy of credit relaxation was clearly appropriate.)



THE HISTORICAL RECORD

The complete history of the current period cannot be written until the next phase has taken over. Yet it may be recorded here that the System has used all three major instruments of general credit control for the purpose of mitigating recessionary tendencies and of establishing a sound base for a renewed expansion in industrial activity.

The discount rate was brought down in several stages from the long-time high of 3½ percent, to 2¼ percent. Legal reserve requirements of member banks also were reduced by roughly $1 billion. Meanwhile, purchases and sales of United States Government securities were of such a nature as to permit member banks to reduce their indebtedness to the reserve banks from a level of nearly $1 billion (September–October 1957) to almost zero.

Changes in the supply of money have been somewhat slow in reflecting these several developments, but there has been a vigorous expansion in member bank "loans and investments" in recent weeks, with possibly much more to come as a result of the latest cut in reserve requirements.

The decline in the cost of money has been one of the sharpest on record.

Margin requirements on stock exchange collateral were reduced to 50 percent (from 70 percent) in January 1958.

The remainder of the historical record of this period will depend not only upon the course of economic activity and prices during the coming months, but also upon the extent to which the effects of actions already taken are yet to be felt in full.

PART III. OBJECTIVES OF ECONOMIC POLICY

The question calls for our judgment of the relative importance of objectives of economic policy. The reply below begins with a brief summary of our position and follows with a more detailed consideration of question 6.

SUMMARY

1. The three objectives should be considered as of broadly equal importance. (Price stability, employment stability, sustained economic growth.)

2. None of the three should be interpreted in terms of a target of 100 percent fulfillment—all can be taken in a relative sense.

3. By its very nature, objective number 3 (growth) does not require a stipulated quota of performance each year.

4. Such general objectives in relative terms can be posited, even in the absence of specific arithmetic criteria (i. e., allowable percentage of unemployment or tolerable creep of prices).

5. From a theoretical standpoint, we believe that the three objectives are generally compatible. Furthermore, we see no empirical evidence in the historical record which compels the conclusion that the three objectives must be considered mutually incompatible, although the practical difficulties of reconciliation are painfully obvious. There has as yet been little experience in a full-scale testing of monetary-fiscal policies, applied in a sustained and determined manner, to achieve price stability without sacrifice of the other two objectives.

6. As a practical or political matter, price stability is often relegated to a junior order of precedence. We believe that its relative rank could be elevated to a position of approximate equality with the other objectives.

FEDERAL RESERVE BANK OF RICHMOND,
Richmond, Va., March 31, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: This letter is in reply to your request of February 17 for my thoughts and opinions on some of the vital matters which affect our economy.

The list of questions which you suggested as a guide to this reply raises such basic and far-reaching issues for consideration within a short period of time that it seemed desirable for the presidents of the Federal Reserve banks to join in preparing a series of comments concerning them. A copy of these comments is attached, and I trust that they will prove useful to you in providing information on the broad subjects which your questions encompass.

Your inquiry centers on three major questions in areas within which the Federal Reserve System has special responsibilities: (1) What are the objectives of economic policy and, more specifically, of monetary policy? (2) Is our present monetary system adequate to the task of achieving these objectives? (3) How well has monetary policy performed in recent years? The following comments relate to these aspects of the inquiry.

Our country's economic objectives are clear: stability in the value of the dollar and the avoidance of instability in production, employment, and income, and through these two, the attainment of sustained economic growth. I am firmly convinced that these objectives are not only compatible but are in fact interdependent. I can think of no basis on which to rank economic objectives in order of their relative importance, for their interdependence makes each important to the others as well as important in itself. At any given time one objective may be deserving of more emphasis than another, but this must be judged in the circumstances of the time. For example, during World War II all three of our objectives were shouldered aside to assure adequate financing of the war effort, and in 1953–54 actions needed to combat declines in production and employment planted the seeds of later price increases.

Mass unemployment is viewed by many as the major economic threat confronting the country, while the evils of price inflation are less evident and therefore seem less menacing. Concern—quite proper concern—over the distress of unemployment tends frequently to obscure the more widespread injustices of inflation. This may have resulted, as some observers state, in greater pressures on the Government to combat unemployment with less regard to future price problems. There may be a reluctance to combat price increases, through action in the early stages of the boom, for fear of choking off an upturn in the economy. Whether this is the case or not, the belief has apparently spread that our economy has within it an inflationary bias that cannot—or will not—be successfully combated by Government action.

Stability in the value of the dollar has many desirable features of equity as an end in itself but, even more important from an economic standpoint, it is absolutely necessary if instability of production and employment and interruptions to growth are to be avoided. Experience has demonstrated again and again that chronic price increases make impossible the maintenance of high and rising levels of employment and production. Notwithstanding the lessons of experience, it has been suggested that a "creeping inflation," defined as a mild and controlled inflation amounting to perhaps 2 or 3 percent a year, would be worth the price in terms of its contribution to growth and prosperity. This I deny. The whole concept of creeping inflation is dangerously misleading, for a chronic inflation cannot be either mild or controlled. If the public in general, and business in particular, should become convinced that a continuous loss of purchasing power were inevitable, the incentive to save would be greatly reduced, the incentive to spend sharply increased, and the end result could only be an acceleration of inflationary pressures. The process would tend to feed upon itself and eliminate any possibility that the pressures could be controlled within narrow limits. Efforts to avoid the consequences of inflation by some groups through escalator clauses and other means could only temporarily insulate a portion of the economy at the expense of the remainder and lead to serious problems for our present economic and social order. These favored groups would still face, with the rest of the population, the inevitable aftermath of an unsustainable boom.

Even if inflation could be held within narrow limits approximating a price rise of 2 or 3 percent per annum, widespread suffering would result. This relatively minor increase in prices, if continued each year, would lead to an erosion of the purchasing power of the dollar of about one-half in the course of each generation. Millions of elderly and disabled Americans living on fixed dollar pensions and annuities would find even their modest standard of living threatened. Millions of others on low and inflexible salaries would similarly experience further reductions in their living standards. Other millions would face a loss of a substantial part of the real value of their savings, and the incentive to save would be seriously impaired.

The question of the adequacy of the entire monetary system is so broad that I could not undertake to give a complete answer. I should like to comment, however, on several of the aspects of this question with which I have firsthand knowledge, particularly the manner in which the monetary mechanism serves as a device for bringing monetary policy to bear upon the economy. Many features of the monetary mechanism have proved so adequate as to be taken more or less for granted in recent decades. A flexible supply of currency—a problem of great concern a half century ago and one of the principal reasons for bringing the Federal Reserve System into existence—has long been assured through the operations of the Reserve banks. Seasonal and growth needs for changed amounts of coin and currency are met with routine ease; recurring seasonal periods of credit stringency have become a thing of the past. All forms of money are readily exchanged into other forms, and each day millions of individual payments are made with little regard to distance through the operation of the check collection machinery of the Reserve banks and their members. A smaller number, but an extremely large dollar amount, of telegraphic payments are daily effected well-nigh instantaneously through the books of the Reserve banks, and the revenues of the United States Government are speedily mobilized and efficiently utilized with little concern over the multiplicity of individual transactions required. In short, these parts of the machinery of the United States monetary system function so well as to make a positive contribution to the efficient operation of our economy and the attainment of our economic objectives.

As I indicated, the monetary mechanism is a device for bringing monetary policy to bear on the economy. Demand deposits of commercial banks, which serve as our principal medium of exchange, stem primarily from deposits of currency and coin and from loans and investments made by the banks. Legal reserve requirements set by the Board of Governors of the Federal Reserve System, within the limits fixed by the Federal Reserve Act, make it necessary for member banks to maintain with their Federal Reserve banks reserves equal to a given proportion of their deposits. Therefore, before the banks can create new demand deposits through new extensions of credit, they must have available reserve funds in excess of legal requirements. Demand deposits issued in exchange for currency and coin offer no problems, of course, since some portion of this currency and coin can be surrendered to the Federal Reserve to augment the member bank's reserve account, thus enabling it to meet the requirement. For the banking system as a whole, there are a number of factors which affect the total volume of reserves available to the banks for additional loans and investments and, consequently, the creation of additional deposit money. The principal of these factors are changes in the Nation's monetary gold stock, changes in money in circulation, changes in the Treasury's account at the Federal Reserve banks, and changes in Federal Reserve credit outstanding.

When the net result of these influences is an increase in reserves available to member banks, there is a strong tendency for these reserves to be employed either in loans or in investments, with a consequent expansion in the money supply. When the net effect is to drain reserves from the banking system, attempts by individual banks to secure reserves will cause a decline in the money supply. Thus the reserve positions of the Nation's commercial banks are the key to their extensions of credit. This particular type of credit extension is in its turn of unusual importance because it puts purchasing power into certain sectors of the economy without first removing it from other sectors, as is the case when any nonbank financial institution extends credit to its customers.

This crucial money-creating role of reserves makes them a fulcrum through which Federal Reserve monetary policy actions can be magnified into forceful and pervasive influences on the entire credit structure of the economy. To illustrate, the Federal Reserve may purchase Government securities in the open market and add to the volume of reserves outstanding, thus enabling member banks to increase bank credit. Or, as was done in February and again in March of this year, the Board of Governors of the Federal Reserve System may reduce the reserve requirements of the member banks and, while not altering the total volume of reserves outstanding, free a large amount of reserves to provide the basis for new deposits.

The influence of Federal Reserve actions on the reserve fulcrum extends to other sectors of the credit structure because of many intricate and necessary relationships among the various sectors. When the Federal Reserve, for example, purchases Government securities in the open market, it does so as one of the many participants in the market, all of whom exert some influence on the prices which exist there. In addition, however, by increasing the reserves of commercial banks, the System affects the nature and the degree of bank participation in these markets, thus providing additional effects on prices. Consequently, actions affecting the availability of reserves to member banks also affect conditions in the money market which have a pervasive effect throughout the credit and capital markets.

One other Federal Reserve credit policy instrument also affects the reserve fulcrum and reaches directly into the credit markets. Changes in the discount rate change the cost of borrowing reserves at the Reserve banks and in the market as well, since short-term market rates are related to the discount rate. Even more important, the announcement of a discount rate change may affect market expectations by indicating the direction or intensity of credit policy.

Changes in the credit and capital markets have far-reaching effects throughout the economy. Rising security prices tend to make financial institutions more liquid because investments can then be sold on a more favorable basis than in the immediate past. Consequently other demands for credit, such as that for mortgage loans, tend to be met more readily than when bond prices are declining and capital losses may be involved in any conversion of funds. Furthermore, rising bond prices—declining interest yields—lead to reappraisals of the most profitable allocation of the loanable funds available to the institutions. Rising security values also affect the spending and saving decisions of individuals and business firms that hold securities or may find it attractive to do so.

In addition to affecting credit extensions by banks to their business and individual customers and affecting conditions in the credit mar-

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kets, a changed availability of bank reserves directly affects other financial institutions through their credit transactions with banks. Many nonbank financial institutions rely heavily on short-term bank credit to support their own lending activities. For example, mortgage companies employ short-term bank credit to acquire mortgage loans for resale to ultimate mortgage lenders, such as insurance companies and mutual savings banks. The ultimate mortgage lenders themselves have in recent years employed bank credit quite extensively to assist them in their mortgage lending programs. In another important credit field, sales finance companies use a very large volume of bank credit to support their own lending to individuals for the purchase of automobiles and household goods. When reserves are made more readily available to commercial banks, they are in a position to expand their credit extensions to these other financial institutions; conversely, when reserves are less available, there is a tendency to curtail such lending, thus driving nonbank lenders to seek other sources of funds or to curtail their own lending activities.

In this manner Federal Reserve actions influence the monetary and credit climate in which businessmen and individuals conduct their economic affairs. I should like to emphasize the fact that Federal Reserve influence is solely on the credit climate in which private and public spending decisions are made. The System does not make any of the millions of daily decisions on production, pricing, purchasing, investing, and a host of other aspects of the private economy; these decisions are private decisions, dictated ultimately by the consumer through the mechanism of the market place. In short, while a proper monetary policy is indispensable to the achievement of our national economic objectives, it cannot by itself guarantee stability and growth.

As to how well the role of monetary policy has been performed within the framework of our monetary system, I should like to comment briefly on your question concerning the System's policies since 1942. At the outset, let me emphasize two caveats applicable to any critical review of past actions: First, hindsight provides information and perspective not available at the time decisions were made; second, even with this hindsight, an evaluation of policy actions against the record of actual events is confronted by facts and statistics that are not there—what would have happened in the absence of the policy actions taken.

Both of these caveats affecting the validity of present judgments may be illustrated by any attempt to judge now the feasibility and desirability of an earlier abandonment of the System's policy of supporting Government securities in the immediate post-World War II years. The effectiveness of the System's restraint policy in the early postwar period was undeniably inhibited by the continuance of support operations. Having been involved directly in the decisions at that time, I still feel that the apprehension, both within and outside the System, as to the consequences of abandonment of the support policy was fully justified in the light of such factors as the more-than-fourfold increase in the public debt in the short space of 5 years, the constant refunding problems of the Treasury, and the distribution of the debt that had evolved under a system of price supports, with many holdings judged to be very sensitive to price changes. In effect, monetary policy in the immediate aftermath of war had to be subordinated to the considerations that prevailed during wartime; so far as I know, no abrupt termination was advocated by any responsible authority. The fact that the support policy was successfully abandoned in 1951 is no assurance that chaos in the market might not have resulted from an abandonment in early postwar years.

The period from the spring of 1951 to the spring of 1956 was characterized by marked price stability and economic growth. From the spring of 1951 through early 1953 the System took measures to reduce availability and increase the cost of credit in order to deter excessive spending at a time when the economy was operating on an expansionary or overtime basis generating inflationary pressures. A shift in System policy in mid-1953 corresponded with what subsequently had been identified as a turning point in the business cycle and the beginning of a moderate downturn.

As a result of System operations during the recession from mid-1953 to the latter part of 1954, bank lending was facilitated and a decrease in the money supply was avoided. In addition, the easier credit availability provided support for mortgage and consumer lending and for financing by utilities and by State and local governments. The increased liquidity of the banking system resulting from this easy-money policy automatically created problems for later monetary policy in that the impact of subsequent tightening actions was delayed. While there is certainly a point in the development of liquidity beyond which further increases cannot be expected to contribute to recovery, it must nevertheless be remembered that the function of monetary policy in recession is to provide increased liquidity—as it is to reduce liquidity during periods of excessive expansion—and that in the difficult task of drawing the line as to the proper degree of liquidity, errors are likely to be made on the side of too much rather than too little ease.

In late 1954 and early 1955, as the recovery movement gathered momentum and expansion became more apparent, System policy shifted quickly toward restraint. Inevitably this restraint policy, which continued until the latter part of 1957, resulted in curbing some spending that would have taken place if the restraint had not been present. The primary purpose of restraint was to curb the aggregate demand for goods and services. It could not curb aggregate demand without reaching into the specific plans of individuals and business enterprises. This inevitably caused some dissatisfaction among those most affected.

More recently, as economic developments have been characterized by a recessionary movement, System policy has shifted toward ease. Since last November there has been an unprecedentedly rapid drop in the cost of credit and a substantial increase in its availability that already appears to be having some cushioning effect both in maintaining the money supply and in lending support to mortgage financing and to other sectors of the economy where debt is important to demand.

From a review of monetary policy in action since the spring of 1951, I conclude that in spite of many obstacles it made a significant contribution to the overall objectives of economic growth and stability at the highest sustainable levels of production and employment. It was always in the right direction. Whether the degree of restraint or ease prevailing at any given time was too much or too little is a matter on which judgments may differ. Those who refer to the actual price rises over the period as indicative of a failure of monetary policy neglect both the factors operating on prices that lie outside the scope of monetary policy and the certainty that in the absence of System efforts directed toward restraint there would have been much more price inflation, followed by more severe corrective adjustments.

Monetary policy is indispensable but it is not all-powerful, and, because of its inherent limitations, too much should not be expected of it. Some of the obstacles to monetary policy have recently become more clear. Prices and wages have shown expansionary tendencies when the economy was booming—as might have been expected—but have shown startling rigidity during the current as well as the most recent recession. This is attributable to factors outside the direct influence of the Federal Reserve System, but it gives me great concern. The loss of flexibility in prices restricts the capacity of business and labor to adjust to changes in demand and reduces the power that flexible market processes give the ultimate consumer in determining the uses to which the Nation's productive forces are to be put. Monetary policy certainly cannot function at its best when wage increases persistently exceed the rise in productivity for the economy as a whole or when prices are held rigid in the face of declining demand.

The task of monetary policy has also been made more difficult by the high rate of taxation needed to support a high level of Government expenditures; high tax rates have dulled the cost consciousness of businessmen and have diminished the effectiveness of high interest rates during periods of restraint. In the related field of debt management, while some progress has been made by the Treasury in its efforts to achieve less frequent financing, more progress along these lines would give monetary policy a better chance to operate effectively.

It is my sincere hope that the hearings being conducted by your committee will bring about a better and wider public understanding of the nature of the broad, long-run objectives of the Nation's economic policy. The Federal Reserve System has been attempting for many years to do this through written articles, discussions, speeches, moving pictures, seminars for college professors, and other means, but the subject is complicated and progress is slow.

One of the least understood of these long-range economic objectives is stability in the purchasing power of the dollar. This lack of understanding relates not only to the widespread and serious consequences of a persistent erosion of the purchasing power of income and of savings, but also to the fact that such stability is absolutely essential to our achieving maximum economic growth under continuing high levels of employment and income. Public understanding of the suffering caused by inflation and of its effects on the Nation's productive processes should be as clear as public understanding of the evils of unemployment.

The problem of maintaining a stable dollar is a challenge not only to the monetary authorities but to all others who are in positions of public responsibility. I hope that you and your committee will devote particular attention to this issue.

Sincerely yours,

HUGH LEACH, *President.*

FEDERAL RESERVE BANK OF ATLANTA,
April 3, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: Please pardon the delay in getting to you a response to the questions accompanying your letter of February 17.

The questions are important and searching. As we have studied them here at the Atlanta bank it has seemed to us that many of them are not subject to definitive answers—at least we are not able to give such answers.

So the comments that follow serve simply to emphasize what are admittedly points of view on some of the problems encompassed in the questions posed. Since the questions were addressed to the presidents of all the reserve banks, the presidents have developed a far more complete discussion jointly and copies of that discussion, I believe, are being transmitted to the committee.

Questions 1 and 2

Inflation is most easily defined in terms of its immediately visible result, which is a general depreciation in the purchasing power of the dollar or, viewed from the opposite side, a general rise in prices. There are other indirect results that do not lend themselves to the definition.

Many circumstances may predispose an economy to inflationary developments. A principal circumstance is an effort of the economy, overall, to operate above its level of efficient capacity. Inflation occurs as the result of, or in the permissive presence of, an effective money supply—that is, quantity times rate of spending—that exceeds the supply of goods and services offered at, or capable of being produced at, existing price levels. The money aspect of inflation thus involves a matter of quantity plus a psychological element, that is, the willingness of people to spend.

Peacetime fluctuations in the general price level can be moderated by limiting the reserves available to the banking system in times of boom, thus limiting the banking system's ability to extend additional credit, and by increasing the supply of bank reserves during recessions, thus increasing the banking system's ability to extend new credit. Even such restraining and stimulating effects cannot have a perfectly calculated result because the rate of use of the money supply depends in large part on the voluntary spending and saving decisions of individuals and business firms. In a free society, people cannot be forced to borrow or spend in a deflation, nor can they be prevented from using their own funds during an inflation—they can only be discouraged from the use of borrowed funds.

Neither inflation nor deflation can be completely avoided in a free economic system. Complete avoidance would require rigid controls not only over the prices and qualities of goods and services, but also over the allocation of manpower and other productive resources to their myriad uses. Furthermore, controls, complex and numerous enough to prevent inflation or deflation, unless it be assumed that the administration is perfect, would only mask and conceal the misuse or disuse of productive resources—the basic economic evil of inflation and deflation.

Legislation aimed at avoiding either inflation or deflation by direct measures would put the economy into a harness of controls that would, in the long run, seriously injure the dynamic characteristics of the economy—its ability to shift rapidly from less wanted to more wanted goods and services and from less efficient to more efficient producers' instruments. Indirect measures of economic stabilization—monetary policy and, if necessary, fiscal policy—are still the best methods of dealing with inflation and deflation in a free society.

Questions 4 and 7

The causes of the increase in the consumer price index beginning in August 1956 were of long standing.

Following the letdown in economic activity at the end of the Korean war, American business generally embarked upon a program of capital expansion to enlarge productive capacity through projects long delayed by the depression of the 1930's, World War II, and the Korean war. By the fall of 1955, this capital expansion program began to exert substantial pressure on the economy.

The pressure was increased because American consumers, who had fairly well maintained their spending in late 1953 and 1954, despite the recession, substantially increased their rate of spending in mid-1955, and sales of consumer durable goods reached levels exceeded neither before nor since. Federal spending, although down substantially from 1953 levels, was still high, and spending by State and local government units, financed in part by credit expansion, increased almost enough from 1953 to 1956 to offset the decline in national security expenditures.

At both the consumer and wholesale level, prices of a substantial number of items had been rising before 1956, but the upward adjustments in some components had been masked by the fall in the prices of food and farm products following the Korean war peak. Still another element acting on prices in the recent period has been the continued catchup of prices fixed by public agencies—freight rates, utility rates, taxes, etc., which did not reflect current conditions but were rather long overdue adjustments to the change in the price level arising from World War II.

These causes, and there are others, show that no single cause was responsible for the rise in the Consumer Price Index. In sum, the economy was pressing on the upper limit of its productive capacity, and the competition for goods and services, arising from nearly all quarters, caused a bidding up of prices and a depreciation of the dollar.

Among the factors not to be overlooked was a growing conviction of the American people that there would be a continuous loss of the dollar's value, and that, therefore, it was wise to rush, even with unneeded expenditures, in order to have protection against such a loss. Some part of the pressure on total resources represented a flight from the dollar; and the credit restraint was apparently inadequate, at least until the very last stages of the boom, to convince many that a long-run depreciation of money was not inevitable. In any event, the quantitative restraint on the volume of credit was partly offset by an increasing rate of use of the money supply.

Questions 6, 11 (b), and 15

There is no conflict between economic growth and stability of prices. Nor is there a conflict between the goal of stability in prices and the goal of stability in production, demand, and employment. Indeed, stability in prices seems to be a necessary condition for stability in production, demand, and employment around a long-run growth trend: insofar as fluctuations in aggregate economic activities are induced by changes in the price level, over the long run they almost certainly result in a less than maximum utilization of resources and also in a lower level of efficiency than would be attained if the price level remained reasonably stable.

Since the end of World War II, general public policy has sometimes subordinated strictly economic objectives of stability and growth to other national objectives—necessary military security and desirable decontrol of the civilian economy. Broadly speaking, until 1951 monetary policy was primarily aimed at preservation of stability in interest rates, particularly those of Government securities. Such a policy was justified on grounds that possible unsettlement of financial markets was not only a threat to the goal of full employment but was undesirable from the standpoint of national defense and the unsettled foreign situation which might require Federal borrowing at any time. But the objective of stability in one price—interest rates—was achieved partially at the expense of stability in the general price level. Since 1951 monetary policy has been free to recognize the importance of general price stability as a major factor in long-run economic stability and sound growth.

Although inflation may temporarily induce a fuller utilization of productive resources than would otherwise be the case, the misapplication of productive resources is almost certain to create distortions in the economy that become increasingly difficult to adjust the longer the inflation runs. The result of inflation is thus an economic euphoria that has a grave cost: it ultimately produces a good deal more unemployment—or misemployment—of productive resources than would be the case in its absence.

In the long run, it seems reasonable to believe that the net of the inflation-deflation cycle is a reduction rather than an increase in the average employment of productive resources, including manpower. In the short run, however, some variation in prices and employment must be expected and is, in fact, one means by which a free-market, consumer-dominated economy adjusts itself to consumer wishes and to the most efficient productive processes. The complete elimination of such variation, as noted aforetime, cannot be accomplished without imposing direct, detailed, and administered economic controls repugnant to the American tradition of economic freedom, and less efficient than the free market.

No more dangerous economic doctrine exists than that enunciated in recent years that continuing inflation is necessary to maintain high employment goals and growth. Inflation victimizes those who make their savings in money and instruments repayable in fixed money amounts, the immediate effect of inflation being the transfer of purchasing power by means of money depreciation from moneysavers to other classes of society. The small possible additional production stimulated by inflation is gained only at the cost of discouraging savings in money or fixed money obligations. Relieving the public of part of its savings through a depreciation of money not only induces spending most often when it should be curtailed, but is morally repugnant to all who value honesty in financial matters.

Finally, inflation, however modest its annual increment, when long continued diverts people's energies from efforts to produce goods and services efficiently to efforts to protect themselves against depreciation in the value of money. Acceptance of a national policy of gradual inflation would be disastrous to the moral fiber, economic well-being, and military security of the American people.

Question 9

Fiscal policy relates to the effect upon income creation and aggregate spending produced by Government expenditures, taxation, and debt creation and liquidation. Monetary and credit policy, however, operate only indirectly upon aggregate expenditures by making borrowing and spending less attractive in times of boom and more attractive in times of recession.

Theoretically, there seems no reason why fiscal policy, by variations in Government expenditure, taxation, and debt creation or liquidation, could not contribute to economic stability. That is, the Government could increase its utilization of the country's resources as manpower and materials are readily available or diminish it as these resources are being sought after by other users. Practically speaking, however, the difficulties of using fiscal policy in that way, as our experience seems to show, are immense.

National defense considerations, resource development, highway programs, and a host of similar necessary or desirable public projects will nearly always—though, perhaps, in some cases they should not—take precedence over more general economic considerations in determining Federal spending and revenue needs. Decisions in such matters must be primarily related to the worth of the project as against its cost and are not likely to be effectively related in the short run to the aggregate spending or lack of spending in the economy. It is thus probable that fiscal policy will not be notably flexible in determining aggregate economic spending and, at least in the short run, pressure or lack of pressure on economic resources. The advantages of continuity of planning and programing in most governmental undertakings are great, and the very immensity of the Federal apparatus makes both the adoption and administration of appropriate and timely decisions difficult.

The foregoing emphasis on the difficulties of fiscal policy as an anticyclical device is not intended to exclude the idea that fiscal policy could be, and in some situations should be, used for economic stabilization. What is intended is merely to emphasize that it is not an instrument readily adaptable to every minor fluctuation. Of necessity it must be reserved for more serious situations in which, say, the level of unemployment could be considered to override other aspects of public policy. Of necessity, moreover, it seems that deliberated fiscal policy is only applicable in situations of long enough duration to permit the Government's marshaling its weapons.

Questions 10 (a), 10 (b), and 14

The monetary system of the United States as now constituted has been adequate to meet the country's requirements for a means of payment and, certainly, for credit expansion. However, if the banking system is to remain adequate to the task of extending the bank credit that a growing economy will require, then additional reserves, or a greater permissible use of existing reserves, will be needed over the years to match the sustainable growth potential of the economy. The problem of supplying to the banking system the reserves that will be needed does not appear to be difficult of solution over the course of the next several years, but over the longer run the problem is likely to require a good deal of thought, particularly with regard to the most desirable means of providing the reserves.

The fiscal system of the Federal Government has been adequate in the postwar period to carry out those expenditure programs that have been judged by Congress to be in the national interest. In the light of all postwar economic developments, it would have been well if Federal borrowing could have been avoided and, indeed, if some of the debt could have been retired, as was the case in the earliest postwar years, but the amount of Federal postwar borrowing, at least quantitatively, does not appear to have been a major cause of postwar inflation when measured against the size of the gross national product.

The principal problems of the postwar period have been the direct result of fiscal inadequacy in the war period, when far too much reliance was placed on borrowing, especially through bank credit, and far too little reliance was placed on taxation and on borrowing the savings of the public. The resulting expansion in the money supply brought in train an almost inevitable inflation, to which most of the postwar economic problems are directly and importantly related.

The adequacy of the fiscal system to meet the expenditure requirements of the Federal Government, however, is not the whole test of the system's long-run economic soundness. The size of the tax take, and the sources on which levied, may be having an important effect on the monetary savings available to the American economy, and may exert an inflationary pressure by promoting the substitution of bank-credit expansion for real savings.

Questions 13 and 17

Causes of the present recession stem largely from the exuberance of the preceding boom, when the volume of spending pushed up faster than the volume of available goods, when speculative commitments in inventory were stimulated, and when manpower and other resources were used inefficiently. Capital-goods spending during the boom was at an unsustainable rate, and anticipated reductions in plant and equipment expenditures coincided closely in time with a much-publicized phasing out of certain elements of defense procurement by the Federal Government.

The amelioration of an economic downturn is, in general, more easily accomplished early in the course of a recession than later when the private economy has lost some resiliency and may, indeed, be frightened. Nevertheless, at present, because there is danger of a long-run inflation and probably less danger of a long-run recession, and because the burdens of the Federal Government are stupendous, fiscal measures to relieve a recession should not come before there is reasonably convincing assurance that something more than a relatively minor economic adjustment is involved. We should avoid further maladjustments of the economy that will result if our procedures serve only to create an expectation of inflation.

Unfortunately, there is no mechanical approach or single figure or group of figures that reveal precisely when the Federal Government should move into the problem in major ways, such as tax cuts or large increases in public works. The matter must remain one of judgment. The general principle, especially in view of the hazards of economic forecasting, would seem to be that the most moderate measures should be applied earliest and measures of increasing impact applied only when and if the more moderate measures seem to be failing. In general, this would mean that major fiscal policy moves, which almost inevitably at some later date increase the budgetary difficulties of the Government, should be instituted only after it is apparent that self-correcting forces and monetary measures are not adequate to prevent a serious recession from gathering momentum.

The factor of production whose underemployment we are most concerned with is manpower. Because of the hazards of economic forecasting, the figures that should be primarily watched, so far as the motivation of major fiscal-policy moves is concerned, are not consumer demand, production, or others of that nature, but the direction of change, relative amount, and duration of unemployment.

Question 16

The growing prevalence of escalator clauses in recent years is more nearly a symptom rather than a cause of inflation. Such contractual provisions chiefly represent the attempts of parties to contracts to protect themselves from one of the immediate and visible adverse effects of inflation. They are but one manifestation of a vast array of economic decisions motivated, in an inflation, by the search, not for efficient production or needed consumption but for protection from money's decline.

Please let me express again my admiration for the searching character of the questions presented.

Sincerely yours,

MALCOLM BRYAN, *President.*

FEDERAL RESERVE BANK OF CHICAGO,
April 15, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: This is in reply to your letter of February 17 in which you refer to the inquiry entitled "Investigation of the Financial Condition of the United States" and request my thoughts and opinions concerning certain matters affecting our economy.

I welcome your suggestion that the list of questions enclosed with your letter serve merely as a guide, and I will confine myself to areas in which I hope that my comments may represent a contribution to your investigation. Those areas are:

1. The importance of price stability to the attainment of our economic goal.
2. Factors which have contributed to the inflation we have experienced in recent years and thereby to the current recession.

3. The growth of private debt as a threat to the stability and vitality of the American economy.

4. Fiscal policy and the desirability of reducing expenditures, taxes, and debt.

I will refrain from comment on the monetary control policies of the Federal Reserve System within the years 1942–57 because I have been connected with the System for only a small part of that period and anything I might say would be a matter of hindsight.

I am not a professional economist. Most of my business life has been devoted to commercial banking and to manufacturing, of which I can claim some knowledge. My comments will necessarily stem in large part from my experience in those fields.

1. The importance of price stability to the attainment of our economic goal

Our goal is maximum employment, production, and purchasing power, which means that we seek sustainable economic growth. I do not think we can have sustainable economic growth under conditions of either sharp or continuing periods of inflation or deflation. A relatively stable general price level is an essential condition to the attainment of our goal.

An interesting question in your list refers to the relationship to one another and the relative importance of price stability and economic growth in production, demand, and employment. In my judgment they complement each other and one does not exist for long without the other; we will not have sustainable economic growth unless we have price stability, nor is it likely that we will have price stability for any appreciable length of time unless we have sustainable economic growth. They are natural partners and it is unnatural to seek opposition or priority between them.

In referring to price stability I do not mean a condition where there are no changes in individual prices. In a free market economy new products continually challenge the supremacy of old products, tastes change, and more efficient ways of producing and distributing existing products are found. When prices are free to reflect changes in consumer demand, increases in some individual prices may be offset by decreases in others. Flexibility in individual prices is a necessary condition for overall stability in all prices.

I have said that price stability is a partner of sustainable economic growth. The record of recent years and months provides proof of that statement. Changes in the general price level tend to be cumulative and rising prices, especially when they are more or less continuous, distort the outlook for business profits and consumer income. Businesses are tempted to engage, and they do engage, in unsustainable expansion programs and excessive accumulation of inventories. Marginal businesses, which in the normal course of events would be reorganized, defer remedial action, and live by the illusory profits of rising prices. But the time comes when the expansion which accompanies and contributes to rising prices ceases to be sustainable.

2. Factors which have contributed to the inflation we have experienced in recent years and thereby to the current recession

Except for a few welcome intervals the purchasing power of the dollar has declined steadily for almost 20 years. In assessing the causes I would start with what is often called the great depression. Beginning with that economic disaster and carrying on through the

1930's, civilian demand and business activity were less than normal for a country of our size and potentialities. Then came the war when our energies were necessarily directed to armament, and the desires and needs of our people for civilian products were properly subordinated. And so the end of the war in 1945 marked the end of a period of 15 years during which production of civilian goods had been curtailed, and a tremendous deferred demand for such goods had been created. Not only had the demand been created, the means to satisfy the demand had been accumulated. Our people had set aside substantial amounts of savings from their wartime earnings. The level of consumer debt was unusually low.

It is important to note that the huge sums required for financing the war were raised in large part by methods which produced rapid expansion of bank credit and the money supply. Unfortunately, only 40 percent of the funds obtained were raised through taxation, and an excessive portion of the balance was derived from the sale of securities to commercial banking institutions, resulting in creation of new supplies of money. The expansion of bank credit and purchasing power contributed to the buying power of our people in the postwar period and to the inflationary pressures which, held in abeyance in large part by wartime regulations, became active when those regulations were removed.

The end of the war, then, found us with two powerful ingredients of inflation, the deferred demand for civilian products on the one hand and the substantial increase in purchasing power on the other. Also, and very important, were the inflationary impulses caused by the use of Federal Reserve credit in endeavoring to maintain a uniform price for Government securities; no discussion of the course of inflation can leave that out. It was not surprising under the circumstances that our country experienced the development of an unprecedented amount of business and expansion. Nor was it surprising that prices rose under such circumstances.

There was intense competition for materials, and there was a sellers' market. There was competition for labor and the unions succeeded with few exceptions in securing annual increases in wages and other benefits. Selling prices were increased, but the deferred demand assured a high level of business. And as I have mentioned, accumulated savings and the increase from the low level of consumer debt at the end of the war contributed in a substantial way to the buying power of our people. Our industries built new plants at an unprecedented rate. It all added up to the greatest peacetime activity this Nation has ever known.

But it also brought a correspondingly severe decline in the value of the dollar. There have been a few welcome interruptions, but speaking of the period as a whole we have not had price stability for almost 20 years. Since 1939 the dollar has lost more than half its purchasing power.

I have stated my belief that we cannot enjoy sustainable economic growth unless we have price stability. Yet we have experienced substantial economic growth in the period from 1945 to 1957, and at the same time suffered the decline in the purchasing power of the dollar to which I have just referred. I have named two powerful ingredients which permitted that anomalous situation. But I am convinced that the current recession is the result of unsustainable growth in recent years. It is an example of the truth that sustainable economic growth and price stability are inseparable companions.

I have referred to the success of labor in securing annual increases in wages and other benefits as understandable under postwar conditions. That does not mean that I believe labor was wise in taking such full advantage of those conditions. Nor do I feel that management was wise in granting all of the increases and benefits and increasing their own selling prices without regard to the ultimate effects on a sustainable market. But both acted under the laws of the country and the market place, and so long as it was possible to increase selling prices without reduction of markets, their judgment, at least for the short-term, could appear to be justified. But the day of reckoning made inevitable by constantly rising prices was sure to come, and the adjustments which must follow are made more difficult by certain aspects of labor contracts and apparent disinclination of manufacturers to reduce prices to invite demand for their products. According to the Department of Labor, more than 4 million workers are eligible for increases in wages in 1958 contracted for in prior years. And adding further to costs is what is known as the cost-of-living formula. Most of the workers receiving deferred wage increases have contracts which include the cost-of-living feature.

You ask the question "Are escalator provisions in wage or other contracts compatible with achieving economic stability?" I do not believe that they are helping in achieving economic stability and I doubt if they will in the long run prove beneficial to either labor or management. When falling demand and price increases exist side by side, as they do today, the escalator provisions contribute to higher costs and militate against the price flexibility which is essential to sustained economic progress. And in periods when inflationary pressures reflect heavy and rising demand, escalator clauses add fuel to the fire. They add an uncontrollable factor to the controllable factors which are the proper subjects for the negotiating table.

Let me repeat that the action of labor and management in building cost rigidities into our cost structures has not been surprising under the conditions which have obtained in the postwar years. Labor, noting substantial corporate profits and dividend disbursements, and led by energetic leaders striving to outdo each other, sought more for its services. Meanwhile management, naturally aggressive and competitive, sought to grow in size and in profits. With its eye constantly on the percentage of profit markup it has not been duly concerned over the rapid increase in labor and transportation costs because a percentage of those costs has been added to its profit margin. And so it has gone on in some cases until both labor and management have overreached themselves and priced their product into a limited and shrinking market. They have themselves to blame for their excesses, but they adhere to the traits of human nature and seek out a culprit on the one hand and a savior on the other. Labor turns to industry as the culprit and to the Government as their savior. Industry points to labor as the culprit and to the Government as their savior. The culprits are different, but unfortunately the hoped-for saviors are the same—the Government.

The answer to both their problems, if we are to establish and maintain stable prices, is to reduce costs and prices until a ready market for their products is again obtainable. Price flexibility is essential to sustained high levels of output, and it will be a sad day for our private enterprise economy if governmental intervention replaces price flexibility as the equilibrating mechanism.

3. The growth of private debt as a threat to the stability and vitality of the American economy

One of your questions suggests that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy. I believe that to be the case, and I would include public debt as well because that is the debt of the people just as surely as their own private debts. They must both be serviced and paid out of private income.

In this matter of private debt we can choose from several courses of conduct, with different results attendant on each choice. If we choose to exchange our goods and services with each other without borrowings, we may avoid business fluctuations but our charted curve of economic progress will be rather flat. If we borrow and spend today a moderate part of our future earnings we will add to our normal current spending and will progress faster, but we run some risk of eventual curtailment of spending in order to pay some of our debts. If we choose to borrow excessively and progressively we will contribute to rapidly rising prices and we will find ourselves in an inflationary spiral which means spending not only our current but too much of our future earnings as well. Moreover, the inflation depletes the value of our past savings invested in savings deposits, life insurance, bonds or other fixed dollar assets. This is truly burning the candle at both ends.

In my judgment, the increase in private and corporate, as well as public, debt which has taken place in recent years has been excessive and has contributed in a substantial way to the rise in the general price level and to the current recession. Borrowing capacity is a desirable attribute; it should and usually does bear witness to character and earning ability. And utilization or availment of borrowing capacity in moderation contributes to progress and to economic growth. But excessive and progressive borrowing should be avoided. Borrowing capacity can be fully used only once; when too many people have borrowed to the extent of their capacities, they have in the process contributed to inflationary pressures; and they have fully depleted the reserve which unused borrowing capacity represents. That reserve could be useful in combating the recession which invariably follows the period of inflation.

We have no way of knowing the extent to which the borrowing capacity of the private sector of our economy has been fully utilized. We do know that private debt has increased substantially and progressively for many years. And I am distressed at the encouragement to debt which I seem to see on every hand, for a lender can do no greater disservice to a borrower than to lend him a sum beyond or near his reasonably assured ability to repay. The records of our lending institutions show that even the most experienced and conscientious lenders will occasionally err on the liberal side.

And when I refer to experienced and conscientious lenders I think principally but not exclusively to our commercial bankers. In my judgment most of them are doing a creditable job. As a general rule they extend credit with the long-range best interests of the borrower in mind, among other reasons because a relationship which includes business additional to borrowing is often involved. The sound commercial banker is concerned not only with the financial health of his customer today or next month, but with his financial stability also in the years to come. Not so with some banks and some other lenders who are active in today's market. Too often the desire is only to make loans which add to the volume, which are sufficiently well secured and which will earn interest, to the end that the lender will show a profit without considering the hardships which the borrowers may suffer in liquidating their indebtedness. In the course of 32 years in banking and industry I have seen many individuals and business concerns in serious distress because they borrowed excessively. I have never seen anyone in trouble because he did not borrow.

In principle I favor less rather than more Government supervision or control, and I believe that a call for Government intervention in our business or financial structures is more often a needless and costly confession of failure than a solution. But the number and the activity of credit-granting intermediaries outside of our charted banking institutions has grown so substantially in recent years, and the level of private debt has increased to such a degree, that in my judgment the public welfare calls for a review and recommendations by competent and unbiased persons. I am hopeful that the examination of our monetary and credit institutions to be made by a commission organized by the Committee for Economic Development will prove illuminating and helpful in this highly important field.

4. Fiscal policy and the desirability of reducing expenditures, taxes, and debt

Fiscal policy, to which several of your questions relate, is an important influence in our economy because of the high levels of Government expenditures, taxes, and Government debt. In my judgment, a program for the reduction of those related items is urgently needed in the interest of the financial stability and sustained growth of our economy. Such a program will necessarily be long-range, but the sooner it is adopted and a start made, the better for our country.

There are principles of debt management which have been proven and are accepted in the area of private debt. In my judgment, they apply also to Government borrowing. When debt is certain to be outstanding for an extended period, every effort should be made to extend its maturity and to do so in periods of relatively low interest rates to the end that the carrying charges will be less. A measure of the quality of financial management in private business is the timing of its security issues, and the successful manager is he who matches the maturity and amount with his requirements and does so at opportune times, that is, at rates which are attractive from the standpoint of the borrower. I am familiar with the view that our Government should not borrow on a long-term basis in a period of low interest rates because such a period is usually one of a recession in business. The Government, so the argument goes, should not compete with private borrowers at that time. Over the years I have become convinced, however, that the proven principles are as sound and as desirable for our fiscal managers as for private borrowers, and that, in view of the size of our Government debt, every opportunity to extend its maturity at attractive rates should be seized. If the Government is not to compete in the money market with private concerns, then it should have no debt; as long as it has any debt it must compete to its best advantage or be faithless to its people. Further, I believe that when the levels of business activity and tax collections are high, the debt should be reduced, and I regret that debt reduction has not been accomplished in the postwar period.

But we are more concerned with the future than with the past, and I have expressed my opinion that a program of reduction in taxes, expenditures, and debt should be undertaken. To consider taxes first, I regard our personal and corporate tax rates as excessive. For reasons which I will mention later, I recognize that immediate reduction in substantial amount is not feasible, but, if a program of progressive reduction over the years were adopted, the results would, in my judgment, be salutary.

Articulate proponents of tax reduction and the elimination of inequalities have advanced convincing arguments before congressional committees and elsewhere. I will try to refrain from repeating what has been said many times. But I will draw briefly on my experience in banking and industry, first with regard to personal taxes and then in reference to corporate taxes.

The current rates of tax on personal income discourage the incentive of gain which has contributed so much to the growth and prosperity of our country. I know from personal observation that the possibility of making money, and of keeping or spending it according to taste, has been a powerful and a desirable stimulus to hard work and creative effort. And I believe that the point of diminishing return created by highly progressive tax rates has in many cases dwarfed the incentive, deprived us of the full benefits which derive from the application of our best minds, and averted wise and constructive decisions.

In the course of my business life, too, I have known many successful industrial corporations—companies employing thousands of our citizens and producing items which contribute to our high standard of living—I have known many such companies which started with little more than an idea in the brain of a talented young man. At that time the young man could successfully solicit capital subscriptions, perhaps from his friends and neighbors who were familiar with his character and impressed with his idea. The investment carried risk, often substantial risk, but the possible rewards were substantial too. If the business succeeded, the dividends to the shareholders were, in large part, total gain. But today the friend or neighbor is reluctant to back the talented young man. The element of risk may be the same, but the possible reward under current tax rates is quite different. Probably the best-known example of the type of situation to which I have referred is Henry Ford, but there are countless other business organizations which started under similar conditions and which are important and prosperous today.

I believe, also, that corporate income-tax rates are too high for the good of the country. Parenthetically, let me say that, although I use the words "corporate tax," the evidence is all to the effect that corporate income taxes are borne by the corporations' customers. The average ratio of net income after taxes in recent years has been much the same as in earlier periods of high activity when tax rates were much lower. Generally speaking, corporations have been able to treat the tax on profits as an item of cost and to add it to selling prices. They have no other income than from the sale of their products or services, so where else can the tax be but in their selling prices? The corporation is, in effect, a tax collector rather than a taxpayer. And that is necessarily the case, for the corporation must earn a sufficient profit after taxes to interest stockholders and, if the business is growing, to attract additional capital.

But I favor lower corporate income-tax rates because I can say I know that high rates promote wasteful expenditures and contribute to inflation. Business management, however competent and conscientious, is influenced by the 52-percent tax rate, and tax considerations weigh heavily on corporate decisions. I am sure that in periods of great activity and high corporate profits, when inflation is a matter of particular concern, the tax rate is a factor in expenditures which add to inflationary pressures.

I would urge tax reforms, too, in the area of excise taxes, many of which were designed to help finance the war effort and at the same time to dampen the demands for particular goods and services which were then in limited supply. Selective excises possess a number of potentially harmful characteristics. They discourage consumer consumption of the taxed items relatively to other goods and services, and distortion of free consumer choice does not contribute to maximum output in a free economy. Excises which enter into business costs, such as those on transportation and communications, may be pyramided at each stage of the productive process and inflation the prices of finished goods out of proportion to the revenues derived by the Treasury. This has been a factor which contributed to relatively greater increases in the prices of manufactured items as compared with raw materials.

I have advocated a program of tax reduction to become effective progressively over a period of time. And I say over a period of time because I would prefer to see nothing which would contribute to a reduction in our tax receipts until we find it possible to reduce our expenditures. As mentioned earlier in this letter, we have suffered grievously from inflation in the past 20 years, and, while inflationary pressures appear relatively inactive at the moment, their resurgence is an ever-present possibility and source of anxiety. Government deficits under such conditions are, of course, undesirable.

But I am hopeful that the efforts to reduce Government expenditures will continue and will be successful. In the light of world tensions, adequate defense measures outweigh all other considerations, and I am aware that a large portion of our expenditures are allied in one way or another with defense, but if we have the will I am sure we can find ways to reduce the civilian portion of the budget, and continuing study of defense expenditures may bring additional efficiencies in that area. In private life in times like this we do not ask ourselves, "Is this something we would like to have?" but, rather, "Is this not something we can do without?" I recommend that philosophy in Government spending.

Reduction of our Government debt will necessarily await either reduction of expenditures, increase in income, or both. I have expressed my regret that the size of the debt has not been cut in the period of prosperity which we have enjoyed in recent years. Our failure to effect a reduction under those conditions gives rise to the query as to when we can expect to make progress in the area and adds to the fears of those who are concerned about further inflation. At the same time, it doubtless encourages the advocates of inflation, those few who seem to feel that continuing inflation at some modest rate is both desirable and possible. It also adds materially to the cost of servicing the debt, for the rates applied to a steadily diminishing debt are less than proportionate for those applied to a constant or increasing debt.

As I review what I have said in this letter, I realize that, out of the many approaches to the road to inflation, I have emphasized the approach which becomes a commercial banker—that of incurrence of debt and its consequences. Over the years, I have noted that neither happiness nor prosperity were the natural concomitants of debt; rather, personal and corporate financial difficulties were always attendant with too much debt. I have noted that excessive borrowing brought discord and unhappiness into homes, and that peace and concord were often the possessions of a couple with moderate indebtedness or no debts whatever.

These observations over the years have caused me to wonder why some of those in authority keep insisting that more and cheaper loans be not only available from public moneys but that they be urged upon those they wish to favor—farmers, small-business men, and veterans. In my judgment, a really helpful service would be to seek ways of getting them out of debt rather than into it.

I feel, too, that we must constantly remind ourselves that in our democracy the people are the Government—the farmers, small-business men, veterans, and laboring men and women, employed and unemployed—they are the Government and when the Government creates deficits, or borrows and spends, or borrows and gives, it is the same thing as all those people I have named going deeper in debt personally. There is no magic purse to be tapped and refilled. Today, for instance, when private credit has been so fully utilized in an inflationary orgy, should the people be plunged into deeper debt by proxy, as it were?

I repeat that in my judgment we must find a way to reduce the debt. It will not be an easy road. Those who would reduce expenditures are seldom popular. But they are respected and they are earning the respect of future generations as well, for the adoption and pursuit of sound fiscal policies will bring cumulative benefits. We must take the hard road because it is the right road and for the sake of the America of tomorrow.

Permit me to express my appreciation for the opportunity to comment on the highly important matters which are under consideration by your committee.

Sincerely yours,

CARL E. ALLEN.

FEDERAL RESERVE BANK OF ST. LOUIS,
St. Louis, Mo., March 31, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United State Senate,
Washington, D. C.

MY DEAR SENATOR BYRD: I am pleased to respond to your request for comments along the lines indicated in your letter of February 17, 1958, and the questionnaire appended thereto. I must say at the outset, however, that I lay no claim to professional economic expertise on the highly technical questions propounded, to which the Nation's leading economists have devoted much study and research—and, I may add, without always achieving agreement. In matters of this kind it is my practice to turn to members of the professional economics staff of the Federal Reserve System for technical assistance. Indeed, such is the function of a professional staff. In the present instance, I have found the replies prepared by a committee of Federal Reserve System economists to contain a great deal of information which is helpful in considering your questions. Two copies of these replies are enclosed.

On reading the material prepared by the professional economists, I find little that I, as a practitioner of the art of central banking, could add on such technical and theoretical questions as are discussed. However, I do feel that I might supplement these replies with certain observations which center on the role of the Federal Reserve System in contributing to the achievement of the objectives of public policy.

In one of your questions a judgment is asked concerning the relative importance of three objectives of economic policy in the United States: price stability; stability of production, demand, and employment; and economic growth in production, demand, and employment. The form of the question, I believe, carries with it a possible implication of inconsistency among these three objectives. Yet the basic goal served is the material well-being of our people. Contemporary policy directed toward this goal may well vary in relative importance from time to time. In the longer run I see no conflict among the objectives set forth in your question. Rather than accept an implicit premise of inconsistency, I should be inclined to hold that reasonable price stability is itself a condition for a relatively stable, healthy, and growing economy. I find it difficult to accept the view that instability in the general level of prices is, in some fashion, a necessary condition of a healthy economic organization.

Since I hold this view, I should like to place additional emphasis on monetary aspects of the discussion of inflation and deflation contained in the other materials enclosed with this letter. My observations will be confined to what I believe to be some of the principal outlines of the problems posed by price instability, inflation, and deflation, for monetary authorities. It will be understood, I am sure, why I pass over the many technical aspects of these matters which are discussed in the replies prepared by the professional economists.

It is helpful, I think, to define inflation in layman's language as a reduction in the purchasing power of money or, more simply, a rise in the general price level under conditions of relatively full resource utilization. Conversely, deflation may be defined as a decline in the general price level accompanying sustained declines in economic activity. The many historical examples of fluctuations in the value of money, some of which were so extreme that they could be classed as disasters, are well known, and there is no need to dwell here on their effects. But these episodes provide abundant evidence that in the highly complex and rapidly changing economies of the world today, money does not automatically remain stable in value. Price stability, we have learned, is not to be presumed.

It has also been observed in many countries and over long periods of time that changes in the money supply have been closely associated with changes in the general price level. I do not hold to the view that there is a simple 1-for-1 correspondence between changes in the money supply and changes in the price level. Nor do I consider that changes in the volume of the money supply are the only influences which affect the value of money. The manifold other influences are discussed at length in the replies prepared by the professional economists. However, it remains true that it is the relationship between the supply of money and its value which provides the means by which monetary authorities everywhere endeavor to carry out their responsibility with respect to the purchasing power of money. By their influence over the rate of growth of the money supply, monetary authorities can and do offset in varying degree the other influences which tend to alter the value of money.

These obvious propositions are stated in order to remind us to look through the myriad details and difficulties discussed in these hearings to the basic problem underneath. In such an economy as ours, where productive effort, saving, and investment are elicited in large part by expectations of future money payments, money with a stable value in real terms is important. The central bank must continually strive to adjust the money supply in response to complex and shifting influences which often are difficult to perceive and sometimes cannot be countered as promptly as one might wish. Discussion of the practical difficulties of this task elsewhere in the technical materials submitted with this letter might create an impression that the job exceeds human capabilities, or may be too costly in terms of other objectives, such as maximum employment or economic growth, so that we must be resigned to continuing erosion of the dollar. I do not believe such depreciation is inevitable. To the contrary, recent experience both here and abroad through a period of severe inflationary stresses seems to me to suggest that swings in the purchasing power of money can be significantly moderated and, indeed, have been.

This conclusion, of course, leads directly to a discussion of the adequacy of our monetary system. To my mind the most important criterion for evaluating the adquacy of a monetary system is that which stresses the adaptability of the monetary system to the contemporary objectives of public policy. In performing this evaluation, there are two sets of questions which require answers. The first relates to the susceptibility of the monetary system to control by those who are entrusted with its management in the public interest. The second and more controversial set of questions relates to the extent to which central bank actions encourage economic decisionmaking that is consistent with the fundamental goals of public policy.

With respect to the first of these questions, the susceptibility of the monetary system to control, I think it is clear that under existing arrangements the Federal Reserve System can exercise effective control over the supply of money. The major outlines of the monetary system are well known, as are the detailed techniques of Federal Reserve System control. Therefore, I should like to direct my remarks to the second and more difficult set of questions.

Though we agree that the Federal Reserve System can effectively control the money supply, we still must ask whether this control can contribute effectively to the accomplishment of the contemporary objectives of public policy. In essaying an answer to this question, I should like to emphasize that the economic effects of monetary action alone are limited, a point to which I shall return. The real question, however, is not whether monetary policy can go it alone, but whether the effects of monetary policy are consistent with the more basic goals of public policy in other respects.

Analysis of the monetary system in a society so complex as ours necessarily requires recognition of a host of highly specialized financial institutions, each of which plays its unique role. Some of them accumulate savings and finance real estate activity, others are engaged in consumer financing, still others assist business firms to obtain funds for expansion. However, all of these institutions—and I have suggested but a few—make use of money, which consists in minor part of currency and coin issued by the Federal Government and in major part of deposit credit on the books of commercial banks, and the total of which at any given time is referred to as the money supply. Fundamental to any analysis of the monetary system is understanding of the fact that the powers delegated to the Federal Reserve System by the Congress enable the System only to influence the rate of change in the money supply and thereby, in that sense, the magnitude of the money supply at any time.

This leads to the question, Who decides how the money supply shall be used? By way of answer one must take into account the flows of spending resulting from production, distribution, and consumption of goods and services. One must also take into account the funds made available by those who elect to save rather than spend. All things considered, the answer may be truly made that the people of the country, operating in and through their market places, their private financial institutions, and their political institutions, decide how the money supply shall be used and how fast it shall be turned over in the stream of spending. The people make these decisions, not the monetary authorities.

Essentially the Federal Reserve System stands as a moderating force in an economy which, guided by a host of individual decisions, sometimes moves too rapidly and sometimes too slowly. In a period of sharply rising economic activity when the demand for credit threatens to outpace the economy's ability to supply goods and services at stable price levels, monetary policy will be directed at restraining the growth of the money supply. The effectiveness of the restraint will be tempered by the normal responses which such a condition evokes in a free economy. An intense demand for funds coupled with a policy of monetary restraint will stimulate a more efficient utilization of the available money supply. Monetary policy, however, may compensate for this increase in the velocity of circulation. By and large, the effect on decisionmaking is such that spending on goods and services is restrained, a result consistent with the objectives of public policy.

On the other hand, when the economy is characterized by substantial excess capacity and when economic activity is declining, the effectiveness of increased availability of money and credit and lower interest rates may not be immediately discernible. This is because the complex of other factors which affect the decisions of businesses and consumers may not be conducive to immediate expansion of demand and spending. Depressed anticipations do not encourage the accumulation of debt. The effect of easing monetary policy is to produce a monetary climate which provides, to whatever possible degree, encouragement both to lenders and to borrowers. This climate is clearly consistent with the objectives of public policy in such a situation. These remarks lead to emphasis upon this truth: That monetary policy cannot be considered as if it were conducted in isolation or in a vacuum but attains its greatest effectiveness when combined with wise and sensitive application of public policy in other areas and prudent decisionmaking in private affairs.

In my view, the adequacy of the monetary system cannot be considered apart from our perspective on a free society. For at the heart of the question of adequacy of the monetary system is really this problem: Shall our people continue to possess the prerogative of deciding in the main how their money supply shall be used? This is a profound question involving fundamental issues of political as well as economic philosophy. We can admit that democratic institutions and processes may not always provide perfect answers, because these institutions are no less fallible than their human components. It would occur to me, however, that the group judgments of the body politic, derived through the free market system, are more likely, in the long run, to be sound and acceptable than under any other alternative in sight. From this perspective and in my opinion, our monetary system serves the Nation well.

Very truly yours,

DELOS C. JOHNS, *President*.

FEDERAL RESERVE BANK OF MINNEAPOLIS,
April 3, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: In response to your letter of February 17, 1958, and the enclosed questionnaire of the Senate Finance Committee, I submit the attached comments. These are in two parts. One part was prepared under the supervision of a special committee of the Conference of Presidents of the Federal Reserve Banks and may be said to represent a consensus comment in response to the questionnaire. The other part represents my own remarks, which are designed to supplement the consensus comment.

Taken in its entirety, the Senate Finance Committee questionnaire is a most searching inquiry into judgment and opinion concerning economic policy, with particular emphais on monetary, fiscal, and debt-management policies, and the recent economic record in the United States. In order to cover the questionnaire fully and competently, and thus be as responsive as possible to the inquiry, the Conference of Presidents of the Federal Reserve Banks decided to prepare a common or consensus reply. At the same time, it was understood that the Senate Finance Committee wanted to obtain individual points of view with respect to particular matters of concern or fields of competence of people living in various sections of the United States. Thus, the second part of the attached comments constitutes my own approach to certain aspects of the United States economy and economic policy as brought out by the questionnaire.

I am in general agreement with the statements contained in the conference document. Consequently, my supplementary comments consist primarily of discussion, giving somewhat different emphasis to certain points. In keeping with your letter and as indicated in the foreword to the first, or consensus, document, the questions have not been answered separately in the common reply, but have been used as a guide in organizing the discussion under five main headings. My supplementary statement is organized along similar lines.

May I say that I appreciate the opportunity to submit comments on the field covered by the questionnaire. I hope that the material submitted may be of some help to the Senate Finance Committee.

Very truly yours,

FREDERICK L. DEMING, *President.*

COMMENTS OF FREDERICK L. DEMING, PRESIDENT OF THE FEDERAL RESERVE BANK OF MINNEAPOLIS, IN RESPONSE TO THE QUESTIONNAIRE OF THE SENATE FINANCE COMMITTEE, APRIL 1, 1958

PART I. ASPECTS OF INFLATION AND DEFLATION

Comments grouped under this main heading cover, generally, the points brought out by questions 1, 4, 6 (b), 11 (a), 12, and 17 in the Senate Finance Committee questionnaire.

The careful and thorough analysis presented in the consensus comment on these questions has my virtually complete concurrence. My own discussion merely emphasizes certain points a little differently from the consensus comment.

The economic record of the past 12 years, in my judgment, shows 3 key trends—2 highly favorable and 1 unfavorable. The two favorable trends are tremendous total economic growth and a higher than prewar productivity; the unfavorable development is a strong inflationary trend. The prime question of the moment is how quickly can the economy recover to the 2 favorable trends; the prime question for the future is can these 2 favorable trends be maintained over time and the unfavorable trend be eliminated so that the value of our currency remains stable.

Since the end of World War II, our economy has functioned remarkably well in several important respects. The massive unemployment which was expected to result from the large decline in Government expenditures for war materials and from the release of millions of men by the Armed Forces failed to materialize. Rather, resources were transferred from the production of war goods to other endeavors with little unemployment, despite the abnormally high rate of growth in the civilian labor force occasioned by the return of veterans plus normal growth factors. The transition from war to peace was accomplished with far less economic distress than had appeared likely.

Subsequently, employment opportunities continued to appear, with the exception of the relatively minor recessions of 1949 and 1954, in approximately sufficient numbers to absorb the net increase in the labor force which occurred in every year but one of the postwar period. In 1957, the civilian labor force averaged 10 million more than in 1946, while unemployment averaged virtually the same as in 1946.

Thus, one of the conditions required for satisfactory economic growth, jobs for those seeking work, was largely met in the postwar years. Another condition of economic progress, rising productivity per unit of labor, also was met to a greater degree than had been considered normal by productivity statisticians. Chiefly as a result of improved productivity, the real gross national product could grow by an estimated 44 percent from 1946 to 1957 while employment was increasing by just 18 percent.

Productivity depends to a large degree upon the size of the stock of capital with which labor must work. Thus the rate of capital investment has a powerful bearing upon the success we achieve in efforts to lift our living standards. A high rate of business spending for plan and equipment, accompanied by the continuous improvement in technology characteristic of the American economy, in the postwar period made possible the large productivity gains and was a major factor in the rising per capita real income.

Such business spending did add to the competition for scarce labor and materials and hence must be associated with the inflationary forces of the period. It is unfortunate that Government (Federal, State, and local) expenditures and some consumer spending could not have been held to lower levels during this period to make more room for the capital boom which was enlarging our industrial capacity. Could that have been done, inflationary pressures would have been reduced. The major impediment to reducing Federal Government expenditures, of course, was the Korean war and the very heavy defense expenditures during the whole post World War II period.

In this connection it seems important to me to stress the points that most of the inflation of the past 12 years came as a result of war and part of the remainder may be more statistical than real. These points have considerable bearing on the problem of preserving stable currency values in the future.

An inspection of the price index charts reveals that most of the postwar inflation occurred in the 2 years following the removal of price controls in 1946 and during the initial months of the Korean war. In contrast, during 1953 the consumer price index averaged only 3.1 percent higher than in 1951, while the wholesale index averaged 4.1 percent lower than in 1951. During that entire 3-year period unemployment averaged less than it had been in any of the other postwar years, previously or subsequently.

The real gross national product in 1953 was estimated to be 8 percent over the 1951 figure; employment in 1953 averaged less than 2 percent above 1951. An important lesson of the period is that impressive economic growth and relatively abundant job opportunities can prevail for more than just a few months, in an environment of marked price stability. The lesson suggests that most of the dollar's loss of buying power was occasioned by war and that the chances for price stability in peacetime should not be gaged by the experience of the entire postwar decade.

Further, it might be observed that success in achieving price stability should not be measured exclusively by an index of prices. No index has yet been devised which can adequately measure changes in the satisfaction which is derived from the expenditure of a dollar. Because of the constant improvement in the quality of products and services included in the price index and the continual appearance of entirely new products, and extension of the range of choice, it is likely that the real worth of a dollar has declined by less since 1940 than the 100 percent increase of the Consumers Price Index suggests.

However, the imperfection of our yardsticks does not mean that money cannot lose purchasing power, nor does it detract from the importance of preserving the dollar's buying power. It does suggest that the meaning of small changes in the price index is not always clear and that while economic policy should not ignore the indexes of prices, neither should it be wedded to them.

The foregoing does not mean to imply that monetary and fiscal policies and other instruments of public policy can be held blameless for part of the upward swing in prices. In retrospect it appears that monetary policies which permitted less commercial bank credit expansion and fiscal policies which placed greater emphasis on debt reduction could have fostered greater price stability without damage to economic growth. The failure to produce more than a small Treasury surplus at times of great prosperity was especially disturbing to those who believe that deficits and surpluses should at least approximately offset over the business cycle.

The postwar expansion of monetary demand was associated in part with growth in the stock of money and in part with a persistent upward trend in the turnover of money. Since 1950 alone turnover has risen by one-third. In 1957 turnover averaged 13 percent higher than in 1955. At the end of 1957 the sum of demand deposits and currency outside banks was unchanged from 2 years earlier. Yet, during those 2 years the Consumer Price Index and the wholesale price index each rose by approximately 6 percent.

These figures demonstrate that demand can expand to bid up prices without an increasing money supply. They do not tell us how far the velocity of money can rise and hence how much spending can expand with a stable money supply. The effectiveness of monetary controls in stopping inflation has been the subject of debate among economists. Some have emphasized the institutional framework of our economy which has permitted many important prices to be less responsive to changes in demand than formerly was true. But the fact that some prices are established with less reference to current market conditions than other prices, does not warrant the conclusion that limitation of the money supply is not a necessary condition for price stability. Not only in the United States, but in other countries as well, central bank action has reflected fairly general agreement that inflation cannot be stopped without appropriate monetary policies.

In this connection, one further observation concerning price stability seems appropriate. Price stability does not have to mean price rigidity. In our type of economy prices are the major allocaters of resources and as new developments occur, individual prices may be expected to vary. Theoretically, a perfect price index would aggregate and average all price changes, but this net movement of prices at any given point in time might well produce a somewhat higher or lower index number than was produced in a particular base period. There is nothing inherently wrong in such movements; the real point about price stability seems to me one which stresses long-run rather than short-run stability.

Thus, I would be inclined to be a little more moderate than those who define inflation as any general rise in prices or deflation as the reverse. These definitions seem to imply that even very gentle waves in prices are bad and should call for action. There have been times in our economic history when price reflation was desirable, for example, in the early 1930's. At the moment I believe some price deflation would help spur consumer buying.

Before discussing the current economic recession, a general comment concerning economic growth and full employment of human and natural resources seems pertinent. One lesson which economic history would seem to teach us is that total growth and productivity gains come in surges rather than as a smooth upward sweep. The economy seems to resemble a human being. It cannot operate perpetually at full capacity: it has to digest, to catch its breath, to rest from time to time. The real problem is to see that the breathcatching or resting phase does not get to be an uninterrupted habit.

Since the physical volume of goods and services produced depends upon the level of employment and productivity which in turn depends upon investment, technology and labor quality, it is not likely that aggregate output will grow at a steady pace. Even with unemployment at satisfactory (low) levels, growth will be affected by changes in the number of people who wish to work and by erratic success in finding better ways to produce. The presence of short plateaus or even occasional mild dips in the gross national product is not inconsistent with economic growth, particularly in a market economy where productive resources must constantly shift to accommodate the changing preferences of buyers. Economic policies designed to prevent any departure from persistent growth in the output statistics may easily create more damage than good.

Unemployment as well as aggregate output is affected by those forces which operate in a free economy. Small fluctuations in the number of people seeking work may be regarded as a part of the price that must be paid if freedom of choice is to be preserved and if resources are to be encouraged to seek their most productive uses. It is clear, however, that large amounts of unemployment cannot be allowed to persist if the goals of economic policy are to be achieved.

The rising unemployment of early 1958 reflects a scarcity of job opportunities not only for new members of the labor force but for workers released from production by the liquidation of business inventories, the decline of exports and military spending and the decline in business capital formation. In 1954 rising unemployment was produced chiefly by the substantial cutback in spending by Government which followed the conclusion of the Korean war. And in 1949, attempts by businessmen to liquidate excessive inventories necessitated substantial layoffs by producers. These are examples of the types of adjustment which create unevenness of growth.

Currently there is some evidence that many consumers have elected to accumulate liquid assets such as savings balances rather than maintain their spending. This suggests that more attractive products and price adjustments could elicit additional spending, which in turn could provide more employment opportunities.

Two specific means of cushioning the effects of the current recession and paving the way for a resumption of growth with stability seem to me desirable. First, the relaxation of monetary policy is designed to create a climate for expansion of credit by making funds more freely available at reduced cost. This has led to some general improvement in bank liquidity and to general lowering of interest rates. Monetary policy action has been taken, it seems to me, with force and dispatch. It obviously cannot, all by itself, bring about full recovery; it can, however, lay the groundwork for a full recovery movement.

Second, to cushion and relieve the economic distress occasioned by the large-scale unemployment some extension of the unemployment compensation system would seem desirable. By increasing benefits and by lengthening the term over which benefits are payable, the people directly hurt by the current recession could be helped directly and consumer buying power could be prevented from falling sharply. Could this kind of program be accompanied by some modification of standards of eligibility for unemployment compensation, it would go far to cushion the adjustment taking place. Some State eligibility standards require elimination of unemployment compensation payments if the recipient locates work yielding an income in excess of a very small fraction of the benefit payment. The purpose, of course, is to eliminate the incentive to remain unemployed; I believe this purpose could be served adequately even though the minimum earned income level for eligibility were revised upward in substantial degree. This would have the effect of permitting more part time or lower pay work without jeopardizing the unemployment payments and hence would hold up income.

If the above changes could be coupled with a provision for the use of Federal funds to cover the additional cost, it would eliminate the destabilizing effect of higher payroll taxes at a time of reduced business activity. Finally a major virtue of such a program would be its automatic reduction as unemployment declined.

PART II. OBJECTIVES OF ECONOMIC POLICY

Comment under this heading is intended to cover questions 2, 6 (a), 11 (b), 15, and 16 of the Senate Finance Committee questionnaire.

I have no particular difference even as to emphasis with the consensus comment on objectives of economic policy. What I state here is mainly repetitive both in respect to the consensus comment and part of my comment under part I.

To me, it is of key importance to recognize that economic growth, employment, production and demand stability, and price stability are indivisible in the long run. The old unanswerable questions about which leg is more important to a walking man or which scissors blade does the cutting seem to be pertinent when applied to the long-run objectives of economic policy. In the short run, as the consensus comment points out, one objective or another may assume some priority. On a pragmatic basis there has not been any great difficulty in arriving at reasonable conclusions as to priorities under differing conditions. There are times, of course, when there can be honest differences of opinion as to the state of the economy and hence as to the priority of a particular objective, but by and large these would seem to be very temporary situations.

Much has been written in recent years about the incompatability of the objectives of growth, stability in employment, production, and demand, and price stability. It seems to me that a far more persuasive case can be made for their interdependence. Without reasonably full use of resources, both human and material, we encounter economic waste and therefore something less than optimal growth.

Without reasonable price stability, we encounter uncertain business decisions, speculation, and questions as to the desirability of saving which lead to less than efficient use of resources and to swings in capital formation which certainly do not contribute to balanced growth. The fact that we had growth with price inflation during the past decade is discussed in my comments under part I. That history seems to me to prove no more than that we had both growth and inflation; not that the two are complementary; certainly not that this situation is desirable.

Also noted in part I is the point that a dynamic economy does not perpetually operate at full capacity. Public policy should be concerned with the length of time and the amount it is below full capacity, rather than with minor and transitory interruptions to full-scale operation. If consumer choice is permitted to point the general direction of economic expansion, then small amounts of temporary unemployment from time to time may be inescapable. These can be cushioned by various devices, notably the unemployment insurance program. If consumers shift their preferences from one good to another, we ordinarily should not interfere with the allocation of resources which will give consumers what they want. Our profit-motivated economy is admirably suited to solving such problems of resource allocation. The role of public policy in the economy is not so much to direct the allocation of resources (although it undeniably has effects on resource allocation) as to insure that cumulative economic disturbances such as serious inflation or serious unemployment do not lead to wasteful use of resources.

A final point on this section deserves restressing. Because the American economy is not a perfect economy and because economic policymakers are human, we do not attain all objectives of economic policy at all times. To me, this is no reason to abandon any of them. Some of the proponents of creeping inflation imply that since, in their view, inflation cannot be stopped, it should be accepted. I do not agree with the premise, nor do I believe that the record or reason supports it, and I certainly would question the conclusion. While we may experience creeping inflation at times, this is a far different thing from acceptance of it as regular and inevitable or as a necessary condition for growth.

We may not know precisely what would be the results of public acceptance of such a condition, or its acceptance as a matter of public policy. We can, however, reason that it would stimulate current spending and inhibit private saving. We can reason further that the savings gap would have to be made up, either by credit expansion or by some sort of directed economy device, or else capital investment would be retarded and the rate of economic growth slowed. If the savings gap were filled by credit expansion, inflation would be intensified; if it were handled by direction, the nature of the economy would change—in my opinion, for the worse. The effects of inflation on individuals who cannot keep up with it are serious enough; the effects of acceptance of inflation as a matter of public policy would be far more serious.

PART III. MONETARY POLICY, 1942–57

The discussion under this heading deals with question 3 of the Senate Finance Committee questionnaire.

The historical review detailed in the consensus comment is thorough and warrants little additional comment from me. Thus my remarks are confined to a brief note on 1 or 2 points.

Although it is impossible to say with certainty how economic developments since 1942 would have been affected had different monetary policies been pursued, the statistical evidence suggests that somewhat more restrictive monetary policies could have aided price stability without damage to employment or economic growth. Interest rates doubtless would have averaged higher under policies which occasioned a lesser rate of growth in credit.

But considerations of war finance, early in the period, dominated the formulation of monetary policy. The decision to finance the heavy Government expenditures in perhaps greater than desirable proportion by borrowing, imposed upon the market for securities the burden of absorbing the swollen volume of new Treasury issues. Without some increment to investable funds from commercial bank credit expansion, it is doubtful that Treasury finance could have been accomplished without much more serious problems.

After the war, monetary policy was operating in an economy being subjected to the powerful disturbances attending vast reductions in Government spending and rapid growth in the number of people wishing to work. In retrospect, it appears that the deflationary forces were overrated, as was the danger of allowing Government securities to fall in price.

Some evidence can be assembled to support the view that, subsequent to the "accord" in 1951 when Treasury securities were allowed to fall in price, monetary policies continued to overrate the significance of the deflationary elements which appeared from time to time. While the accumulation of unemployment in 1953 and 1954 clearly warranted some relaxation of monetary restraints, hindsight suggests that the inflationary problems of the past 3 years could have been lessened and the recovery in late 1954 could have proceeded with less commercial bank credit expansion than monetary policy allowed at the time. About these matters, however, there is no certainty.

That monetary policy emphasized restraint after 1954 is evidenced not only by the choice of adjectives popularly used in its description, but also by the facts that the Nation's money supply was virtually unchanged at the end of 1957 from 2 years earlier and interest rates generally rose to postdepression highs. Despite this, the boom in business investment followed by the development of excess capacity and the tendency of prices to edge higher indicates that perhaps policy erred more on the side of ease than was proper, even though much of the public criticism took the opposite position.

In 1957 prices continued to rise throughout the year and unemployment fell in every month before November except May and June. Beginning in November, unemployment began to accumulate, and by the spring of 1958 numerous measures were under consideration for the treatment of the recession. A reduction of Federal Reserve bank discount rates in November constituted recognition by monetary policy that economic conditions had changed.

There was awareness on the part of the monetary authorities of the uncertain economic outlook throughout 1957. What is important to remember is that the uncertainty properly reflected concern over further inflation about as much as concern over possible deflation. Some opinion now holds, as the statistics have become available, that the turning point toward deflation came in August 1957. In my opinion, an equally good case can be made for late October as a turning point date. I believe the System saw the turn in the road about when it came and moved at once to take prompt and forthright action.

In summary, had monetary policy been less restricted by the necessity to facilitate Treasury finance in the war and by concern for the huge debt after the war, a greater measure of price stability probably could have been achieved. These considerations illustrate the importance of harmony in the use of monetary and fiscal policy and the other instruments of public policy.

PART IV. FISCAL AND DEBT MANAGEMENT POLICY

Discussion under this heading is intended to cover questions 5, 7, 8, 13, and 14 of the Senate Finance Committee questionnaire.

My remarks relate primarily to question 13, although I wish to comment briefly on certain points brought out by questions 5 and 7. In general, I agree with the consensus comment; my statements are intended to be supplementary only.

In my opinion, the point (in terms of unemployment, production, consumer demand) at which the Federal Government should move in major ways to counteract an economic downturn cannot be determined by any fixed figure, such as a percentage or an index number. The particular cause or causes of economic instability are more important in determining a course of countercyclical action by Government than are specific points of reference. As a matter of fact, we have built into our economic system a series of automatic stabilizers (a progressive tax system, unemployment compensation programs, farm price supports, etc.) which can and do operate to moderate economic distress occasioned by downward adjustments in activity. In upswings, these either tend to become neutral in their effect or operate as anti-inflationary devices.

For example, an inventory adjustment or spotty unemployment resulting from changed consumer tastes should not require additional direct Government intervention. In the first instance, the adjustment presumably is desirable, in fact, is required by the economy. In a sense, it is required because preventive measures to inhibit speculative inventory buildup have been inadequate and the economy has to go through a brief convalescent period. Here the built-in stabilizers, particularly unemployment compensation, should cushion the effect of the adjustment on consumer income.

Similarly, it would be unwise to interfere with an adjustment stemming from changed consumer tastes or resistance to high prices, beyond the use of the built-in stabilizers. Desirable changes in production follow such developments; these are constantly in process in a dynamic economy such as ours.

In other instances, when the causes seem more far-reaching—say, adjustment from a war to a peacetime economy, or one stemming from a deepseated maldistribution of income—Government intervention should come quickly and forcefully in order to avoid major cumulative output, employment, and price downswings. In such cases, however, intervention should be based on thorough analysis in the interest of avoiding massive intervention against minor disturbance, which could pose more problems for the future than it solved at the time.

With respect to question 5, I must agree for the time being with the statements forming part of the consensus comment on this question. While debt management policy theoretically offers great possibilities as a fairly flexible countercyclical device, as a practical matter it has not proved feasible to use debt management in this way to any appreciable degree.

The theoretical case for debt management as a flexible countercyclical measure is so impressive, however, that I would not like to see it ruled out by policy. Sale of long-term securities and retirement of short-term issues during inflation would tend to reduce liquidity and hence inhibit bank loan expansion; reverse action would occur during deflation. In addition, such a program would lead to absorption of some long-term funds in inflation and thereby restrain other demand which could be made effective mainly by utilizing these funds. During deflation the long-term market would be left relatively free of Government demand for funds, thus leaving room for other demand. Mere lengthening of the debt would tend to act as a stabilizing force. In inflationary periods, with rising credit demand and higher interest rates, the price of securities falls, thereby inhibiting switches into other investments. The longer maturities are affected more than the shorter ones, simply because their call or maturity dates extend well into the future.

Perhaps the market factors of today argue against effective use of debt management as a stabilizing tool. I hope this kind of use will continue to be studied, however, and that more effective techniques of use may be discovered as time goes on.

Government spending as a countercyclical device also has offered more theoretical than real possibilities in the postwar years. Spending programs take some time to become effective, even when prompt congressional action is taken. Given today's very large budgets dominated by defense programs, it has not proved feasible to make any sharp reductions in Government spending during inflation. Whether the reverse holds true has not been strongly tested during the past decade.

In the field of fiscal policy, tax policy apparently holds the greatest promise as a stabilizing implement. A progressive tax structure has a large measure of built-in stabilization qualities since income changes automatically change the amount of tax receipts. Going beyond this automatic factor, tax rate cuts or increases have pronounced effects on disposable income and on spending. These are not usually the products of quick action, however, and thus do not lend themselves well to short-run situations.

PART V. THE UNITED STATES MONETARY SYSTEM

Comments grouped under this main heading cover generally questions 9 and 10 (a) and (b) of the Senate Finance Committee questionnaire.

The central points covered by the consensus comment: Definition and description of the monetary system, standards for judging its adequacy, and relationships between monetary policy, fiscal policy, and debt management, are presented in a form with which I can concur completely. I agree that the primary question of working with the three instruments of economic policy is one of coordination rather than one of selection, and that it is highly important to have mutual awareness of problems in all three areas. I share the feeling that there has been reasonable coordination of policies over the past 7 years. Finally, I should note that I concur almost completely in the consensus comment as to the adequacy of the monetary system in responding to economic change in accommodating orderly economic growth on a national scale and in the allocation of bank credit to promote effective use of the Nation's resources.

My supplementary comments relate to two broad areas: The "financial intermediaries" (insurance companies, savings and loan associations, savings banks, pension funds, etc.), and the adequacy of the monetary system on a regional basis.

With respect to the financial intermediaries, I agree with two points noted in the consensus comment: that they do not expand the money supply by means of their extensions of credit, and that any action to bring them directly under monetary control should await the results of extensive study of their functioning. Two additional points, however, might be noted; these undoubtedly would be studied in connection with any extensive review of the financial intermediaries.

The first point has to do with the velocity of money. There seems to be little question that the operations of the financial intermediaries, through activation of relatively idle cash balances, can influence the rate of money turnover. While there does seem to be some natural limit to the turnover rate so that control over the supply of money is the key factor in the supply-velocity combination, the velocity factor can prove troublesome enough in the short run to blunt the cutting edge of a restrictive money policy. I recognize that velocity changes stem from other sources than the financial intermediaries operations and that most, if not all, of these other sources are not susceptible to greater public control. This ,however, does not seem to me to be an adequate argument against bringing sources which may be susceptible to control under control, unless they are so minor as to make little difference.

The second point relates to the effects on the economy of the growing institutionalization of savings, which development is underlined by the growth of the financial intermediaries. I have no preconceived ideas on this point, but it would seem highly desirable to study it.

The balance of my comment under this discussion area relates to the adequacy of the monetary system from a regional point of view—specifically, in this case, from the point of view of the upper Midwest or the Ninth Federal Reserve District. This is a large geographic area, much of it sparsely populated, with great natural resources. It is heavily agricultural, but has substantial mining and lumbering activity. Its only major metropolitan area and industrial-commercial-financial complex is the Twin Cities of Minneapolis and St. Paul.

At times in the past, this region has had difficulty in obtaining as much capital and credit as it could employ usefully and desirably, a situation not particularly unusual in a new or relatively underdeveloped area. The net flow of funds tended to be adverse, a condition that was accented whenever farm prices weakened relatively or farm production fell substantially. Flows of capital and credit from outside seem to have been inhibited, partly, I suspect, because of imperfect knowledge of opportunity, partly because of imperfect understanding of risk. Also characteristic of a new or developing area, the region's own financial system, primarily a small-bank system, seems to have been overextended almost as a chronic condition, and at times was under severe strain as it sought to meet financial needs. The big banks of the Twin Cities and some of the larger institutions in other population centers served as the correspondents for the small banks. They also faced severe strains at times.

This state of overextension made the credit system quite vulnerable to economic misfortune, particularly farm recession. When such occurred, heavy waves of bank failure followed; these were proportionately far more severe than those which took place in more developed and better capitalized areas. Thus, despite the yeoman efforts of the region's own financial system, which really did an extraordinary job under trying circumstances, I believe it fair to say that, from the point of view of this region, the credit side of the monetary system was not always adequate in the past.

This situation no longer holds true, and today the monetary system can be regarded as adequate from the standpoint of this area as well as that of the Nation. Ties with other regions are stronger, the national credit structure has become more closely linked, and outside sources of funds can be tapped more successfully. The big change, however, has come in the growth of the area's own financial system, which is now much stronger and has resources of its own which are far more adequate to meet needs than they were in the past.

It should be noted that the present state of credit adequacy for this region came about mainly through developments inside the region and via private rather than Government endeavor. To be sure, Government programs which helped agriculture, Government spending for war and public works, and other Government programs contributed significantly to the general economic growth of the region. Also, changes in the banking laws helped strengthen the whole credit-granting structure. These all operated on a national scale, however, and there is no reason to believe that this area benefited appreciably more than others from such developments.

Government farm-credit agencies have made a real contribution to agricultural finance in the region, but, again, that contribution has been no greater (in fact, it seems to have been slightly less) than in other areas. As of January 1, 1948 and 1957, of total short-term farm credits held by commercial banks and production credit associations in the 6 States of Michigan, Wisconsin, Minnesota, North and South Dakota, and Montana combined, the proportion held by production credit associations represented only 14 and 15 percent, respectively, as against 16 and 18 percent, respectively, for the country, as a whole.

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Three recent developments in making the regional credit system even more adequate are worthy of note, and, again, it is important to stress that these are local endeavors. South Dakota, Wisconsin, and Minnesota have chartered industrial development credit corporations. These are institutions, operating on a statewide basis, designed to aid in the financing of new and expanding industry. They are privately capitalized, and were actively sponsored by the State bankers associations.

It is with real pleasure and pride that I recite this record of accomplishment. If the next 25 years bring with them as much real growth in the regional economy and the regional financial system as did the past quarter century, the upper Midwest will have an enviable record, indeed.

FEDERAL RESERVE BANK OF KANSAS CITY,
Kansas City, Mo., April 3, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: I am glad to respond to your letter of February 17, 1958, requesting my thoughts and opinions about various matters affecting our economy. Inasmuch as you made a similar request of each of the other Federal Reserve banks, it appeared to us that a joint reply might be possible on our behalf with respect to a number of the matters to be covered, which would serve to eliminate a considerable repetition of views as well as to facilitate the completion of our replies within the time, substantially, that you requested them. A similar procedure was followed in replying to inquiries from Senator Douglas and Representative Patman in the hearings on monetary policy which were conducted under their chairmanship, respectively, in recent years. A joint reply of that kind has been prepared, and a copy of it is herewith sent you. The joint reply, together with the comments in this letter, constitute my reply to your inquiry.

These comments reflect a desire to give somewhat more attention to the dynamic interrelationships existing among the major goals of economic stabilization policy—price stability, maximum employment levels, and sustained economic growth. Viewed from the standpoint of their dynamic aspects, the mutual interdependence of these goals assumes a degree of importance which is deserving of particular emphasis.

A point of departure for considering dynamic aspects of economic policy goals is found in noting the importance of achieving steady growth of output in an economy displaying a positive growth potential. The existence of a continuously enlarging supply of resources requires an expansion in real output to prevent underutilization of resources, unless productivity is declining. To the extent that productivity rises, the expansion rate of real output necessary to circumvent the emergence of idle resources is increased. Since our economy displays ample evidence of a positive growth potential, the result of both efficiency gains and enlargement of resource supplies, the actual growth rate of real output clearly is a necessary concern in the formation of monetary and fiscal policies. Satisfactory employment levels would not be achieved if the actual growth rate of real output became and remained significantly below the economy's growth potential. Thus, policies designed to achieve and maintain satisfactory employment levels inherently are directed toward the absence of serious interruptions to the forward progress of total real production.

It would be folly for public policy to attempt to promote a fixed annual increment to physical production. Once the economy has attained maximum levels of employment and output consistent with price stability, the extent to which further annual gains in real output can be accomplished, within the framework of stable prices, cannot be determined with any degree of accuracy. Our postwar experience, indicates that productivity gains vary markedly from year to year, and the yearly expansion in labor supplies is itself subject to variations, depending upon the growth and changing age composition of the population and alterations in the labor force participation rate. Observation of the growth of real output, nevertheless, provides important clues for the guidance of policy decisions. Thus, a retardation in the growth rate, when labor force participation rates and plant capacity rates of operation are high and rising, provides confirming evidence of exceptional strains on basic resources that are productive of inflationary pressures. Contrastingly, slow growth of real output, accompanied by indications of declines in labor force participation and plant capacity rates of operation, confirms a moderation of these fundamental tensions.

Achieving comparatively steady growth in output is necessary not only to the attainment of satisfactory current utilization rates of resources, but also to the establishment of conditions favorable to the maintenance of these utilization rates in future periods. The ability of the economy to realize its growth potentialities is greatly enhanced by the provision of reasonable assurance to businesses and consumers that marked variations in the expansion rate of business activity are to be counteracted by measures of public policy. Wide swings in aggregate output levels magnify the risk of business enterprise and place a damper on business investment. The anticipation of highly unstable income levels equally affects the willingness of individuals to incur debt obligations and acquire homes, autos, and other goods and services. The absence of major cumulative downward movements during the mild recessions of 1949 and 1954, and to date in the current recession, reflects, among other things, the confidence of business and consumers that economic growth can proceed with minimal interruption. The expectation of reasonable output stability has been a vital element in the stabilization of investment and consumption outlays. This expectation, in part, rests upon public recognition of the potential expansion in incomes and markets made possible by population growth and technical progress. But it is in no small measure related to the acceptance by Government of an increased responsibility to avoid cyclical output fluctuations.

No less important to the continual maintenance of steady economic growth is the avoidance of instability in prices. Throughout the postwar period, this problem has posed itself as one of controlling inflation. It is worth recalling, however, that secular price deflation, or wide cyclical fluctuations in prices around a constant average level, also would create serious obstacles to the sustainment of satisfactory production and employment rates.

One of the dangers of inflation is that price advances in a period of cyclical expansion may increase the vulnerability of the economy to a succeeding contraction. Distortions in price-cost relationships, a redistribution of real income away from persons whose money incomes are inflexible, and speculative investment in inventories or capital equipment are among the kinds of structural maladjustments which may accompany price increases. How important inflation-created maladjustments have been in generating observed downturns in employment and production during the postwar period is not readily determined. While there is little evidence suggesting that the contractions of 1949, 1954, or the present recession were due solely or mainly to maladjustments traceable to price changes, such factors were among the casual forces of these interruptions to economic growth.

A second inflationary threat to economic growth and stability lies in the psychological attitudes and expectations engendered in the minds of the public. To the extent that continuing price advances become more widely anticipated, efforts to escape the effects of inflation may decrease seriously the resistance of the economy to future inflationary pressures. Evidences such as the adoption and spread of wage contracts tied to the cost-of-living index, the declining reluctance of businesses and consumers to incur debt obligations, and the general increase in price-earnings ratios on industrial stocks during the past 10 years point to significant changes in public attitudes regarding the future course of prices. This may be the principal threat created by inflation in the postwar period. Policies to combat inflation in this kind of economic environment must be designed not only with a view to avoiding the short-run disturbances associated with price maladjustments, but also with a view to the longer run implications of continuing reductions in the purchasing power of money. The success of anti-inflationary policies cannot be measured by price indexes alone. The effect of such policies on the public's attitudes toward inflation is also important.

Reasonable price stability and the absence of wide fluctuations in the levels of output and employment clearly are conditions necessary for a climate conducive to economic growth. But the limits of tolerance within which prices, employment, and output may vary without undermining this climate depend heavily upon the reactions of the community and upon the kinds of institutions present in the economy. Thus, it cannot be assumed that the experience of other countries, or even our own historical experience, necessarily provides reliable answers to this question.

It seems probable that the limits of tolerance in our economy are quite narrow. For a variety of reasons, the sensitivity of the economy to inflation—the extent to which price rises induce expectations of further advances (and motivate reactions which tend to justify the expectations)—appears to be high. Important decision-making economic units, such as corporate management and labor organizations, are large and knowledgeable. Prospects for future price advances cannot help but influence industrial pricing practices, investment decisions, and wage negotiations. Widespread access to credit facilities provides a financial basis for both businesses and consumers to accelerate purchases. The high and rising level of general economic intelligence familiarizes individuals with the effect of inflation on their financial position and suggests means of escaping its effects; publicity given to inflation in the postwar period has added to the community's awareness of the problem.

As has been suggested earlier, the postwar period has witnessed the development of public expectations that periods of depressed output and employment will be a less prominent feature of our business experience than they were in earlier years. Recognizing that public policy has placed narrower limits of tolerance on what are regarded as satisfactory employment and output levels, public confidence has been sustained in periods of declining business activity. In this sense, the sensitivity of the public to downward adjustments in business activity—the extent to which pessimistic expectations are engendered which contribute to the downward movement—has been reduced and the sensitivity to inflation increased. Nevertheless, it remains true that an economy with investment tied to the profit motive, an economy with a heavy volume of future income committed to debt retirement, an economy with considerable downward inflexibilities in its cost structure, an economy in which the commitment of resources to the capital goods industries is geared to continuing economic expansion cannot tolerate sharp and protracted declines in employment, output, and prices without risking serious disruption to the economic growth process. It is just as important to preserve public confidence in the ability of the economy to resist downward adjustments in business activity as it is to evidence a firm determination to fight inflation.

Another sense in which economic growth falls within the focus of public policy is revealed in the increased attention given in recent years to the concept of sustainable economic growth. There have been at least two major kinds of problems distinguished in discussions of this concept, problems which pose distinct questions from the standpoint of public policy.

The first of these deals with maladjustments created in the process of moving rapidly to full capacity production from a state of resource underutilization. Frequently, periods of recession in economic activity are followed by extraordinary surges in production, investment, and consumer spending, as business activity moves to new peaks well above those achieved in any preceding boom period. The rate of expansion often substantially exceeds the long-run growth potential of the economy, as rapidly rising levels of output are permitted by the existence of unused resources in the initial phases of recovery. Such headlong expansion cannot proceed indefinitely; the expansion rate of real output necessarily must slow down as the economy moves into the range of full capacity production.

If the expansion rate during the upswing is too high, an encounter with full capacity ceilings may retard the growth process so abruptly as to make a continuance of growth quite tenuous. Certain kinds of economic activity may become geared to the excessively high growth rate of output, and a marked reduction in the growth rate may produce serious setbacks in these industries. The "shock effect" of these setbacks may be sufficient to turn boom into recession.

Economic growth of this kind is unsustainable; it generates an industrial distribution of resources which cannot be maintained indefinitely. The policy implications of this kind of unsustainable growth are generally clear, albeit imprecise: the exercise of restrictive policies must begin in the early stages of industrial expansion to foster orderly, balanced growth in business activity.

A second form of unsustainable economic growth is associated with the difficulty of avoiding cyclical fluctuations in output when labor is the relatively scarce productive factor limiting the potential growth rate of physical production. This situation often is thought to be characteristic of industrialized Western economies, as opposed to the so-called underdeveloped countries in which a shortage of capital instruments to equip the labor force frequently poses the effective limitation to economic growth. That a relative scarcity of labor resources could lead to an interruption of the growth process, to recessionary tendencies, and to general unemployment may seem paradoxical, but the problem is no less serious because of its unusual character.

The source of the difficulty in sustaining economic growth in this case may be stated in 1 of 2 ways. One formulation is that the volume of investment needed to keep the economy operating at maximum employment levels is too high, because the resulting additions to plant capacity exceed the growth in complementary human resources and hence in total output. Thus, an increased share of output flowing to consumers or to Government and a smaller share in the form of investment would permit a continuance of maximum employment levels with smaller additions to plant capacity. A second formulation is that the potential growth rate of output is too low, given the proportion of output taking the form of net capital formation. This formulation suggests that acceleration of the potential growth rate would prevent the emergence of unused plant capacity. Innovations which increase labor productivity, especially innovations which are highly labor saving, for example, would help in this respect by removing or scaling down the obstacle to growth—the relative scarcity of labor.

This kind of unsustainable growth points to important interrelationships between cyclical disturbances and growth potentialities. Therefore, economic stabilization policies and policies aimed at altering the economy's growth potential are not entirely separable.

When the effective limitation to economic growth rates is found in a relative scarcity of labor supplies, central banking actions can do comparatively little to elevate the potential growth rate. Stimulation of particular kinds of investment which would increase the potential growth rate cannot be accomplished readily through credit policy. In these conditions, the contribution of central banking to economic growth is limited to the maintenance of an atmosphere in which the growth potential can be realized.

Maintenance of an atmosphere favorable to economic growth is also a responsibility of other kinds of governmental policies. Providing a climate in which private initiative and competition can function effectively are major prerequisites to a high economic growth rate, but the contribution of Government to economic progress does not end there. In a negative sense, concern with the effects of governmental policies on economic growth potentialities is inevitable, for virtually every aspect of governmental action has some influence, for good or for evil, on our potential growth rate. The structure of taxes, for example, has implications for initiative and the supply of risk capital which bear importantly on growth possibilities. Policies directed toward the conservation of resources, fostering of the educational system, and Government research programs exemplify kinds of action directed more positively to the goal of a higher rate of economic progress. In general, policies such as these have not been concerned with the interrelationship of economic growth potentialities and economic stability. Rather, their major purpose has been to increase per capita income and hence the standard of living. Conscious direction and perhaps extension of such programs might be appropriate in the event that economic growth proves unsustainable by virtue of an inadequate potential growth rate.

This brief résumé of the dynamic interrelationships among the major goals of economic stabilization policy by its nature ignores a broad area of social values whose achievement falls within the focus of economic stabilization policies. Considerations of equity, as these are related to sharing the fruits of economic progress, for example, are involved in the choice among kinds of stabilization policies. The viability of our socioeconomic institutions, as it affects their continuing survival, ultimately may determine the effective limits of tolerance on fluctuations in employment, output, and prices. Such broader considerations obviously must play an important role in the design of programs to achieve economic growth and stability.

Very truly yours,

H. G. Leedy, *President.*

Federal Reserve Bank of Dallas,
April 10, 1958.

Mr. Samuel D. McIlwain,
Special Counsel, Committee on Finance,
United States Senate, Washington, D. C.

Dear Mr. McIlwain: Enclosed are three copies of Mr. Irons' supplement to the joint reply of the presidents of the Federal Reserve banks in response to the questionnaire of the Senate Finance Committee.

In line with our telephone conversations today, we have slightly changed a few sentences in some of the footnotes so that they could stand separately as supplementary comments, but there are no changes in substance. The page references at the beginning of each supplementary comment refer to the pages in the joint reply as submitted to you, for example, by Mr. Hayes and certain other of the presidents; they do not refer to the pages in our original reply, in which the pages were renumbered to allow for insertion of our footnotes.

As I told you on the telephone, we shall be glad to cooperate with you in any way possible in your preparation of the material for publication.

Yours sincerely,

Charls E. Walker, *Vice President.*

Supplementary Views and Comments of Watrous H. Irons, President, Federal Reserve Bank of Dallas, to the Joint Reply of the Federal Reserve Bank Presidents in Response to the Questionnaire of the Senate Finance Committee

SUPPLEMENT NO. 1—COMMENTS ON THE PROBLEM OF DEFINING INFLATION AND DEFLATION

(Pertaining to pp. 1–5 of the joint reply)

The question as to the definition of inflation and deflation, while comparatively simple on its face, involves numerous conceptual difficulties, some of which are pointed up in the joint answer covered in pages 1 to 5. This supplementary statement, which reflects my views, may be of interest.

In my opinion, the terms "inflation" and "deflation," in their broadest sense, mean a general reduction or increase in the purchasing power or value of money and, consequently, may be defined as an increase or decrease in the general price level. This sort of definition which, in my judgment, represents a useful—though not infallible—concept is immediately subject to certain qualifications. There is first the question "What general price level?," and second there is the problem of "the time lag and short-run rigidity of prices." Other qualifying problems also might be mentioned.

Although inflation and deflation may be defined in terms of price changes, or tendencies toward price changes, the underlying causes of inflationary or deflationary tendencies must be considered in terms of the many economic forces—actually imbalances—which tend to produce price changes. For example, inflationary (or deflationary) pressures may be generated by monetary forces; by fiscal forces and Government spending; by aggregate demand excessive (or deficient) relative to available supply; by rising cost pressures in relation to productivity gains; by developments in the private sector of the economy, such as a capital goods boom; and by other forces. One or more of these or other forces likely will be the generating force which leads to inflationary (or deflationary) pressures and ultimately to rising (or declining) prices.

The various price indexes that are commonly used to measure broad price movements will not always move together. Moreover, a timelag in the movement of different price indexes is not uncommon. Consequently, an upturn in all major price indexes is not necessary for the identification of inflation, nor is a downturn in all major price indexes required for the identification of deflation. Even during inflationary or deflationary movements, all price movements will not be uniform for all market items; moreover, all price changes will not necessarily be in the same direction. In addition, major price sectors (e. g., agricultural prices) may run counter to other major price sectors (e. g., industrial prices), under which conditions it becomes difficult to establish with assurance the existence of inflation (or deflation).

It is important to recognize that inflation and deflation are concepts involving persistent pressures which affect, with some possible timelag, prices over a broad range. This point of emphasis is significant because the prices of individual goods and services, reflecting as they do the myriad conditions of changing supply and demand, are in a more or less continuous state of flux. At any point in time, some prices are rising, others are falling, while still others are holding steady. Under such circumstances, modest short-term fluctuations in what might be termed "average prices" are to be expected, and these fluctuations do not necessarily represent either deflation or inflation. For example, a sudden freeze of the citrus and winter vegetable crops in Florida and the Southwest, resulting in an increase in food prices and in the cost of living, may not be serious as an inflationary problem. However, aside from these short-run fluctuations there exist from time to time for one reason or another unmistakable pressures which produce, or tend to produce, persistent upward or downward movements in prices over a broad range of market items. Depending upon the direction of these broad price movements, they may be characterized as inflationary or deflationary movements.

Inflationary or deflationary pressures may be present for some time before the effect of such pressures upon prices is discernible. It is true that inflation is experienced during the upward leg of the business cycle and deflation is characteristic of the contractive phase of the cycle and each is accompanied by the employment, production, income, and price forces that are characteristic of those phases of the cycle. However, due to such factors as the stickiness of price movements, the maintenance for an indeterminate period of time of final demand on the part of the consumer, the mere sluggishness of adjustments, and possibly for other reasons, actual price movements may lag the appearance of inflationary or deflationary pressures. This is not to assert, however, that such inflationary or deflationary pressures do not exert tendencies toward (and will not ultimately achieve) higher or lower prices over a broad general price area. In the moderate recession of 1953–54, and again during the current recession to date, final demand on the part of the consumers of goods and services was maintained at a much higher level, relatively speaking, than demand at the manufacturing or production level; consequently, it was, and has been, possible to effect a much more orderly inventory adjustment without appreciable price cutting than would have been the case if final demand had been less strong. This is not to say, however, that such conditions would continue to be the case if the adjustments were to proceed beyond the period of maintenance of final demand at a high level.

But one should not bind himself unalterably to the rigidity of price increase or decrease as the defining concept of inflation or deflation. At least theoretically, consideration should be given to relative rates of productivity over time and their relation to price movements. With respect to this problem, it is possible that inflationary pressures might prevail during a period of overall price stability provided productivity were improving and some part of the productivity gains were not being passed on to the final consumer in price reductions. Likewise, it is possible that a period of gradually declining prices might not be regarded properly as deflationary, if such declining prices were the consequence of increased productivity being shared by the final consumer in the form of lower prices.

Finally, it may be appropriate to associate inflationary and deflationary tendencies with situations which, for one reason or another, are characterized by over—or under—utilization of resources. Inflationary conditions generally prevail when there is a tendency toward the overutilization of economic resources and, sooner or later, are reflected in general price inceases; on the other hand, deflationary conditions generally prevail when there is a tendency toward an underutilization of resources and, sooner or later, are reflected in general price decreases. Moreover, it should be emphasized that, as a general rule, the seeds of deflation are sown in periods of inflation and the overutilization of resources. Therefore, the real point of attack upon deflation is during the preceding period of inflation; if inflation can be limited or prevented, the problems of deflation will not be very consequential.

SUPPLEMENT NO. 2—SOME VIEWS ON THE SIGNIFICANCE OF PRICE RIGIDITIES

(Pertaining to pp. 8–13 of the joint reply)

To the extent that price rigidities and inflexibilities, as outlined in the joint reply, prevent price adjustments during periods of economic contraction, serious problems with respect to the maintenance of the stability of the value of the dollar may arise. In my comment in supplement No. 1, I have associated deflation with a tendency—or actuality—toward declining general prices. It is admitted, however, that during periods of moderate or short-term economic contraction, when final demand is relatively well maintained, the downward price movement may be slight or even negligible. It is significant under such circumstances that if the preceding period were one of price inflation, e. g., 1955 to August 1957 versus August 1957 to date, the price increase of the preceding period becomes consolidated in the price structure with consequent long-run shrinkage in the value of the dollar.

If it is true that general downward price adjustments with all of their consequences are unacceptable under the Employment Act of 1946, then it should also be true that general price increases with all of their consequences should be regarded as equally unacceptable under that legislative doctrine. We simply cannot achieve stability in the value of the dollar over the long run if we are willing to permit and tolerate inflationary price increases but are unwilling to tolerate deflationary price decreases. This statement is not to be regarded as an argument in support of deflationary price decreases, but it does represent an appropriate emphasis upon the compelling importance of restraining and preventing inflationary developments and general price increases during the expansive phase of the business cycle. It also reemphasizes that the point of attack in the quest for economic and price stability first must be in the period of threatening or actual inflation.

SUPPLEMENT NO. 3—SOME FACTORS IN THE DECLINE OF THE VALUE OF THE DOLLAR, 1956–57

(Pertaining to pp. 26–32 of the joint reply)

Supplementing the discussion in the joint reply, and with specific reference to those factors which were most significant in their contribution to the decline in the value of the dollar as reflected by the Consumer Price Index from mid-1956 to mid-1957, I think it may be concluded that the most important causes or factors were a continued increase in wage rates, an absence of any appreciable increase in productivity, maintenance of a very high level of final demand by consumers, upward price pressures in the areas of services, and relatively low consumer price resistance.

In 1955, as the boom gained strength and economic expansion accelerated, rising total demand was met by increased productivity and increased production. Gradually, however, as we moved into 1956 and as total demand continued to rise, the Nation's productive resources, including plant, materials, and labor, came under increased strain. Actually our labor force, our sources of raw materials, and the physical machinery of production approached full utilization.

The continuation of unusually strong final demand by consumers through 1956 and into 1957, against a background of virtually full utilization of economic resources, produced the results usually associated with a strained demand-supply relationship, namely, price increases. Price gains were most notable in areas of strongest competition for goods and services and least notable in the case of those commodities for which the demand—supply relationship did not run parallel to that of the economy as a whole. As the labor force approached a stage of full employment, competing demands for skilled and unskilled workers served to bid up wage rates and in many industries the increases surpassed gains in productivity.

Rising prices and wages were reflected in increased costs of business operations and, under circumstances of very strong final demand, businesses tended to pass on their added costs in the form of higher prices. Increases in the Consumer Price Index reflect at least in part this transmission of higher costs of business operations to the ultimate consumer. Also to the extent that escalator clauses and productivity clauses in wage contracts were used, they served as an instrument to pass the higher cost back to the business community which in turn attempted to pass them on to the consumer and give further impetus to the price movement.

The economic environment which provided the original impetus to price advances also supplied the conditions which were favorable for the transmission of the increased operating costs; namely, the existence of very heavy final demand, low resistance to price increases, and a growing belief in the inevitability of continuing inflation, at least in some degree.

Both the "pull" of demand on prices and the "push" of costs on prices prevailed and were, in fact, products of the same economic phenomenon—a final demand which in the aggregate was excessive relative to the available supply of goods and services.

SUPPLEMENT NO. 4.—SUPPLEMENTAL VIEWS ON THE GROWTH OF PRIVATE DEBT AS A THREAT TO STABILITY

(Pertaining to pp. 32–36 of the joint reply)

The question as to whether the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy is a very difficult one to answer because the amount of such debt and its carrying burden must be considered in relation to the means of payment of the debt and its carrying cost.

In my judgment, it would be very dangerous to minimize the significance of the statement made in the joint reply that "no debt structure is likely to be impervious to major reductions of income." As a general rule, debt only becomes unwieldy and an unbearable burden when it becomes unbalanced in relation to the income of the debtor available for its servicing and repayment. Moreover, it is the income which shrinks with unfavorable economic conditions, not the debt.

Statistically it may appear that, due to rising incomes and growing liquid assets, the burden of debt upon individual debtors is lessened, although the principal amount of such indebtedness may have increased. However, the soundness of the debt-income relationship is just as dependent upon the maintenance of the level of income and the means of debt payment as it is upon the debt side of the equation.

While it is true that during periods of debt expansion incomes tend to rise, it is not true that during periods of declining income debts necessarily tend to shrink proportionately. A debt structure that might be wholly manageable in relation to a given amount of income might become quite unmanageable if the income level were to shrink, say, 10 percent. In my opinion, we should not overemphasize the debt-carrying ability of the public, under adverse conditions, merely because of such factors as a lower average interest cost on the debt, changes in the average maturity of the debt, a lengthening of the term structure of consumer credit, a shift in relative indebtedness toward higher income groups, and indebtedness relationships to liquid assets. It is a fact that repayments on indebtedness are currently consuming a larger proportion of disposable income than was the case, say, 10 years ago. A shrinkage in income could magnify the debt burden appreciably and, consequently, the much larger outstanding volume of indebtedness, even when measured in terms of much larger disposable income at the moment, should not be regarded complacently.

SUPPLEMENT NO. 5—ADDITIONAL COMMENTS ON THE CONSEQUENCES OF CREEPING INFLATION

(Pertaining to pp. 45–46 of the joint reply)

I should like to add my support to, and agreement with, the remarks in the joint reply relative to the question of "creeping inflation."

The long-run consequences of a policy of persistent, gradual, creeping inflation can hardly fail to create mechanisms whereby the various affected sectors of the economy attempt to protect themselves against a steadily depreciating currency. Once this process begins to grow, there is no reason to believe that inflation would thereupon remain gradual. Creeping inflation might become running inflation and ultimately galloping inflation. It appears evident that a responsible government cannot advocate as a measure of continuing public policy a course of action which, aside from being self-defeating in the long run, capitalizes on the inability of various groups within society to protect themselves in the short run.

One additional factor creating skepticism about the effectiveness of persistent, gradual, creeping inflation as a guide to public policy arises from considerations of international monetary movements. Under conditions favorable to an effective international monetary mechanism, it would be doubtful whether the United States, even with its very large supply of gold, could continuously follow an inflationary policy relative to the rest of the world without setting in motion forces which ultimately would bring the process to a halt.

SUPPLEMENT NO. 6—DISCUSSION OF APPROPRIATE PUBLIC POLICIES TO COMBAT INFLATION AND DEFLATION

(Pertaining to p. 37–48 of the joint reply)

At the risk of repeating some of the material in the joint reply, it seems appropriate to supplement the discussion by presenting my views as to the implementation of the three objectives of economic policy; namely, price stability, business stability, and a satisfactory rate of economic growth. The discussion that follows can be considered as an explicit answer to question 2 on the committee's list, namely: "Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new lays required, then make specific suggestions."

The Employment Act of 1946 provides the basic framework for economic policy actions by directing the Federal Government "to coordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining, *in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities*, including self-employment, for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power." I have italicized two clauses which, in my opinion, are particularly important in considering the type of public policies that should be adopted in promoting the ends of the act. These provisions indicate clearly that, insofar as possible, Congress desired to promote stable economic growth through measures compatible with free competitive enterprise and the creation of useful employment opportunities.

In view of these considerations, there seems little doubt that sound monetary and fiscal policies must play a very important part in achieving the desired objectives. These measures operate indirectly but nevertheless powerfully affect the flow of spending relative to the flow of goods and services. In 1950, a highly regarded subcommittee of the Joint Committee on the Economic Report stated unanimously: "We recommend not only that appropriate, vigorous, and coordinated monetary, credit, and fiscal policies be employed to promote the purposes of the Employment Act, but also that such policies constitute the Government's primary and principal method of promoting those purposes."

The nature of monetary and fiscal policies, and their coordinated use in a flexible manner as countercyclical instruments, are discussed in the joint reply. It is highly important, however, that certain other aspects of reliance on these instruments be understood. In the first place—and of primary importance—the limitations of these policies should be clearly recognized. While such policies are indispensable and should occupy a leading position in Government efforts to combat inflationary and deflationary movements, it is dangerous to assume that even their flexible and timely use can compensate for maladjustments stemming from a variety of nonfinancial causes. Certain of these causes arise from Government action; others originate in the private sector of the economy. As is pointed out in the joint reply, a tendency for wage rates to rise faster than productivity can result only in inflation or unemployment; it is therefore essential that such increases be held within productivity limits. Indeed, there is much to be said for a gradually declining "real" price level for consumer goods and services, as productivity rises, so that at least part of the fruits of greater efficiency could be passed on to consumers rather than absorbed wholly by the factors of production. Similarly, developments in international trade, finance, and politics inevitably affect the pace of economic activity in the United States. At times, such events (e. g., the outbreak of fighting in Korea in 1950) exert an almost overpowering influence that may be temporarily beyond the practicable influence of monetary and fiscal policies. In short, sound monetary and fiscal policies are an essential ingredient in governmental efforts to promote stable economic growth; they can, further, provide a substantial positive contribution to the attainment of such growth; but they cannot be expected to compensate for internal structural imbalances in the economy and external events that sometimes exert a profound effect on aggregate spending and production.

Secondly, we cannot and should not expect future growth to be a continuous, uninterrupted, straight-line progression to higher levels of output, employment, and income. Rather, given a satisfactory long-term growth trend, we should expect and hope to follow a course roughly along the path of the growth line, sometimes rising above the trend and sometimes falling below it. Efforts to remove completely this moderate instability around the long-run trend may lead to the assumption of greater responsibility by the Government for directing economic affairs, a narrowing of the area of economic freedom, and other actions which encroach upon the basic tenets of a competitive, free enterprise economy. One of the prices of economic freedom is a moderate degree of fluctuation in economic activity. There is, however, ample evidence to indicate that the upper and lower limits of these fluctuations may be kept in reasonable bounds by flexible and timely administration of monetary and fiscal policies. Moreover, use of these instruments involves least interference with free market processes, as contrasted with direct controls which, by their nature, must be arbitrarily selective in impact. This approach is consistent with the provision of the Employment Act relating to free competitive enterprise.

Thirdly, in attempting to promote the ends of economic policy, we must accept reasonable definitions of price stability and maximum employment. Price stability should not imply rigidity of prices, either in the aggregate or with respect to individual prices. This does not mean that we must accept some degree of inflation if the other objectives are to be realized; it does mean that we must strive for general price stability over the whole period of the business cycle, as opposed to a fixed, rigid price level on a week-to-week or month-to-month basis. In like manner, the objective of maximum employment must be viewed on a longer run basis. In this respect, it is suggested that, for all practical purposes, full employment has been achieved during the 12 years since the passage of the Employment Act. Admittedly, however, unemployment has temporarily increased during periods of economic adjustment.

Finally, inasmuch as postwar experience has demonstrated the increasing resistance of prices and costs to downward adjustment, the major effort with respect to Government economic policy would seem to be in avoiding the extremes of speculation and unsustainable expansion in business that inevitably lead to adjustment and recession. If we are to avoid long-run inflation resulting from relatively short spurts of price rises, followed by periods of price stability, every effort must be made to keep expansive tendencies within bounds during the rising phase of the business cycle. This view is supported by the judgment that certain policy techniques—especially monetary policy—may be more effective in restraining demand, as opposed to stimulating it. While I do not share the view that monetary policy is ineffective during recession—it seems obvious that economic recovery is fostered by a favorable monetary and credit atmosphere—it is clear that access to money is a prime requisite of expanding activity, although such access may not stimulate spending during a pronounced slump. Thus the greater effectiveness of monetary policy in combating inflation as opposed to deflation should be fully capitalized upon in our efforts to promote stable economic growth.

The legislative framework for effective monetary and fiscal actions appears adequate. With respect to fiscal policy, the problem is not so much one of existing legislation as that of timing and scale of actions and determination on the part of Congress and the executive branch to maintain a balanced or surplus budget over the period of the business cycle. In the nonfinancial sector, study should be devoted to the important areas, among others, of Government agricultural and housing policy, labor-management relations, and international trade.

SUPPLEMENT NO. 7—COMMENTS ON THE USE OF FISCAL POLICIES IN A PERIOD OF RECESSION

(Pertaining to pp. 68–70 of the joint reply)

The following remarks supplement the joint reply and summarize my views with respect to some of the aspects of question 13, namely: "Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy?"

The question of appropriate Federal governmental intervention to counteract a decline in economic activity is of significant importance. In the past quarter century, the concept of compensatory fiscal action has been extensively examined and was an important factor leading to the passage of the Employment Act of 1946.

It is true that through appropriate fiscal actions the Federal Government can contribute to economic stabilization. It is also true that the desirable way or ways by which these actions should be implemented is a subject on which a unanimous opinion has not as yet been formed, nor has general agreement been reached on the precise role to be played by countercyclical fiscal policies. Such questions as the timing of action, the problem of dealing with relatively moderate as opposed to relatively severe cyclical movements, and the respective weights to be attached to tax policy versus expenditure policy present important difficulties.

Recognizing that our perspectives and understanding will improve as experience on these subjects accumulates, I nevertheless suggest that major changes in the Government's countercyclical fiscal position should probably be reserved for serious changes in the state of the economy as a whole. The difficulty of diagnosing the severity of a recessionary trend in its incipient stage warrants a cautious approach to fiscal actions. In the meantime, the effects of the built-in stabilizers will come into action promptly and monetary policy may be expected to be adjusted quickly to the changed circumstances. For example, it would be unfortunate for the Government to embark upon a program of increasing expenditures substantially to deal with a declining economic trend only to find the economy rapidly turning upward well in advance of the actual fiscal stimuli. While there are grounds for believing that we may avoid a cumulative downturn in the economy through the automatic operation of the built-in stabilizers, coupled with appropriate monetary and fiscal action, it is by no means clear that the stimulus afforded by major fiscal-policy moves will be appropriate to deal with moderate fluctuations in the level of economic activity.

So far as stabilization policy is concerned, the essential issue revolves around the resolution of the conflict between near-term and long-term objectives. Thus, if Government fiscal actions attempt to offset or prevent short-run and temporary adjustments in the economy, this likely will contribute to secular inflation and, consequently, a reduced rate of growth in total production and real income. This problem is particularly relevant, since the disposition to incur deficits to meet a recessionary movement appears to be much stronger than the disposition to achieve surpluses during periods of full employment and inflationary pressures. Yet no government properly can afford to permit excessive unemployment and the accompanying waste of productive resources without resort to some compensating actions. With respect to basic issues of this sort, a continuing and intensive examination of our experience seems to be in order. Given the imperfect state of our forecasting techniques and our insufficient knowledge of the precise impact of alternative courses of action, the chances are very slender that any simple formula can replace sound judgment with respect to the establishment of appropriate fiscal-policy actions.

To be more specific, during the early stages of a recessionary trend such as those we have experienced during the postwar period, overt and direct fiscal action should be at a minimum, although the automatic stabilizers will be operating. Thereafter, if the economic situation continues to deteriorate, some moderate intensification of existing Government programs might be in order, especially with respect to those programs in which a speedup will affect output and employment within a relatively short period of time. If economic activity continues to decline and shows signs of serious deterioration, consideration could then be given to a combination of tax cuts and/or expenditure increases. Both the amounts and the types involved necessarily would have to be based upon the existing circumstances and outlook. Moreover, the market mechanism should be given the greatest scope for correcting maladjustments and restoring a balanced position.

SUPPLEMENT NO. 8—SUPPLEMENTAL COMMENTS ON THE CAUSES OF AND REMEDIES FOR THE CURRENT RECESSION

(Pertaining to pp. 70–72 of the joint reply)

It is appropriate to supplement the joint reply by commenting upon question No. 17, namely: "List and briefly discuss what you consider the causes of the present recession, and what should be done to terminate it."

The underlying causes of the recession of 1957–58 are to be found in the excesses and imbalances that developed during the boom of the preceding 2½ years. These developments included a growing inefficiency in the utilization of labor and resources, inaccurate estimates of sales potential in certain major industries, and an accompanying overexpansion of business investment in plant and equipment and inventory. In addition, the high degree of liquidity, which was built up in 1954 and carried over into 1955, contributed to the rapid, expansive developments of the period.

The impact of these underlying forces was manifested in several important ways during the latter part of 1957. Confronted with topheavy inventories relative to sales, a number of industries—particularly in manufacturing—shifted rapidly from inventory accumulation to liquidation. Growing capacity, as related to current sales, caused many producers to reduce expenditures on new plant and equipment, and also stimulated inventory liquidation. The impact of the underlying forces was magnified by a decrease in Federal spending for goods and services, particularly military items, and a sharp cutback in new orders for defense. Finally, a psychology of caution permeated most of the business world and, perhaps, led to greater reductions in business spending than might otherwise have occurred. Consumer spending was, in the aggregate, well maintained during most of the period, even though sales of durable items and housing expenditures were considerably below the advanced levels that had been reached in 1955 and 1956.

The type and extent of action that should be taken to terminate the recession depend largely on one's views as to its probable magnitude and duration. It is important to recognize that some of the excesses and imbalances will take some time to correct, and overemphasis on Government fiscal actions now might serve to hamper such correction. In addition, there is the possibility that such actions would being to exert stimulative effects at a time when they were no longer appropriate. As private expenditures turned upward, large Government deficits would magnify expansive pressures and contribute further to erosion of the purchasing power of the dollar.

Monetary policy, since the time of its reversal in the autumn of 1957, has been designed to cushion the adjustments brought on by the underlying forces and, further, to provide a monetary and credit atmosphere conducive to recovery, once the adjustments have been completed. The reduction in discount rates in November 1957 was followed in early 1958 by additional decreases in rates and reductions in member-bank reserve requirements. In addition, Federal Reserve open-market operations have added significantly to the volume of reserves available to the banking system. In response to these actions, interest rates on both short- and longer term debt instruments have declined sharply, bond prices have risen, and the reserve position of the banking system has shifted from one of considerable tightness to one of marked ease. Confronted with declining loan demand, banks have put additional reserves to work by purchasing Government and other securities in large amounts. Monetary growth has been resumed at a rapid rate.

The degree of monetary ease that has been achieved appears fully sufficient, and the flexibility of monetary policy assures that it can be quickly adjusted to the developing business situation. On the other hand, the lack of flexibility of fiscal policy suggests that proposals to embark upon large-scale public-works projects and to grant tax reductions should be approached cautiously. If the decline in business activity should show no signs of moderating, and if final demand for goods and services appears to be weakening significantly, Congress should, in my opinion, give consideration to additional fiscal actions. Under such circumstances, emphasis should be placed on policies and actions that can be quickly reversed should the situation change rapidly.

SUPPLEMENT NO. 9—VIEWS ON THE EFFECTS OF DEBT MANAGEMENT ON THE ECONOMY

(Pertaining to pp. 73–76 of the joint reply)

The joint reply describes three approaches to the problem of debt management. The following remarks are offered as a supplement to these views, and relate particularly to question 5, namely: "What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?" As is emphasized in the joint reply, several practical difficulties seriously complicate the implementation of debt-management policies in accordance with some generally accepted principles. Nevertheless, further comment on these principles may be appropriate.

The economic effects of debt-management policies stem largely from the relationships between debt management and (1) the money supply, (2) the liquidity of the economy, and (3) the supply of long-term funds available for private investment. Since each of these points has important implications for economic stability, debt management long has been considered as an important tool of economic stabilization.

With respect to both the maturities and the method of payment involved in cash offerings and refundings, debt management decisions affect significantly the placement of debt as between bank and nonbank holders. Sales of Government securities to nonbank investors divert purchasing power from the private sector of the economy to the Federal Government without producing expansion in the money supply. Investment expansion by commercial banks, however, involves the process of deposit creation, producing an expansive influence on the total money supply. The source of funds which is tapped in financing Government deficits is, consequently, of strategic importance in directing debt management policy toward economic stabilization. Financing Government deficits by sales of securities which appeal to commercial banks—primarily short- and intermediate-term issues—may, during periods of recession, serve the interest of economic stabilization by inducing expansion of the money supply or by offsetting contractive influences originating in a decline in private credit. On the other hand, resort to bank credit for the financing of Government deficits during periods of inflationary pressures tends to add to these pressures by contributing to growth in total bank credit and complicating the stabilization efforts of monetary authorities. Commercial bank participation in Treasury offerings is influenced, of course, not only by the relative attractiveness of the new instruments as bank investments but also by bank reserve positions. For this reason, it is important that monetary and debt management policies be directed toward the same goals.

Because of the difference in economic effects between financing deficits with bank credit, on the one hand, and nonbank credit, on the other, there exists a widely held preference for bank financing of Government deficits during deflationary periods and for nonbank credit to be tapped during periods of inflationary pressures. The issuance of securities which appeal primarily to nonbank investors—primarily longer-term instruments—during periods of accelerated economic growth and inflationary pressures serves not only to prevent the monetization of these debt instruments but also to divert funds from private expansion projects, which contribute to the inflationary movement. Conversely, bank financing of deficit spending during recessionary movement serves not only to sustain the money supply but also avoids Treasury competition in the market for long-term funds which are available for private spending programs. It should be recognized, of course, that under ideal circumstances, the problem of financing deficits during inflationary periods would not exist.

Irrespective of whether the Federal Government is operating with a surplus or deficit, the Treasury periodically is confronted with the problem of refunding maturing instruments, and changes in the ownership and structure of the debt as a result of refinancing operations have important economic implications. In particular, a great deal of significance attaches to refunding operations which effect a shift in ownership (as between banks and nonbank investors) of the outstanding public debt. Refunding operations which feature the liquidation of bank-held debt with the proceeds from issues designed to attract nonbank holders serve to exert a contractive influence upon the money supply and reduce the availability of long-term funds for private investment. Thus, such refunding operations are associated with anti-inflationary debt management programs. Conversely, the liquidation of debt held by nonbank investors with the proceeds of securities made attractive to commercial banks produce an expansive influence upon the money supply and increase the availability of funds to private borrowers. Because of this effect, such refunding operations are consistent with antideflationary debt management programs.

In connection with shifts in ownership of the public debt, it may be noted that monetary policy also may be instrumental in effecting a transfer of public debt from the banking system to nonbank holders, or vice versa. During periods of credit ease and depressed private credit demands, for example, additions to the supply of bank reserves provide both the inducement and the facility for expansion of bank investments. Conversely, credit restraint during a period of heavy credit demands in the private sector of the economy may necessitate bank liquidation of Government securities to accommodate loan requests. In each case there occurs a shift in the ownership of public debt as between bank and nonbank holders. To the extent that the Treasury can respect these shifts in setting the maturities on new offerings, the administration of monetary policy is facilitated and its effectiveness is enhanced.

Because of the prime economic importance of Government securities as instruments of liquidity, changes in the volume of shorter-term instruments have a direct influence upon the economy's liquidity position. A shortening of the average maturity of the public debt, and particularly a significant increase in the volume of shorter-term instruments, serves to increase the liquidity of business institutions, particularly financial institutions, and contributes to an environment conducive to private credit expansion. For this reason, concentration of offerings in the short end of the market generally is regarded as consistent with the objectives of economic policy during a recessionary movement. It should be recognized, however, that the creation of excessive liquidity during a period of credit ease may serve to delay the effectiveness of credit restraint, should the subsequent economic recovery require its application. Debt management policies which serve to lengthen the public debt, and particularly to reduce the supply of short-term credit instruments, operate to reduce liquidity and to restrain private credit expansion.

As in the case of managing Government deficits, the disposition of surpluses may have an important influence upon the money supply and the availability of funds for private investment projects. Utilization of a surplus to retire bank-held debt produces a contractive influence upon the money supply and facilitiates the implementation of monetary restraint, while Government surpluses which are used to retire longer-term debt held outside the banking system release funds to the market for private investment.

In addition to the various points discussed above, management of the public debt, by influencing the demand for funds at various points along the maturity range and by influencing the supply of debt instruments at each of these points, may also have effects upon the structure of interest rates. This effect, of course, is an inevitable consequence of the volume of the public debt and the strategic importance of Government securities as debt instruments. In addition to the influence which debt management may exert upon the structure of market rates of interest, the fact that the Treasury appears alternately on both the supply side (in the case of Government surpluses) and the demand side (in the case of deficits) in credit markets indicates that the budgetary position of the Federal Government is a factor determining the absolute level of rates.

SUPPLEMENT NO. 10—SOME VIEWS ON THE EFFECTIVENESS OF MONETARY POLICY DURING A RECESSION

(Pertaining to pp. 89–90 of the joint reply)

The portion of the joint reply relating to the role of monetary policy in a business recession, by placing its emphasis on extreme conditions such as those that prevailed during the great depression, seems to me to understate the potential stimulative effects of monetary policy during a business decline. Granted that monetary policy alone cannot be expected to achieve recovery from a depression in which financial assets have become frozen and deep pessimism prevails, the importance of monetary policy in creating an atmosphere conducive to recovery should not be underestimated. Furthermore, low interest rates and ready availability of credit are essential to such recovery.

In addition, the fact that business and consumer demand for bank loans may be sharply reduced or even nonexistent during such a period does not mean that monetary expansion, as manifested in growth of bank demand deposits, will not occur. Whether or not the Treasury is financing deficits through the banking system, commercial banks, with ample reserves made available through monetary policy, will aggressively seek existing debt instruments—particularly Government securities—in order to bolster earning positions. To the extent such securities are purchased in the market from nonbank holders, demand deposits will expand, the liquidity of the economy will increase, and the growing money supply and liquidity will support the willingness and ability of businesses and consumers to spend. The impact of this type of action was clearly demonstrated in the recession of 1953–54, when the decline in interest rates and the marked increase in availability of credit provided a financial basis for the boom in residential construction and consumer durables.

FEDERAL RESERVE BANK OF SAN FRANCISCO,
San Francisco, Calif., April 11, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: This letter responds to yours of February 17, 1958, enclosing a list of questions which have been used as a guide in preparing this reply. On previous occasions, when inquiries were received from committees of Congress on questions relating to financial or other aspects of our economy, it was found to be constructive to have the responses prepared on a joint basis, particularly in those areas where there was unanimity of thinking on the part of all 12 Federal Reserve banks, with such supplemental comments as each or any of them deemed it necessary to make. In the case of your inquiry, because the general questions lend themselves to such a joint response, there has been prepared a series of statements which cover in a general, as well as in a specific manner, the points of inquiry raised. A copy of those statements is enclosed. The observations on debt management, at pages 73 to 76, should have further study and consideration before the use of debt management as a countercyclical policy by the Treasury can be dismissed.

At the risk of some duplication of material in the joint response, there follow some comments on the general functioning of monetary policy, with some reference to fiscal policy, and also brief comment on the problem of recession.

Basically, it is the nature of our free enterprise economic system which determines the objectives of monetary policy. This system has had a fairly rapid rate of growth and a high degree of efficiency in its operation, but has also had occasional, and at times even violent, fluctuations in economic activity and prices. These alternations of inflationary and deflationary periods, or of booms and depressions, are wasteful, unsettling, and dangerous to the continued existence of our traditional economic and political system. One of the primary objectives of economic policy in general, and of monetary policy in particular, is to minimize such cyclical fluctuations within the framework of an enterprise economy, with continued reliance, in large measure, upon market processes.

In a free enterprise economy, the levels of production, employment, and prices are determined primarily, given the economy's productive resources at the time, by the amount of money spent on all goods and services. General fluctuations of economic activity result from sharp swings in the aggregate demand for goods and services—that is, in total spending. Changes in business spending on plant and equipment or on goods for inventory, and accompanying shifts in public sentiment and consumer purchases, are among the factors contributing to such swings. Shifts in Government spending policies and foreign investment also affect the total volume of spending and, hence, general business activity.

To combat the tendency for private spending to go through wide, erratic swings, the Federal Government and the Federal Reserve System attempt to induce offsetting changes in those portions of total spending which are most subject to their influence. Monetary policies affect that part of total spending which is done out of borrowed funds. Fiscal policies increase the total volume of spending through the direct expenditures of the Government and decrease it through taxes and borrowing, which curtail the spending power of individuals and firms. The success of monetary and fiscal measures depends upon whether sufficient influence can be brought to bear upon certain areas of spending.

Monetary policy operates through measures which exert control on the supply of bank credit. The Federal Reserve System is able to regulate, through open market operations and the discount rate, the volume and cost of reserves available to its member banks. It can also regulate, within limits set by law, the maximum amount of deposits that can be held against any given volume of bank reserves. Since changes in the amount of deposits arise primarily from changes in the volume of loans and investments of banks, the System's control over the cost and availability of bank reserves exercises considerable influence over the amount of bank credit extended. Thus the money supply, or the total amount of purchasing power in the hands of the public, can be influenced upward or downward through the application of monetary controls by the Federal Reserve System. At the same time, it should be noted that, although changes in interest rates and asset values, which are influenced by monetary policy, affect the extension of nonbank credit, the System has no direct control over nonbank credit. Although extension of such credit, in contrast to bank credit, does not increase the total amount of purchasing power in the hands of the public (since the lender gives up whatever funds the borrower receives), it can increase the extent to which such purchasing power is actually employed and can therefore affect the total volume of spending. This creates some problems for the monetary authorities but not insuperable ones, since their credit control measures are taken in the light of the economic situation at any time and the latter reflects all monetary and fiscal influences.

With the supply of bank credit held within limits but the demand for it free to fluctuate in response to changes in business conditions and public sentiment, variations in interest rates are bound to occur. Monetary policy can be most effective if the public's spending and savings are responsive to changes in interest rates and the availability of credit, but the extent to which this is so in practice has been much debated and is still uncertain. Probably, spending and savings are fairly responsive if all other things remain unchanged, although even this has been questioned. But when interest rates are changing other important factors, such as public sentiment, may be changing too. Consequently, the effect of monetary policy can be submerged by the effects of other factors. For instance, a drop in interest rates at the beginning of a business recession may not be able to halt the latter if business sentiment is worsening so rapidly that businessmen become less willing to borrow and spend, even at lower interest rates. It may be said that, in general, monetary measures are likely to be less effective during severe fluctuations in business activity, when other factors are undergoing drastic changes, than they are during moderate fluctuations.

Nevertheless, prompt and vigorous use of proper monetary measures will have considerable effect even under unfavorable circumstances. There are always some potential borrowers who are not quite decided whether or not to borrow and who can be influenced favorably by changes in interest rates or in the availability of credit. There are normally other potential borrowers whose spending projects are postponable within limits (for example, home buyers or business firms planning capital improvements), who, because they take a long-run view of economic trends, try to do their borrowing at low interest rates. These spending units may not be moved to action immediately by a change of interest rates, but are likely to curtail their borrowing when interest rates rise much above the longer-run trend and to resume borrowing when the rates drop much below the longer-run trend. While it may be impossible to say how large these two groups are in any given situation, they are probably significant, if not necessarily decisive. Failure to make use of monetary measures would mean throwing away the potential contributions to economic stability which changes in the spending of these groups are capable of making.

The effectiveness of monetary policy at any time may depend on the vigorousness with which it is employed, not only at that time, but also in preceding periods. An easing of credit restrictions will stimulate spending more effectively if there exists a backlog of spending projects which had previously been postponed because of credit restrictions.

What has been said applies to general monetary measures—those which affect the overall volume of credit, permitting the free forces of the market to allocate this credit to particular industries and uses. This type of monetary policy is more appropriate to a free enterprise economy than specific measures which aim to govern the particular uses to which credit is put, since it avoids the necessity for having an elaborate mechanism of direct controls.

When the public's urge to invest and to consume is very strong, as in an extreme boom, general credit restrictions can limit it somewhat but probably not enough to prevent some inflation. When the fear of spending is very strong, credit ease can induce some persons to spend more but probably not enough to maintain full employment. (The latter of these two types of situation is generally the more difficult, since credit cannot be forced upon unwilling borrowers but generally it can be made more difficult to obtain by those who want it if it is made scarce or costly enough.) However, the fact that monetary policy may not be completely successful in the face of major changes in business activity does not prove that it is completely unseccessful. To argue this, as some critics have done, is like arguing that antibiotics are a failure if they keep the patient alive but do not immediately bring his temperature down to normal. No one believes that monetary measures alone can completely prevent all economic fluctuations. Their function is simply to restrain such fluctuations as much as possible.

Because monetary measures have only a limited influence in extreme situations it is necessary that they be coordinated with the proper fiscal and other economic measures. When monetary and fiscal measures pull in the same direction they are complementary rather than competing, and their effects are cumulative. There is no justification, therefore, for placing complete reliance on either type of policy, as has sometimes been advocated, and ignoring the other. Proper use of monetary and fiscal measures also requires that the relative emphasis between them and the precise nature of the actions taken be carefully adapted to the particular circumstances of each situation, since different measures will affect the various sectors of the economy differently.

As respects the current recession, in an economy such as that under which we operate, fluctuations in general business conditions, in production, and in employment are bound to occur. In the postwar period we have been climbing rapidly to higher peaks, with only slight pauses. In the present situation, if industry and Government can accelerate already planned and necessary expenditures, if consumers can be encouraged to spend for their necessities and desires, an increase in activity can be expected which would help correct the present problem of deterioration of our economic climate. Since economic forecasting is still quite imperfect, it would be unfortunate if we were pressed into action not closely related to the extent of the present decline. Thus, if taxes are to be reduced, we should have some understanding in advance of whether spending or saving would be increased and the degree of increase in each. Similarly, the effects of a public works program should be known, at least approximately, in advance of its approval. If it is not already fully developed in its planning stages, would it be effective in the very near future, or not until a time when it would compete with the normal and increasing demands of private enterprise for labor and materials? Action that is not readily reversible, and the full effects of which may be felt only with considerable delay, may result only in additional inflationary pressures in the succeeding upswing. This would further complicate the problem of achieving sustainable economic growth. The very real fear of policy actions being too little and too late should not be allowed to obscure the problems that can be created by intervention that is too much too soon.

On the basis of events to date, our economy is sufficiently strong, in my view, so that needed corrections will probably develop without excessive interference by Government. We should avoid policy actions at this time that would introduce additional rigidities and delay the adjustments in prices and use of resources necessary for a resumption of overall high-level activity and growth. If, in seeking to check recession, we attempt to offset completely the effects on particular industries, areas, or occupations of changing consumer demands and the introduction of new products and methods, the result will be stagnation, not growth. Monetary and fiscal measures of an overall and impersonal nature seem to be the best means that have yet been devised for limiting general fluctuations in business activity and prices, because they involve the minimum of direct, detailed interference with the free market forces of our economy.

Even monetary and fiscal measures combined may not be completely effective in preventing economic fluctuations, because large portions of the economy are fairly insensitive to their influence and because of social and political difficulties in the way of implementing such measures vigorously. Too much should not be expected of them, lest disappointment breed rejection. However, used properly, both monetary and fiscal measures can do much to contain economic fluctuations within tolerable limits. Indeed, the mere knowledge that they will be so used will do much to curb such fluctuations by preventing the wide swings of public sentiment which are partly responsible for them.

Yours very truly,

H. N. MANGELS, *President.*

O

85th Congress } 2d Session } COMMITTEE PRINT

INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES

COMMENTS OF EXECUTIVES OF CORPORATIONS IN RESPONSE TO THE QUESTIONNAIRE

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE
EIGHTY-FIFTH CONGRESS

SECOND SESSION

CHAPTER 2

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INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES

PHILLIPS PETROLEUM CO.,
Bartlesville, Okla., March 28, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance, United State Senate,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: The attached are my replies to your letter of February 17. I have answered the questions where I could and have followed the suggestion in your letter in some cases of using the questions as a guide. I have also tried to answer part or all of the questions, which from my viewpoint seemed desirable or appropriate as you had suggested. Some of the questions are too technical from a financial standpoint for an industrial corporation to answer. In these cases I have so indicated this position.

Sincerely yours,

K. S. ADAMS.

QUESTIONNAIRE

1. Give a definition in your own words of deflation and inflation.

Inflation is the increase in general price levels from unsustainably rapid economic growth, with unemployment at a minimum, wages rising more rapidly than productivity, and supplies and inventories short. Deflation is the other side of the coin.

2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

This question is almost too broad to be answered.

My reaction in brief is that the national economic goal should be to promote sound growth with general stability of prices. Both inflation and deflation interfere with economic growth, therefore, both should be controlled if possible. This is purely a technical matter, but it seems it can be done by use of the Federal Reserve powers over money and credit supplemented by Treasury Department tax changes—both powerful weapons against inflation and deflation. The great trouble is reluctance to use these weapons versus inflation particularly on the wage-price problem.

The solution of the wage-price problem is difficult to find. It is either legislation or public education. I think it is one point where your committee should devote a major share of its attention.

3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942 to 1957. (You may wish to divide the period into two parts, 1942–1950 prior to the accord, and 1951–57.)

This question does not seem to be an appropriate one for an industrialist to answer. However, it is evident there has been less inflation since 1953 when the Federal Reserve was once again able to use its powers over money and credit. The Federal Reserve policies seem to have been about as good as can be expected, at least since the accord between the Federal Reserve Board and the Treasury Department. The Federal Reserve Board should be allowed to have the same degree of independence it now has.

4. Beginning in August 1956 there was an increase in Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

The answer is not a simple one. There were many contributing factors including wage and labor and Federal budget policies. Tight money did not prevent the rise in prices because the circulation of money increased. Prices probably would have risen more rapidly in the absence of tight money.

5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

I do not feel qualified to comment on the technical problems of debt management.

6. (*a*) Discuss in their relationship to one another and according to their judgment of their relative importance the following three objectives of economic policy in the United States:

1. Price stability;
2. Stability of production, demand, and employment;
3. Economic growth in production, demand, and employment.

(*b*) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent two or three years—and especially during 1957.

This is another question that is almost too broad to answer. It would appear that our Nation would want to achieve all 3 of these objectives, which I consider as really 2 since the second and third overlap. We need growth for national and security and high living standards. We need price stability as much as possible. Real growth is not possible under inflation.

It seems in the 1956–57 period we achieved a rate of expansion which was not sustainable indefinitely. Investment boom contributed to a tight labor market and facilitated large wage increases. Developments in recent months have illustrated the consequences of these excesses and it appears that the Nation would have done better had the recent boom been less vigorous. We must place the objective of avoiding inflation close to the top of our list of economic objectives.

7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

We can afford to pay the present level of Government expenditures if it is agreed that such expenditures are necessary. Our present taxes are barely sufficient to cover Government spending, yet Government spending would probably rise so long as international tensions persist. This points to a burdensome tax structure which needs to be eased through intensified economies in the Government and a complete overhauling of the tax system. Our tax system bears down unfairly on incentives to save and invest, to work hard, and to exercise initiative and enterprise. Our tax system needs to be simplified.

9. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy, and then relate them, one to the other. Please discuss these policies, stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

I do not believe I am qualified to comment on such a specialized subject.

10. (*a*) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank credits.) Also please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

(*b*) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

This question seems too sweeping and technical for any but financial companies to answer. To attempt even general comments would involve more research work than is available to the average industrial company.

11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy.

(*b*) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

It is doubtful that inflation and rising unemployment can exist side by side for long. Particular prices may increase during a recession—for instance, beef prices may increase because of a reduction in supply. Moreover, the consumer price index tends to lag behind business conditions.

Prices may not decline in future recessions as much as in the past, because wage rates are likely to be maintained. A great many rigid factors have been built into our economy which place continued upward pressure on costs and prices despite greater unemployment, idle industrial capacity, and ample supplies of raw materials. If prices are to fall less in recession periods, efforts must be redoubled to keep them from rising in boom periods.

Gradual inflation would not be a desirable objective for our economy.

12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy.

A growing economy always incurs debt. So long as private debt does not rise more rapidly than the ability to service it, debt makes a constructive contribution to the general economic advance.

13. Considering the financial condition of the United States, at what point, if any (in terms of unemployment, production, and consumer demand) should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy.

As the answers to previous questions indicated we should avoid both inflation and deflation. We should seek to facilitate the adjustments underway in business investment in new plant and equipment, and in inventories, exports and consumer durable goods. These adjustments take time.

I do not feel qualified to determine at what levels of production, unemployment, or consumer buying, the Government should resort to fiscal policy in order to stimulate the economy. If the choice is between a tax reduction and a public-works program, my preference would be the former.

The first step by the Government should be to ease credit aggressively. The next step should be to cut taxes. Restoration of programs for accelerated depreciation would be especially desirable to stimulate industrial investment.

14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

I think it is difficult to measure the inflationary impact of postwar Treasury deficits. The initial inflationary surge after the war probably reflected less the Treasury's operations in those years than it did the results of the huge deficit spending during World War II. Nevertheless, the Government cannot be wholly cleared of responsibility for the inflation of the postwar era. A large Treasury budget and high-tax rates are in themselves inflationary; they reduce the volume of savings and force increased bank credit which in turn increases the supply of money.

15. Can full employment goals be attained while maintaining a dollar that has relative stable purchasing power?

In the answers to previous questions, it was pointed out that widespread acceptance of the doctrine of chronic inflation would be an unstabilizing factor and would prevent attaining economic growth and rising employment. I believe prospects for maintaining high employment are materially improved if inflationary pressures are curbed.

16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

Escalator provisions which provide for wage increases in excess of the economy's productivity would add to inflationary pressures. Monetary and fiscal policies are more important in this respect than escalator clauses geared to productivity.

17. List and briefly discuss what you consider the causes of the present recession, and what should be done to terminate it.

The direct causes of the current recession include a shift from accumulating to liquidating inventories, a decline in the business investment boom, and a lag in consumer spending, especially for automobiles. Underlying these is the sustained rise in prices.

Perhaps the most important long-term objective would be to reform the income-tax structure. This would fight the recession, support our long-term growth and encourage businessmen to produce and sell goods at a rate that would raise our standard of living.

More favorable tax treatment of depreciation is another step the Government can take to encourage the continuing necessity of modernizing our business plants.

BANK OF AMERICA NATIONAL
TRUST & SAVINGS ASSOCIATION,
San Francisco, Calif., April 1, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate,
Washington, D. C.

DEAR SENATOR BYRD: In response to your letter of February 17, I am enclosing comments on your very thought provoking questions concerning United States economic policies. I trust that this response will be helpful to the Senate Finance Committee in its important inquiry on the financial condition of the United States.

If I can be of further help to the committee, please do not hesitate to call on me.

Sincerely yours,

S. C. BEISE.

COMMENTS ON QUESTIONS POSED BY SENATOR BYRD

1. Give a definition in your own words of deflation and inflation.

Deflation is a condition of general economic imbalance in which the total money demand for goods and services is less than the value of the available goods and services when these are valued at previously prevailing prices. Deflation may also be defined as a condition in which expectations of declining income, employment and prices cause investors and consumers to spend less than would otherwise be the case, thus reducing the level of demand upon which high levels of income and employment and the previously existing cost-price structure rest. Deflation is usually accompanied in varying degrees by declines in the prices of equities, stable commodities and some manufactured goods, reduced demand for bank loans, rising unemployment and a growth of idle plant capacity.

Inflation is a condition of general economic imbalance in which the total money demand for goods and services is greater than the value of goods and services available when these goods and services are valued at previously prevailing prices. Inflation may also be defined as a condition in which expectations for rising levels of money income, employment and prices cause investors and consumers to spend more than would otherwise be the case, thus increasing the pressure on available resources and giving rise to higher prices and costs. However, inflationary conditions may exist with little or no increase in the level of prices if rationing and direct administrative controls over prices are in use. Although inflation is often associated with full employment of labor and plant capacity, it may exist in the presence of substantial unemployment of labor and idle plant capacity, largely because of rigidities in the structure of costs and prices which prevent or retard downward adjustments required to increase employment and plant utilization.

2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

In a democratic society, properly implemented monetary and fiscal policies afford the greatest promise for the avoidance of inflation and deflation. The basic structure of monetary and fiscal policies should be so constructed and directed that total money demand is held within a range consistent with full resource utilization and the most favorable growth of productive capacity without increases or decreases in the general level of prices.

There is a need for a searching review of monetary and fiscal policies to determine:

(1) whether the basic framework of policy formulation—i. e., the objectives of policy, the distribution and coordination of policymaking authority, and the means of policy implementation—is conducive to full utilization and the most favorable growth of productive capacity; and

(2) whether responsibility for policy formulation and implementation is clearly enough defined and sufficiently broad to facilitate effective control of money demand through monetary and fiscal policies.

Some specific areas in which exploration and reevaluation of present laws may be needed are:

(1) the structure and level of rates of taxation of personal and corporate incomes in relation to general economic well-being and economic growth;

(2) the differential treatment of various types of business institutions with respect to allowable reserves and allocation of surplus in the calculation of net taxable income, with proper regard for socially desirable ends;

(3) the Federal budgetary process, including departmental cash disbursement policies and their relationship to monetary policy and economic stability;

(4) the control of Federal credit agencies and the coordination of their activities with the policies of the monetary authorities;

(5) the need for uniform regulation, consistent with socially desirable ends, of various types of business institutions competing in the same markets;

(6) control by the Federal Reserve of the credit expansion potential of nonbank financial institutions.

There is particular need for simplification and downward revision of the present structure of legal reserve requirements of members of the Federal Reserve System. We favor the approach suggested by the Economic Policy Commission of the American Bankers Association.

3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942 to 1957.

The large expansion of the money supply and of the economy's liquidity in general, which took place between the years 1942 and 1946, gave rise to serious problems of monetary control in the postwar decade. Much of the cost of the war was financed by Government borrowing, with the result that the general public emerged from the period of wartime shortage of goods with large holdings of liquid assets. This huge overhang of liquidity at the end of the war undoubtedly did much to ease the transition to a peacetime economy without the recession which was widely held to be impending at the time. Nevertheless, the ease and rapidity of the adjustment, the continued existence of large liquid holdings for some time after the end of the war, and, above all, the official support of the Government securities market after the war, posed major problems for monetary policy.

Federal Reserve restraint of inflationary pressures between 1946 and 1951 would certainly have been more effective if the policy of supporting Government securities at artifically high prices had not been in effect. The experience of this period demonstrated quite clearly that the stabilization of security prices is incompatible with the basic meaning of monetary policy and is inconsistent with the primary role of fostering real economic growth and stability and the full utilization of resources.

Although Federal Reserve policy-implementation since 1951 has not proved completely successful in restraining inflationary upsurges, it has shown that a flexible monetary policy, even against considerable odds, is a potent stabilization device. The large money supply and high liquidity resulting from the period of war finance continued to complicate the problem of monetary control in the 1951–57 period. By increasing the velocity of circulation of money, the economy was able to offset, at least in part, the restraining effects of monetary policy exercised through the control of the quantity of money. In this process, nonbank financial institutions played an important role. By issuing what were regarded by the public as highly liquid obligations as substitutes for money balances, these financial entities made it possible for the public to economize its holdings of money balances without suffering a serious reduction in liquidity. This permitted the financial system as a whole to increase its loans and investments at the same time that monetary policy was restricting the capacity of the commercial banks to increase their loans and investments. A more successful monetary policy in the period 1951–57 would probably have required some form of control over the operations of nonbank financial institutions.

4. Beginning in August 1956 there was an increase in the Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

After July 1956 the total money demand for goods and services exceeded the value of goods and services available, when valued at previously prevailing prices. With productive capacity and employment already rather fully utilized, increases in money outlays for consumption and, particularly, for investment goods could not call forth appreciably larger supplies. There resulted a competitive bidding that raised prices directly as well as indirectly through (a) moving inventories more rapidly, (b) increasing order backlogs, and (c) otherwise indicating to sellers the presence of a strong market. The price rises extended to other resources, including labor, raising costs of production. Increased prices could be, and were, financed by a more active use of the money supply, and were not dependent upon increases in the money stock.

The expansion responsible for the 1956–1957 rise in the Consumer Price Index was sparked by factors which included the following:

(1) tax revisions conducive to increased consumption and particularly to investment outlays;

(2) liberalization of mortgage terms guaranteed by government agencies;

(3) inadequate surpluses in connection with a rising level of government expenditures;

(4) a significant increase of the economy's liquidity as a result of an easy monetary policy that was aimed successfully at reversing the economic downturn of early 1953.

Once underway, the expansion proceeded to an inflationary stage largely because the financial system was able to expand its loans and investments despite increasingly restrictive Federal Reserve control over bank credit, and thereby to increase the volume of spending with borrowed funds. To a considerable extent the monetary authorities appear to have been hampered in their efforts to restrain this expansion partly because a large part of the financial system is not directly subject nor quickly responsive to Federal Reserve policies, and partly because coordination of fiscal and monetary policies was not carried as far as circumstances required.

5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

Debt-management policy has effects upon the national credit structure and the economy of the United States in several respects.

(1) The distribution of maturities of U. S. Government securities outstanding is an important element determining the liquidity of the national credit structure. A shift from long-term financing to short-term financing tends to increase the liquidity of the national credit structure, while a shift from short-term to long-term financing tends to decrease its liquidity. Other things equal, an increase in liquidity is inflationary or antideflationary, while a decrease in liquidity is deflationary or anti-inflationary. In recent years, shifts in the composition of maturities may have had some tendency to be destabilizing, because the average maturity of the Federal debt has been lengthened in recessionary periods and shortened in expansionary periods. Growth in the money supply and in the volume of savings, of course, increases the ability of the economy to hold debt, thereby ameliorating these particular destabilizing influences, while adding inflationary and deflationary influences of their own.

(2) New financing and refinancing accomplished through sales of Government securities to the commercial banking system increases, of course, the total quantity of money in circulation. This tends to be inflationary or antideflationary unless the public's demand for money balances, at prevailing levels of prices of goods and securities, is rising correspondingly, as may well be the case in periods of recession.

Over the past decade this aspect of debt management policy has probably worked in a stabilizing direction because a greater amount of refinancing and new financing has been conducted through the commercial banking system in times of recession than in times of economic expansion. This has tended to offset the destabilizing effect of changes in the average maturities of Government securities.

(3) The magnitude and timing of refundings and new cash issues affect the prices and yields of private as well as public issues. Large Treasury operations and poor timing can disrupt financial markets, for example, by glutting them with new Federal issues at times when they are saturated with private issues. On the other hand, good timing and operations of the proper magnitude can help to stabilize financial markets. Since the time is seldom, if ever, ideal for extending the debt structure, long-term options should be offered frequently, with due regard for market conditions and the general public interest, so that gradual lengthening, or at least offsets to debt shortening, continually take place.

(4) Coupon rates on Government securities are generally set in accordance with prevailing market rates and, to some extent, are regarded by the market as indicators of the trend of interest rates. The effect of this process is to accelerate or dampen already existing movements in the general level of interest rates, depending upon how much the Treasury shades its coupon rates in one direction or the other.

Debt-management operations influence the liquidity of the national credit structure, the quantity of money in circulation, the flow of funds among the various financial markets, and the trend of interest rates. Each of these factors, in turn, influences the level of spending, especially the level of spending with borrowed funds. By thus affecting total money demand, debt-management operations affect the general level of prices and the rate of utilization and growth of productive capacity.

6. (*a*) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand, and employment.
3. Economic growth in production, demand, and employment.

Only the first and third of these objectives (i. e., price stability—in the sense of a more or less constant general price level, rather than a smoothly rising one—and economic growth in production, demand, and employment) should be long-term objectives of national economic policy. Complete stability of output—in the sense of a constant, absolute level of production, demand, and employment—is not a relevant economic objective in an economy with an increasing population and a rapidly advancing technology. Nor would it be an admissible objective even in an economy with a constant population, for improvement of the material welfare of a constant population requires growth of productive capacity.

Even if stable production were taken to mean a smoothly rising output at an unchanging rate, this would not constitute a feasible goal of economic policy in a free economy. As economic growth tends to come in waves, uninterrupted progress in the raising of material welfare cannot be expected. However, inflation and deflation tend to accentuate the unavoidabble fluctuations in the pace of economic growth, and the resulting distortions in the structure of production probably lower the rate of advance below what it would be in the absence of inflationary and deflationary periods. Avoidance of inflation and deflation is, therefore, not only consistent with but actually essential to orderly economic growth. The avoidance of inflation and deflation implies reasonable stability in the growth level of prices. Consequently, price stability and economic growth are essential and concomitant objectives of national economic policy.

(b) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially 1957.

The general upward drift of the level of prices since the end of World War II is a clear indication that the economy tried to expand at a greater rate than was possible with the available supplies of productive resources. If inflationary pressures had been held in check more effectively during this period, as might have been possible if fiscal policies had been better coordinated with monetary policy, and if the monetary authorities had been in a position to affect directly a larger part fo the financial system, the result might very well have been a more stable growth rate over this period and in the years ahead. The material welfare of the economy might have been raised more by a stable growth rate over these years than by alternating periods of high and low growth rates. Especially, if monetary and fiscal policies had been more effectively used in 1955 and 1956, the inflationary excesses of those years might have been mitigated and the reversal in 1957 made less abrupt.

Considering the underlying strength of demand in the postwar decade, more effective and better coordinated monetary and fiscal policies could have probably contributed more to price stability without impeding full utilization and orderly growth of productive capacity.

7. Give your opinion of the effect on our economy of current Federal, State, and local spending.

Federal, State, and local government spending has effects upon (1) the level of total purchasing power in the economy, (2) the composition of output in the economy, and (3) the rate of advance of material welfare of the economy.

(1) Federal, State, and local spending raises the level of total purchasing power in the economy because some part of this spending is financed by taxing away and borrowing funds that would not otherwise be spent so soon. Fluctuations in government spending, like fluctuations in any major type of spending, tend to produce fluctuations in the level of total spending in the economy, thereby affecting the general level of prices and the rate of utilization and expansion of productive capacity.

(2) Government spending alters the composition of output in the economy because certain governmental goods and services would either not be provided at all or not provided in the same quantity if the task were left completely in private hands. Whether government spending increases or decreases the efficiency of allocation of resources depends upon whether the goods and services provided by government increase the welfare of the population more than would the uses to which the resources would be put if these goods and services were not provided by government.

(3) Since government spending affects both the level of total spending and the allocation of resources in the economy, it has significance for the rate of growth of productive capacity and material welfare. It is obvious that greater progress could be made in expanding pro-

ductive capacity for consumption goods if a smaller share of the Nation's output could be devoted to military equipment, with adequate transition to maintain total demand. Theoretically, there is a level and composition of government spending that at any one time would be most conducive to orderly growth in productive capacity and material welfare, although the precise definition of this theoretical magnitude is a difficult, if not impossible, task.

8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

Federal, State, and local taxation, like Federal, State, and local government spending, affects (1) the level of total purchasing power in the economy, (2) the composition of output, and (3) the rate of advance of material welfare of the economy.

(1) Taxation tends to lower the level of total purchasing power in the private sector by reducing the purchasing power of taxpayers. It probably does not reduce demand by the full amount of taxes, however, because a part of the funds obtained through taxation come out of funds that might not otherwise have been spent so soon.

(2) The composition of output is altered, because the relative composition of private spending in the presence of taxation is not the same as it would be in the absence of taxation.

(3) Since taxation affects the level of total spending and the composition of output, it has significance for the rate of advance of productive capacity and material welfare. Theoretically, there is some structure and level of taxation that would be most conducive to maximum, effective growth of productive capacity and material welfare, but a precise definition of this theoretical magnitude, structure and level is a difficult, if not impossible, task.

9. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy, and then relate them, one to the other. Please discuss these policies stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

Fiscal policy relates to the raising and disbursement of Government revenues. Debt policy encompasses decisions concerning the flotation, interest rates and maturity of public debt instruments. Because Government revenues may be raised by borrowing as well as by taxation, fiscal policy, in a broader sense, may be said to encompass debt policy as well. Monetary and credit policy concerns regulation of the cost, availability and supply of credit and money generally. Fiscal, monetary, and debt-management policies all are broadly concerned with the financial aspects of national economic policy. The general economic effects of decisions in these policy areas are discussed below.

FISCAL POLICY

1. *Expenditures*

An increase in the level of Government expenditures tends to increase total purchasing power in the economy. If this increase is accompanied by an increase in the Government deficit or a decrease in the Government surplus on current account, an additional stimulating effect will be exerted upon total purchasing power. Any increase in total purchasing power tends, of course, to increase output on prices, or both. A decrease in Government expenditures, on the other hand, tends to decrease total purchasing power in the economy, and consequently output or prices, or both. If a decrease in Government expenditures is accompanied by a decrease in the government deficit or by an increase in Government cash surplus, an additional depressive effect will be exerted upon total purchasing power. A decrease in total purchasing power tends, of course, to decrease output or prices, or both. By varying the level of Government expenditures and the size of deficits and surpluses in such a way as to offset changes in private spending, fiscal policy can exert a stabilizing effect upon the general level of prices and upon the rate of utilization and growth of productive capacity.

2. Taxation

An increase in taxes tends to decrease total purchasing power in the economy; this increase may, of course, be accompanied by a rise in Government spending, and this may be of sufficient magnitude to offset the depressive effect which increased taxation has on private spending. A decrease in taxes tends to increase total purchasing power; this decrease may be accompanied by a decline in Government spending, and this could well be of sufficient magnitude to offset the stimulating effect that decreased taxation has upon private spending. An increase in taxes, in conjunction with an appropriate decline in the Government deficit or an increase in the Government cash surplus could be used to restrain or reduce private spending in such a way as to contribute to stability in the general level of prices and the rate of utilization and expansion of productive capacity. Conversely, a decrease in taxes, in conjunction with an appropriate increase in the Government deficit or a decrease in Government cash surplus could be used to stimulate private spending in such a way as to contribute to stability in the general level of prices and the rate of utilization and expansion of productive capacity.

3. Debt management

The debt-management phase of fiscal policy involves three types of operations: Sale of new issues for cash, redemption of maturing issues with cash, and refunding of maturing issues with new issues.

(*a*) *Sale of new issues for cash.*—Three types of purchasers of Government securities can be distinguished: The Federal Reserve banks, the commercial banks, and the public. Purchase of new Treasury issues (indirectly) by the Federal Reserve banks is the most inflationary way of financing a Government deficit, for as the Treasury spends the newly created funds thus acquired, the excess reserves of commercial banks are increased, and of course the money supply as well. Purchases of new Treasury issues by the commercial banks tends also to be inflationary but less so than purchases by the Federal Reserve banks. While purchases by the commercial banks, like those made by the Federal Reserve banks, tend to increase the quantity of money in circulation, commercial bank purchases reduce the excess reserves of commercial banks by a fraction of the transaction, thus restricting their ability to contribute to further monetary expansion. Purchases of new Treasury issues by the public are the least inflationary means of financing a Government deficit.

(*b*) *Redemption of maturing issues with cash.*—Redemption of Treasury issues held by the Federal Reserve banks is the most deflationary way of retiring debt—if these redemptions are made from

Treasury balances in Federal Reserve banks, they are kept out of immediate circulation, and if the payments are made from Treasury balances in commercial banks, they reduce the reserves of these institutions. Redemption of Treasury issues held by commercial banks has the immediate effect of reducing the total volume of demand deposits if the payments are made from Treasury balances with commercial banks, so that in the first instance it appears to be deflationary. However, this reduction in the total volume of demand deposits increases excess reserves, and the banks can, therefore, increase their demand deposits back to the former level by purchasing private debt. By thus facilitating an increase in private spending, the redemption of debt held by commercial banks may, although it need not necessarily, tend to be inflationary. Redemption of such debt from Treasury balances in Federal Reserve banks increases excess reserves even more. Redemption of Treasury issues held by the public tends to be inflationary, because it increases the liquidity of the public and expands the public's capacity to spend.

(*c*) *Refunding of maturing issues with new issues.*—The issuance of long-term Treasury obligations in refundings reduces the liquidity of holders of debt and thus tends to be deflationary. The issue of short-term Treasury obligations in refundings does not decrease the liquidity of debt holders appreciably and thus does not do much to retard the decline in the average maturity of the debt associated with the passage of time. Short-term issues are thus less deflationary than long-term issues, and less inflationary than cash redemption. However, any refunding of Treasury debt, whether into long-term or short-term securities, tends to be inflationary or antideflationary if it is associated with a shift of ownership to the commercial banks and an increase in the quantity of money. Similarly, a refunding of either short- or long-term Treasury obligations associated with a shift of ownership from commercial banks, and a decrease in the quantity of money, tends to be deflationary or anti-inflationary.

Fiscal policy can be implemented in a variety of ways to exert a stabilizing effect upon economic activity. During a period of economic expansion, the most restrictive fiscal policy would include the following ingredients: (1) a decrease in the level of Government expenditures, (2) an increase in taxes, producing a cash surplus, (3) the impounding of this surplus in the Federal Reserve banks, or the use of it to retire Treasury debt held by the Federal Reserve banks, and (4) a shift in the composition of outstanding Treasury debt by refunding maturing issues into long-term issues without the creation of new money by the banking system. In a period of recession, the ingredients of the most expansionary policy would be (1) an increase in the level of Government expenditures, (2) a decrease in taxes, producing a cash deficit, (3) the financing of this deficit by sale of securities to the Federal Reserve banks or to the commercial banks if additional reserves are supplied by the Federal Reserve authorities, and (4) a shift in the composition of outstanding Treasury debt by retiring maturing issues in cash and financing the retirement preferably by reducing cash holdings or, secondarily, by short-term issues placed with the Federal Reserve.

MONETARY AND CREDIT POLICY

Monetary and credit policy affects the level of purchasing power by influencing the quantity, cost, and availability of loanable funds. This occurs largely through the control of the reserve position of member banks. By reducing the discount rate and legal reserve requirements and by purchasing securities in the open market, the Federal Reserve authorities can strengthen the reserve position of member banks, thus increasing their capacity to lend. By raising the discount rate and legal reserve requirements and by selling securities in the open market, the Federal Reserve authorities can diminish the reserve position of member banks, thus reducing their capacity to lend.

A reduction in the capacity of member banks to lend tends to decrease the quantity of loanable funds available to borrowers. By increasing interest rates and by reducing the availability of funds, member banks allocate this reduced supply of funds among borrowers. To the extent that a reduced supply of funds from the members banks is associated with a reduced supply of funds from lenders in general, the volume of spending with borrowed funds is decreased. A reduction in the volume of spending with borrowed funds tends to reduce total purchasing power, and in a period of economic expansion this would tend to stabilize the general level of prices and the rate of utilization and growth of productive capacity.

The reserve positions of commercial banks can also be influenced by the Treasury's policy with regard to the nature and location of the balances it holds. A shifting of Treasury balances from cash or Federal Reserve deposits to commercial bank accounts increases the reserve position of commercial banks, while a shift in holdings from commercial to Federal Reserve banks or to cash reduces commercial bank reserve positions.

Fiscal policy, through Government expenditures and taxes, operates upon the level of purchasing power by increasing or decreasing Government and private spending directly. Monetary and credit policy works less directly by attempting to regulate the volume of spending with borrowed funds through changes in the quantity, availability, and cost of loanable funds. Although the action of the monetary authorities is more indirect, there is good reason to believe that it is just as powerful as fiscal policy. Monetary policy can be altered more quickly than can fiscal policy. Therefore, monetary policy is capable of achieving a greater part of its potential power as a stablization device. This conclusion seems reasonable notwithstanding the automatic stabilizing effects of certain aspects of fiscal policy. The principal automatic stabilizing effects are associated with the progressive nature of the personal income tax and with unemployment compensation. Although these aspects of fiscal policy have some stabilizing influence upon economic activity, this influence is somewhat secondary to the effects of other aspects of fiscal policy and to the effects of monetary and credit policy.

10. (*a*) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank credits). Also please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

The United States monetary system today is the result of over a century and a half of evolutionary legislation. There is little doubt that a wide range of reforms would be suggested by many individuals, groups, and organizations, if offered the opportunity of extensive legislative change at this time. A meaningful evaluation of the adequacy of the monetary system today can be made only if specific criteria are posed.

1. Has our monetary system provided an efficient payments mechanism?

Since the passage of the Federal Reserve Act of 1913 and the various reforms of the early 1930's, we have had a very efficient payments mechanism.

2. Has our monetary system provided adequate credit facilities?

An alleged deficiency of credit facilities has frequently been used as the rationale for the establishment of Government credit agencies and for the subsidization and promotion of the development of private lending institutions outside the banking system. To the extent that such deficiencies have existed, one of the most important reasons can be found in the restrictive influences under which the commercial banking system operates. Despite this, the banking system has done much to expand its operations to remedy alleged deficiencies in lending facilities. A great deal more could have been achieved if public policies had been directed more to strengthening and broadening the monetary and banking system than in affording means of circumventing it. It should be recognized that the establishment of many Government credit agencies and the promotion of certain types of nonbank financial institutions have proceeded from a desire to provide services commercial banks were not permitted to render.

3. Has our monetary system provided stability in the value of money?

It is obvious, of course, that our monetary system has not proven adequate to assure stability in the value of the dollar. The reason lies to some extent in a lack of coordination within the area of fiscal policy and between monetary and fiscal policy. It also lies in the nature of the financial structure and the problems it poses for the implementation of monetary policy. Even with the good effort of recent years, the monetary authorities have been unable to stabilize the value of the dollar, because they do not have adequate control over financial institutions outside the monetary system.

While nonbank financial institutions cannot create demand deposits as can banks, such institutions can "create credit" in the sense of transmitting loanable funds. This increased variety of financial services, together with the accompanying growth of nonbank financial institutions, has enabled a growth in income to be financed with progressively smaller additions to the money supply. As a result, traditional monetary controls, which are directly applicable only to banks, are being brought to bear on an increasingly narrow sector of the financial structure.

Nonbank financial institutions are beyond the direct influence of the monetary authorities because they are not subject to variable reserve requirements, nor are they directly affected by Federal Reserve open-market operations and rediscount policies, as are banks. Their operations are affected only indirectly through the application of monetary controls to the commercial banks, which administer the payments mechanism. Consequently, in periods of inflation when monetary authorities are attempting to curtail competition for resources by restricting the money supply, nonbank financial institutions become vehicles by which the velocity of circulation is accelerated and by which competition for resources is intensified. As a result, attempts by the monetary authorities to compensate for such increases in deposit velocity by further restricting commercial bank lending tend to enhance the competitive position of nonbank financial institutions with respect to banks. Aside from the question of equity involved, this reduces the relative size of the base on which monetary authorities exercise their powers in their attempt to control the inflationary effects of the credit operations of the entire financial system.

Effective implementation of monetary policy in the interest of promoting sound economic growth and well-being would be facilitated if nonbank financial institutions were more responsive to policy implementation. Monetary policy cannot make its full contribution to this goal if it is applied to only a portion of the financial structure.

(*b*) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

Our fiscal system, particularly the tax structure, does not lend itself well to compensatory fiscal policies, and is in need of a thorough and careful review for the purpose of making it a more effective instrument of national economic policy. The fiscal system should facilitate to the greatest possible extent the fulfillment of the basic objective of economic policy which should be the promotion of orderly economic growth and the economic well-being of the public. To do this it must be flexible, not only in the sense of adjusting to change per se but adjusting in a manner which will be consistent with this basic policy goal. Flexibility requires general acceptance of the idea that the annual budget need not be in balance every year, and that the size and movement in the public debt is not significant in itself but only in relation to the state of the economy. With this flexibility must go measures to assure that there will be appropriate budgetary surpluses during inflationary periods. Otherwise the deficits in periods of recession which grow out of tax and expenditure policies will set the stage for persistent inflation and a rate of growth in the public debt which would not be consistent with the ultimate general policy objective of sustainable economic growth without inflation. Fiscal policy is too powerful a force in the economy to be ignored. It may be harnessed and used effectively in the public interest.

Apart from the need for flexibility, the fiscal system should be reviewed for consistency, equity, and economic effect of tax rates and the incidence of taxation. The budgetary process and particularly the process of cash disbursements by Government departments should be reviewed. The latter is especially important in connection with economic policy because disbursement schedules may conflict with the requirements of sound economic policy.

Some taxes lend themselves more readily to counter-cyclical use than other types. Relatively more reliance should be placed on the type of taxes most amenable to compensatory use. This entire area should be thoroughly studied to make the taxing mechanism a more effective instrument of economic policy.

11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

The paradox referred to in this question undoubtedly relates to the observation that unemployment and prices may sometimes be observed to rise together, instead of alternatively, as in the usual business cycle experience. A phenomenon of this nature is most likely to be present as the economy tapers off from a boom. This situation arises from the existence in our economy of rigid elements which do not adjust rapidly and easily to changing conditions.

A further factor to note is that, with increasingly widespread unemployment compensation benefits, income and demand do not fall commensurately with a decline in employment, thus lending support to market forces which are boosting prices even though employment may have turned downward.

It should also be noted that forces which do not stem from business conditions influence the level of output and prices independently of the level of employment. The influence of weather and other catastrophes on production of specific goods, for example those dependent on growing conditions or transportation, can result in price increases regardless of the state of unemployment.

(*b*) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

We need not accept a gradual inflationary trend as desirable or necessary to achieve and maintain "full employment"—by which we mean the employment at a high level of the employable labor force not in transition between definite job commitments. Theoretically, a stable price level is consistent with full employment in this sense and, in fact, there have been periods in our history during which reasonably full levels of employment were maintained with reasonably stable prices.

Inflation cannot be scheduled and programed at a certain rate. It is progressive and cumulative. To open the door only slightly to inflation as a matter of conscious policy is to risk having it flung open violently. To assume that a fundamental distortion in the price level is necessary to achieve full employment is to assume that every other alternative has been exhausted and that we are helpless to achieve this end without such a step. This is simply not true. Neither our monetary machinery nor our fiscal system is fully adequate to cope with this problem and both should be thoroughly overhauled as a first step in removing excessive fluctuations from the full-employment growth of our economy.

Attention also needs to be given to other aspects of this problem. Even if the general price level were to be held reasonably stable by monetary and fiscal policies the rate of utilization of productive capacity may be reduced below the full employment level by inflexibility in price and wage policies. Greater flexibility in this area of the economy would contribute to the maintenance of both price stability and full employment. A rising price level is the price we pay for rigidities in our economic structure; it is not the price that we need pay for full employment.

12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy?

In our private-enterprise economy, growth of private debt is essential to economic progress, for it is the principal means by which saving is converted into investment in productive facilities and in other forms of real capital goods. A rate of growth of private debt which is faster than growth in the capacity of the economy to save and create productive facilities—unless public debt is correspondingly reduced—is not only a threat to the stability of the economy but may actually precipitate economic instability. The inflationary periods since the end of the war have been associated with an excessive rate of expansion of private debt. Once excessive debt has been created, it becomes a burden to the economy which increases in weight in the presence of an economic downturn.

13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy?

It is impossible to prescribe a specific point in terms of unemployment, production and consumer demand at which the Federal Government should undertake major countercyclical measures. Economic policy must be based on analysis of many nonstatistical as well as statistical indicators. With respect to statistical indicators, not only their level at any given time, but their direction and rate of change must be taken into consideration. Among the most important indicators whose level, direction, and rate of change reveal what is happening to the economy are indexes of unemployment, industrial production, wholesale prices, consumer prices, personal disposable income, inventory changes, investment in plant and equipment, and housing starts. These indicators, however, act in different ways and rarely all move in the same direction let alone at the same pace. Consequently their interpretation must depend on skillful analysis and sound judgment. There are no mechanical or universal formulas which can provide an automatic signal for the timing, nature, or magnitude of economic intervention by the Government.

14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

Deficit spending by the Federal Government since the end of World War II was not a significant contributor to inflationary pressures except as it was associated with wartime expenditures in 1952 and 1953.

Increases in total Government expenditures, rather than Government deficits have been the more important inflationary force in the economy.

15. Can full employment goals be attained while maintaining a dollar that has relative stable purchasing power?

Yes, full employment goals can be attained while maintaining a stable value for the dollar, if monetary and fiscal policies are properly implemented and if pricing of goods and services can be made more flexible.

16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

Escalator provisions tend to reinforce and magnify, rather than dampen, inflationary and deflationary pressures on prices. When the price level is rising, such provisions increase inflationary pressures by increasing wages and costs. When prices are falling, downward adjustments in wages tend to accentuate the price decline, primarily through the lowering of money income. Not only are the prevailing price movements accentuated in those escalated industries already in the vanguard of inflation or deflation, but escalation may also cause wage rates to rise in inflation or fall in deflation in industries whose prices were stable or were moving in the opposite direction from that of the general price level.

The effects of two-way wage escalation on employment are less clear. Basically, the problem consists of the relative influence on employment of the effects of variable consumer purchasing power on the one hand, and variable labor costs on the other. In inflation, with full employment, higher wage costs do not restrain demand for labor as they would if prices could not be increased to cover rising costs. During deflation, the demand for labor may not rise appreciably in response to a slight decline in wages if, as is likely to be the case, prices and profits are declining more rapidly. In fact, under these conditions employment might well decline, with a consequent reduction of income and demand in general.

A stabilizing device should operate to restrain excess demand for labor and goods in periods of inflation and to increase it in times of recession. On balance, escalator contracts do neither and therefore are not a stabilizing influence either for employment or for prices.

17. List briefly and discuss what you consider the causes of the present recession, and what should be done to terminate it.

The more immediate causes of the present recession are: (1) creation of excess capacity in the economic upswing of 1955–57; (2) cutbacks in Government defense orders in 1957; and (3) reduction of purchasing power of consumers through price increases in 1956 and 1957.

These developments coincided with a somewhat longer-term decline in housing construction and in agriculture. Earlier surging demand for houses, automobiles, and all kinds of appliances could not be indefinitely sustained at their peak levels. The subsequent decline in demand for these goods reflects in some measure a temporary satisfaction of pent-up demand at prevailing price and income levels, and a need to digest the debt created to finance peak sales.

Inventory liquidation has added to the economic decline since the fourth quarter of last year.

Finally, although the current recession does not appear to have been caused by economic developments abroad, it does not seem to have been ameliorated by them either, as was the case in the 1953–54 recession when the business buoyance and economic strength of other countries helped turn the tide here.

Appropriate action to terminate the present recession might include:

1. An expansion of those vitally necessary governmental expenditures which have been delayed somewhat or restricted during the previous period of rapid expansion. These include such projects as defense expenditures, road construction, needed public facilities, water development, etc.

2. Some excise taxes should be reduced or eliminated. Particular attention should be given to those categories of products where such action could be expected to lead to an expansion of demand.

3. Temporary liberalization of unemployment compensation with respect to the length of time for which unemployment payments can be made.

4. Further reduction in the reserve requirements of member banks to assure ample availability of loanable funds.

5. A reduction in personal income taxes when and if an adequate and thorough apraisal of the situation demonstrates that such action would be appropriate.

A sizable cut in personal income taxes would help to absorb the substantial excess capacity which is one of the drags on our economy at the present time. On the other hand, a premature cut in income taxes would serve to aggravate the actual and potential inflationary pressures which are still evident in some parts of the economy. Moreover, tax reductions, by their nature, are an inflexible instrument, and premature or excessive reductions cannot readily be reversed. Accordingly, a decision to cut taxes should not be made precipitately, but only when the need has been demonstrated.

Once need is evident, a cut should be made promptly and, if necessary, should be partially retroactive. The size of the reduction should be large enough to be really effective in stimulating consumer spending.

In order to make tax policy a more effective weapon in dealing with future recessions and inflations, it may be desirable to study the possibility of delegating to the President or Secretary of the Treasury (possibly with the concurrence of the appropriate committee of the Congress), the authority to reduce or raise personal and corporate income taxes when in his, or their judgment this seems desirable. Such delegation should include the provision that any tax rate change may not exceed some specified percentage nor be in effect beyond some specified period of time. In this way, the Congress would retain ultimate control over the taxing power but greater flexibility in the use of this power would be achieved. The adoption of this procedure would involve some rather basic changes in the environment in which tax policy presently operates. For this reason the question of tax reduction to combat the current situation should be considered independently of the longer-run question of whether the suggested procedure would be desirable.

CHRYSLER CORP.,
Detroit, Mich., May 5, 1958.

Hon. HARRY F. BYRD,
United States Senate,
Washington, D. C.

DEAR SENATOR BYRD: We have given considerable thought to the questionnaire dealing with broad aspects of American fiscal policy, and are attaching some comments which we hope will be useful to your committee.

We would like to emphasize one of our comments dealing with a specific tax issue. Perhaps the most effective single stimulus the Government could contribute toward a rapid and vigorous recovery from the present depressed conditions in the automobile industry would be the removal or drastic reduction of the discriminatory excise tax on automotive products. Prompt action on this subject by the Government with retroactive provisions to cover current purchases, holds out the greatest promise of stimulating retail automotive sales.

Presently many prospective customers are delaying purchase of new automobiles because of the uncertainty over the excise-tax issue. Favorable action on the excise tax could bring them into the market quickly. In addition, many other customers would be attracted by the tax savings and decide to buy a new car now.

We appreciate this opportunity to submit our thoughts to you.

Sincerely,

L. L. COLBERT.

MEMORANDUM

In the course of the Senate Finance Committee's inquiry entitled "Investigation of the Financial Condition of the United States," Senator Byrd, chairman, has submitted a list of topics to business leaders and others, for their comment. This memorandum discusses specifically item No. 6 of this list.

6. (*a*) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand, and employment.
3. Economic growth in production, demand, and employment.

INTRODUCTION: OLD RELATIONSHIPS BUT NEW RELATIVE IMPORTANCE

Economic growth is achieved when there are more jobs, more goods, more services, and more dollars of real income for more people. Distinct from growth is stability, which might be thought of as the tendency of the economy to remain in a specified relative position, for example, at full employment. Stability fundamentally means the avoidance in the economy of major economic disturbances and fluctuations in demand, prices, and employment at the same time the economy is experiencing growth. Stable economic growth can be achieved if the economy possesses flexibility. The economic decisions which permit and even stimulate growth are made by the business firm, and it is here fundamentally that flexibility must be maintained. Flexibility means that employment, production, incomes, and prices adapt relatively quickly to competition, to invention, and to innovation. In our economy, most of this adaptation occurs in the market place through the combined influence of demand, supply, and prices.

When all three exist—flexibility, stability, and growth—then there is adaptation to change in such a fashion as to be compatible with full employment, high production, and stable dollars, as well as with more jobs, more goods, and more purchasing power.

It is unlikely that in the next few years new and hitherto unsuspected economic relationships will be discovered between stability and growth, or stability and flexibility, or among the various sectors where stability is a concern—prices, production, demand, and employment. But it is likely that there will be changes in the relative importance businessmen, political leaders, economists, and other interested persons will devote to prices, production, demand, and employment. These changes will call for new criteria to evaluate economic goals and to appraise the contributions of monetary and fiscal policies to achieving them.

THERE HAVE BEEN CHANGES IN THE CONDITIONS AFFECTING STABILITY

The trend of postwar experience suggests that consumers' markets are in a transition period. When the war ended there was no problem in persuading people to buy, for people had plenty of cash, high and secure incomes, and stocks of wornout goods. A lot of wornout stocks had been replaced by the early 1950's. In automobiles, for example, the seller's market became a buyer's market during 1953. Today it is difficult to think of a consumer's item that is not in a buyer's market.

Since the early fifties various market forces have helped to sustain expanded markets. For example, on the side of demand there has been the continuation of high marriage rates, high birth rates, and rising real incomes; while on the side of supply there have been new and improved products to attract customers. Also acting as an expansionary force have been alterations in the terms of sale. Houses are an example of how this latter influence has increased in importance. In the past several years changes in the downpayment, the length of terms, income requirements for potential buyers, and so forth, have all helped sustain the market. In general this is true for most products. The result has been more widespread ownership and a lower average age for consumers' stocks of goods.

However, there is a limit to the process of assisting markets by merely changing the conditions of sale. A product cannot be sold for less than nothing down, for example, or can credit soundly be extended beyond some fraction of the useful life of the product.

As more and more products approach this limit, then other ways must be found to maintain vitality of demand in the huge markets of our economy. One possibility is to devote more time and money to research and to the development of new products, new processes of production, and more modern techniques of marketing. Hence investment increases in importance.

CHANGES IN ECONOMIC CONTROLS

Obviously, it is usually more difficult to maintain or increase sales by creating new products or new processes than by satisfying backlogs of demand or by stimulating demand through changes in the terms of sale. This is why we may expect to face domestic economic problems of the next several years in achieving vigorous yet stable demand, production and employment, as well as stable prices. While there may be no less concern with stability of prices, other problems will appear which may well take on substantially greater importance than at present. In such an event monetary and fiscal policies will be given broader goals than they have had.

For example, it may be that our tax system in the postwar period has not been adequate to cope with inflationary pressures, in that it has tended to influence the decisions of consumers, business, and labor in ways not conducive both to growth and stability. Our tax system should be designed to foster prosperity in an economy where the markets are buyers' markets. The importance of sustained high levels of consumer demand over the next several years calls for careful review of excise tax structure to eliminate discrimination and market strictures. For while relatively high excise taxes can be useful in a demand-inflation economy to hold consumption within the limits of productive capacity, lower excise taxes are needed when the emphasis shifts to stimulating consumption so productive capacity will not be idle.

THE IMPORTANCE OF MARKETING: DEMAND AND EMPLOYMENT

A recent study by the Department of Commerce indicates that the rate of growth of many markets has been slowing, implying a slackening in the demand for additional productive capacity. In their study the Department of Commerce classified products on the basis of rapidly growing, moderately growing, and declining products. In general, most products experienced high growth rates in the period 1940–51. Since 1951 there has been a definite slowing down in output expansion of many fast-growing products. In the moderately growing industries production of about one-half of the products grew less rapidly in the middle fifties than during the preceding years. In the declining industries the rates of decline have become somewhat greater since 1951. These changing growth rates point to the areas of difficulty likely to be met in achieving stable production and employment at high levels over the next few years. This consideration in turn underscores the crucial role investment, product innovation, marketing, and distribution must play if mass production for buyers' markets is to continue to be stable at large volumes.

It is undoubtedly more difficult to sustain growth in markets than to control prices, for price is only one aspect of a sale, not the sale itself. Sustaining market growth in our economy is also more important, from the point of view of employment, for men may be employed whether an inflation-control program works or not, but they cannot continue to be employed if markets fail to expand, or if the labor force is growing faster than the demand for goods.

PRODUCTIVITY

A shift in the relative difficulty of achieving price stability and stability of production places the issue of improvement in productivity in a somewhat different light. Over the past few years we have become accustomed to thinking of these improvements as a safeguard against inflation since they tend to offset some of the excesses of demand over supply. Now there is developing increasing concern over productivity as an offset to costs. This concern is bound to grow.

As productive capacity expands in the years ahead and as buyers' markets become increasingly competitive high costs will be less tolerable than ever. To a greater extent than ever before companies are going to have to find offsets to increases in costs, as well as find ways to reduce costs, if they are going to stay in business.

Obstacles to increased productivity must be removed in the interests of high-level stability in demand, production, and employment. More constructively, improvements in productivity must be fostered. Greater productivity is the result of investment in technological advances, increased mechanization, more efficient use of materials, and improved distribution methods, as well as of a more skilled labor force and an increased recognition by labor that management and labor have interests in common. Clearly, it is important to stimulate business incentives to invest, invent, and to innovate. Full consideration ought to be given to strengthening the individual entrepreneur's confidence in the prospects for private business.

CONCLUSION: ECONOMIC POLICY IS FOR THE FUTURE

We are entering the third stage of postwar economic history. In the first stage pent-up demand was satisfied. In the second stage total demand was sustained partly by changing the conditions of sale. In the third stage new stimuli must be found or old stimuli cultivated more intensively to maintain growth in consumption and reduce costs.

Relatively lower costs of production, and greater efficiency in marketing must constitute a large share of manufacturers' skills over the next few years. This involves greater productivity through investment, invention, and innovation, and greater trade volume through improved marketing methods, within the framework of a tax system which strongly encourages individual initiative.

It would be a mistake to try and adjust our economic polices merely in the light of any real or imagined failings of the last few years. The economic policies appropriate to guide an economy such as ours must preserve freedom, increase economic opportunity, and reward individual initiative. They must reflect major economic facts anticipated for the years ahead, as well as significant past events.

Developments in the relative difficulty of realizing price stability and stability of production mean increasing challenge to legislators, administrators, and businessmen. The tasks ahead may well be more complex than in the past, but we know that the rewards of a stable and growing free economy make the effort eminently worthwhile.

GENERAL ELECTRIC CO.,
New York, N. Y., May 2, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate,
Washington, D. C.

DEAR SENATOR BYRD: In accordance with my telegram to you yesterday I am attaching herewith a statement on, "The Financial Condition of the United States." This is in reply to your letter of February 17 and the questionnaire.

I regret that I have not been able to complete this statement at an earlier date. The delay is due, in part, to securing the collective thinking of the senior officers of General Electric Co. as well as the company's economists and financial advisors.

You will note that for the ready reference of yourself and your staff my statement has been classified as follows:

Introduction.
Objectives of a sound economic policy.
The structure of built-in inflationary pressures.
Wage inflation—the root of the trouble.
Fiscal policy.
Monetary policy.
"Creeping inflation" would mean runaway ruin.

Knowing your interest in contributions and sound leadership, as Chairman of the Senate Committee on Finance, I consider it a privilege to submit to you, and through you to members of your committee, my personal philosophy on these vital issues.

With kindest personal regards.

Sincerely,

RALPH CORDINER.

STATEMENT OF RALPH J. CORDINER, CHAIRMAN OF THE BOARD, GENERAL ELECTRIC CO., ON THE FINANCIAL CONDITION OF THE UNITED STATES

INTRODUCTION

The financial condition of the United States is a matter of continuing concern for business managers because of its dominating influence on the economic environment in which business organizations operate. Changes in national economic policy directly affect business operations and the changing abilities of individual businesses to live up to their full usefulness to the public profoundly affect the development of the economy as a whole.

It is therefore part of the responsibility of a business manager to develop and maintain an informed viewpoint concerning the necessary and desirable objectives of national economic policy and the means by which these objectives can most appropriately be pursued. It is his further responsibility to make this viewpoint widely known to the public and the public's representatives in Government for their guidance in maintaining and strengthening the kind of economic environment in which business can most successfully serve the general good.

In the following comments the objectives of a sound economic policy and the available means for pursuing them are defined with reference to the 17 questions raised by the Senate Finance Committee in its inquiry entitled "Investigation of the Financial Condition of the United States."

OBJECTIVES OF A SOUND ECONOMIC POLICY

The basic problem raised in this inquiry is that of achieving an appropriate balance between the objectives of economic growth and stability. Both are inherently desirable and neither can be achieved without the other, but either objective may interfere with the other if carried to excess. Only through an appropriate balance of economic growth and stability can the Nation achieve the optimum levels of employment and optimum utilization of all economic resources which are the proper aim of economic policy.

The starting point for consideration of these objectives is the need for economic growth. The population of the United States is steadily increasing and the American people legitimately insist upon ever-rising levels of living. The result is a consistent increase in the demand for goods and services, which calls for a corresponding growth in the volume of production. A harmonious relationship between the growth of demand and the increase in production and employment can only be achieved if there is realistic understanding of how our competitive economy functions—and thus how wise economic decisions can be made—on the part of consumers, workers, savers, and their representatives in Government, unions, and other organizations.

A satisfactorily growing volume of production connotes a continuing increase in the number of men and women able and willing to do the work; in the number, size, and efficiency of the Nation's productive facilities; and in the amount of capital funds invested in productive enterprises. A rate of production increase sufficient to insure rising levels of living also requires continual technological innovations and improvements in the art of business management.

These are variable factors with constantly shifting relationships. No economist or statistician, by observing the activities of all the men and women in the United States, could determine the exact relationship existing at any given time between these factors, nor the exact relationship which would be required to produce the ideal balance of economic growth and stability.

Nor are these factors subject to arbitrary control, since they vary according to the individual decisions of millions of citizens, decisions which must in many instances be made long before their effects on the economy can be known.

In a free society, each individual decides for himself where to live and what kind of employment to seek, what to buy and what not to buy, how much of his money to spend and how much to save, how much of his needs to meet from current income and how much by borrowing. Each employer and each employee is more or less successful in his work according to the skill, care, and effort he puts into his job, the wisdom of his decisions, and the ability with which he conducts his relationships with others. The innovations which result from research and development work, whether in the technology of production or the art of business management, cannot be predicted in advance. No scientist can foretell exactly when his work will bear friut or what its effects on the economy will be.

Therefore in a free and dynamic economy, no mechanical system for controlling or stabilizing the rate of economic growth can hope to succeed. Continual adjustments of prices, production, demand, and employment must take place in individual sectors of the economy through the interaction of these millions of decisions made by individual citizens in the course of their daily lives.

New products will displace old ones; changes in consumer needs and wants will promote the growth of some industries and cause the decline of others; growing businesses will draw customers, employees and capital away from obsolescent enterprises. In the long run, our success in maintaining economic growth and stability will be largely influenced by the wisdom and sense of responsibility with which these economic decisions are made and the resulting adjustments are carried out by the individuals concerned.

As long as these adjustments are in approximate balance, with some prices falling as others are rising, and new employment opportunities opening up as others disappear, the overall stability of the economy is not appreciably disturbed.

However, this ideal balance has rarely, if ever, been achieved, nor is perfection ever likely to be attained. The upward and downward trends in different sectors of the economy, in prices, wages, interest rates, employment, productivity, and profits, are not always in balance. Under certain circumstances their effects tend to be cumulative rather than corrective, leading to inflation when the general movement is upward, and deflation accompanied by recession or depression when the movement is downward.

The aim of policy therefore should be to discern as promptly and accurately as possible which trends are acting correctively at any given time, and operating in the direction of growth and stability; and which trends are working in the opposite direction. Sound corrective trends should at all times be encouraged by economic policy, and the opposite trends discouraged. Timely use of preventive measures offers the best hope of avoiding the violent upward and downward swings of the economy which require emergency measures by the government of a more massive and therefore more dangerous character.

Our basic problem is that we are, fortunately, a very well-to-do country. Citizens at every level do most of their buying to satisfy extra desires well beyond any actual needs for survival or subsistence. In such a situation, any conclusions we draw from purely mathematical evidence must be modified by consideration of emotional factors such as the attractiveness of products and the confidence in the future that influences people's decisions to buy. Most purchases can be put off, and many need not be made at all.

There are, in our judgment, two basic obstacles to success in tempering the upward and downward swings of the economy. First is the difficulty of discerning far enough ahead and with sufficient accuracy the changes in direction of the economic trends we have mentioned. This is largely a question of further progress in the sciences of market research and of economic research, analysis and psychology. We can confidently expect additional understanding of these subjects to be achieved in time with the continued application of effort and intelligence.

The second basic obstacle to success is the widespread popular misunderstanding of the nature and effects of inflation, and the misguided notion that measures which result in inflation provide a simple cure for unemployment and other economic ills. This beguiling error leads to continual political pressures upon the government to exert its economic influence in the direction of inflation rather than stability and sound growth. This same misunderstanding, and the long-range inflationary trend which flows from it, are also the continuing source of other errors of economic and political judgment on the part of millions of the decisionmakers who determine the course of the economy.

THE STRUCTURE OF BUILT-IN INFLATIONARY PRESSURES

No single influence on the economy of the United States has a more unstabilizing effect nor is more inimical to orderly growth than the structure of built-in inflationary pressures which have been tolerated and in some respects created and encouraged by government policy. By inflation, we refer to a condition of generally rising prices, characterized by an excessive level of effective demand for the available supply of goods and services. Such a condition has existed in the national economy in most years since the end of World War II, and has acted as a major contributing cause of the current recession.

During these years of inflation, the levels of production, employment and demand were high and generally rising. Individuals, businesses, and the Federal, State and local governments were using a swollen supply of depreciated dollars to bid against each other for the limited supply of economic resources. The inevitable effect was the upward pressure on prices we have seen.

Under such conditions, the volume of money which individuals, businesses, and governments saved out of their incomes by curtailing expenditures could not be as great as the volume required for investment in the expansion and improvement of productive facilities and the establishment of new productive enterprises. The shortage of savings was made up by the expansion of credit, which had the effect of adding further to the Nation's money supply.

The generally optimistic attitude engendered by the continuing increase in effective demand encouraged producers to expand their capacity as long as it appeared that economic growth would continue uninterrupted, and profit incentives would therefore justify the investment.

Underlying this optimism, however, was an awareness that an inflationary spiral could not go on forever, and that the longer it lasted the more damaging it would be. Once such a spiral is set in motion, it tends to feed on itself. The expectation of further rises in the price level and corresponding declines in the purchasing power of the dollar encourages people to buy even further ahead of their needs or usual desires, and to spend more of their income and save less of it. The gap between the supply of savings and the demand for investment funds becomes greater, leading to further expansion of credit. Consumers with rising incomes tend to buy goods before they need them or would normally want them, while those with fixed incomes tend to buy fewer goods because of the rise in prices. Businesses are encouraged to anticipate growth requirements, and to engage in long-cycle construction and expansion programs to build up their inventories too far ahead of needs.

Early last year the rise in interest rates, resulting from the growing excess of demand for investment funds over the supply of savings, serves as a warning to the economy that the inflationary spiral was gaining dangerous momentum. Consumer resistance to rising prices had already begun to appear in some sectors, notably housing and consumer durable goods.

Business responded by cutting back some of its expansion plans, as it began to appear that the rate of growth would be slowed, halted, or temporarily reversed. The effect was promptly felt in the capital goods industry, which was obliged to cut back production. Liquidation of inventories became general, leading to wider temporary cutbacks in production. The outlook of businessmen and consumers shifted from excessive optimism to caution and uneasiness, leading to further postponements of expenditures and a further decrease in overall demand.

What were the inflationary pressures that had created this situation? Psychology was one of them—a general tendency to err on the optimistic side in economic judgments. Government fiscal policies had something to do with it—based on our unwillingness as a nation to recognize that money spent by the government is not the government's money but the people's money, and cannot be spent by both the government and the people at the same time without losing its value. Federal monetary policies had something to with it, for the measures taken to restrain credit did not prevent the level of expenditures from expanding more rapidly than the volume of goods and services available for purchase.

WAGE INFLATION—THE ROOT OF THE TROUBLE

The greatest of the inflationary pressures, however, is the wage-price spiral which has been characteristic of the years since World War II, and is still going on. The driving force behind this spiral is the monopoly power of unions, which has been created in large measure by Federal policy and legislation, and which enables the unions to obtain excessive wage increases by threatening the destruction of any business which refuses to agree. Once granted by a major company, such wage increases tend to spread to other companies and other industries, and to result in higher prices which lead to another round of demands for wage increases. Escalator clauses compound the evil by making these effects automatic, while attempting to protect those who caused the trouble from the ill effects of their errors.

In any period of vigorous economic growth, with high and rising levels of production and employment, the natural tendency of wages is to rise in response to the growing demand for labor. If the productivity of the economy is also increasing at relatively the same rate, a concomitant increase in the general price level or a decrease in the profits accruing to the economy as a whole. Investment of these profits in further expansion of the volume of production and further improvements in productivity will permit continued high levels of employment and continued substantial wage increases.

Inflationary pressures arise, however, when excessive wage increases push the general wage level higher than the economy can sustain without either a rise in the general price level or a decrease in the profits which provide the investment funds needed for further economic expansion. Unfortunately the exact level at which wage increases become excessive cannot be determined precisely in any individual instance, either by Government administrator, union leader, or business manager. It must be worked out through the bargaining of the parties concerned, in the light of economic conditions. When the bargaining is done collectively, both parties must be adequately informed and of equal strength at the bargaining table. The degree of success achieved in the public interest will reflect the flexibility with which both sides adjust their decisions to the shifting forces at work in the economy.

Unfortunately, the existing labor laws and continued misunderstanding on the part of the general public give union leaders the dangerous illusion that their privileges protect them from the operation of economic laws. By carefully planning their strategy of strike threats, they can compel business organizations to yield individually to inflationary wage demands going far beyond the limits of economic reality.

In consequence, the upward pressure on wages arising from high levels of employment has been multiplied by union power to the magnitude of an irresistible inflationary pressure. In recent years an outlet was provided for this pressure by a combination of Government fiscal and monetary policies inadequate to prevent inflation. The presence of inflationary money and credit in the economy permitted businesses for a time to pay the excess wage costs by passing the burden on to the consumers through increased prices. The consequence was to stimulate the wage-price spiral, postpone the day of reckoning, and thereby insure that the reckoning would be more costly when it came.

On the other hand, the experience of the last 12 months show that monetary controls cannot by themselves prevent excessive wage demands. Credit restraints may stiffen consumer resistance to higher prices, but they did not eliminate union pressure for higher wages. The resulting higher costs have led only to a net decrease in demand, production and employment, and the primary burden has fallen on the wage earners who have lost their jobs.

There is no way to prevent excessive wage increases from having these effects. When prices are raised in the face of consumer resistance in order to cover excess wage costs, sales volume falls off, production has to be cut back, and employees are laid off. When excess wage costs are absorbed out of profits in order to maintain sales volume by keeping prices down—a process that can absorb only very small wage increases and then only for a very short time—the effect is to reduce the funds available to businesses to buy capital goods for expansion and improvement, and to the owners of businesses to buy consumer goods. The result is the same—a decrease in total demand that requires production to be cut back and workers to be laid off.

Both these processes can be observed at work today in different sectors of the economy: in combination with the unrealistically high farm prices resulting from the farm support program, they help to explain the continued rise in the general price level in the face of the current recession.

Union officials do not appear to be concerned with protecting the economy from inflation. They disclaim responsibility for the inflationary effects of their excessive wage demands, and seek to shift the burden to other groups in the economy. They claim special protection for their members, in the form of escalator clauses to provide automatic wage increases to offset the tax of inflation which shows up in the increasing cost of living, and they demand further inflationary increases in pensions, insurance, and other benefits. They seek political support by demanding increased social security and unemployment benefits to make up for the declining value of the dollar, and a topheavy tax structure which reduces their share of the inflated costs of Government. Relying on these special privileges, they ignore the fact that the wage earners suffer more than any other group from the periodic recessions that come from inflation, because they bear the primary burden of unemployment.

When Congress originally granted union officials the privileges on which their monopolistic powers have been built, the Nation consented in the hope that these powers would be used with such wisdom and sense of responsibility as to contribute toward greater economic growth and stability. Experience has shown, however, that these powers have been abused in an irresponsible attempt to gain special privileges at the expense of the Nation as a whole, while the penalty for these abuses has fallen most heavily on the group which was presumed to benefit from them.

It is abundantly clear that by these abuses the union officials have forfeited whatever right they may ever have claimed to the enjoyment of such special privileges and immunities. Curbing the monopoly power of unions is a necessary first step if the economy is to be effectively protected against the cycle of inflationary spirals and business recessions, by the use of sound Government fiscal and monetary policies and the exercise of sound business judgment.

In the meanwhile, the current fiscal and monetary policies need to be adjusted in the light of the forces currently at work in the economy, both short- and long-term. The present recession is primarily a corrective swing following the inflationary excesses and related economic imbalances of recent years. It is largely confined to the durable goods industries, and has not yet developed into an uncontrolled deflationary spiral such as would lead to a deep and prolonged depression. Nor does it appear that there is real danger of such a development.

Therefore Government measures to combat the recession should be limited to those required for the direct relief of the unemployed, and for counteracting such deflationary forces as may be temporarily in evidence. Care must be taken to avoid dampening the recovery, to minimize the inflationary aftereffects of these antirecession measures, and to direct fiscal and credit policies toward economic stability rather than inflation as soon as recovery is well underway.

FISCAL POLICY

The fundamental objective of fiscal policy at all times should be to provide the Government with the money it needs to perform the services which individuals and business organizations cannot perform themselves, with a minimum of interference to the economy. The operations of Government fiscal policy inevitably affect the civilian economy, because nothing can be bought by the Government which is not produced by the people, and no money can be spent by the Government which is not provided by the people. These simple principles are too often overlooked by those who believe that management of the national economy is the primary purpose of fiscal policy, and who do not realize that the effects of fiscal policy must be carefully controlled so as to help rather than harm the economy.

Deficit spending during the current recession, for example, may be to a certain extent unavoidable, since the decline in business activity automatically reduces tax revenues, without reducing the necessity for many of the Government expenditures. However, the deficit must be vigorously limited in order to minimize the resulting inflation. The acceleration of spending on certain defense and public works projects temporarily contributes a corrective effect, and avoids the necessity of spending the same money during the recovery period when it would have more dangerous inflationary effects. Where the timing of Government expenditures is subject to flexible adjustment, it is obviously better for the Government to spend money when the civilian demand is at its lowest and avoid spending it when civilian demand is relatively high, but public servants will not be enabled to do the latter until public understanding has improved.

New spending projects specifically designed as antirecession measures must be most carefully scrutinized. Wasteful and unnecessary spending is no more helpful to the economy in bad times than in good times. Plans for spending money later will not help the economy now; on the contrary, current Government planning should be directed toward preparing to limit the growth of expenditures as soon as the economy turns upward.

Proposals for cutting taxes as an antirecession measure must also be resisted. A so-called tax cut without an equivalent cut in Government spending is not a tax cut at all, but merely a shift from visible tax collection to the invisible tax of inflation.

In the long run, correction of current deflationary trends is a less difficult problem than correction of the long-run inflationary trends resulting from current and recent fiscal policy. Budget surpluses sufficient to permit orderly but substantial reduction of the national debt will be an essential requisite for successful control of inflationary pressures once the current recession yields to recovery.

The level of Government spending has been for years swollen by unneeded services, unwise expedients and overgrown bureaucracy. As the economy grows, it will be better able to support the high level of expenditures which may be required, especially for defense. However, even a growing economy cannot support a continued increase on the present scale without suffering either renewed inflation or an intolerable burden of taxes, along with a dampening of the productivity of the freely competitive market.

When recovery from the current recession is well underway, the opportunity will present itself for reducing the scale of Government spending, and plans should be made now to take advantage of this opportunity. Two major areas for reduction come immediately to mind. One is contained in the recommendations of the Hoover Commission, which have already resulted in important savings. Further steps remain to be taken along the lines of returning to private enterprise those operations which it can perform more efficiently than the Government; and eliminating wasteful procurement of military supplies through a unified defense procurement administration.

The second area of Government spending offering even greater room for improvement is the farm price-support program. Certainly everybody wants the farmer to be treated with equity and every human consideration. But a country as resourceful as this should certainly be able to devise a vast improvement over the means currently used. The present farm program keeps millions of farmers doing unneeded work, creates huge and internationally embarrassing surpluses, raises the price of food and clothing to needlessly uneconomic heights, and inflates the cost of living index which triggers the escalation clauses of wage contracts. Thus it raises the prices paid by everybody, including farmers, and causes large Government deficits which add to the inflationary pressures.

Another aspect of fiscal policy which deserves immediate attention is the present structure of personal and corporate income taxes. High corporate income taxes are inflationary in themselves since they represent a cost to business which tends to be reflected in pyramiding price increases. Inadequate depreciation allowances for tax purposes deprive business of the funds needed for investment in the improvement and expansion of productive facilities and the formation of new productive enterprises. High and steeply progressive personal income taxes deprive individuals of both the incentive and the funds for risk-type investments in the Nation's economic growth.

The effect of the tax structure is to reduce the volume of savings and capital formation on the part of business and individuals. In prosperous times the demand for savings is subject to the same upward pressures as the demands for goods and services; and if the supply is inadequate, the shortage is made up by the expansion of credit, and thus the furthering of inflation.

Long-range reforms of the tax structure require a great deal of study, and it cannot be said that the perfect solution has yet been found. However, the approach represented by the Sadlak-Herlong bill, which would gradually scale down the most damaging progressive rates of both personal and corporate income taxes, and at the same time impose a control on Government spending, offers an appropriate starting point for such a study. The present discriminatory system of excise taxes also deserves study, with a view to broadening the base, establishing greater uniformity of rates, and making the specific amount of the tax paid on each purchase more plainly visible to the buyer.

Another long-range reform for which planning could well begin at this time is the transfer of as many Government services as possible from the Federal to the State and local levels. The construction of schools, highways, and public buildings by the Federal Government not only removes the spending authority from the control of the taxpayers in the locality in which the money is spent, but it adds to the inflationary potential of the public debt. Deficit spending by the Federal Government is too largely financed by short-term securities through the credit expansion facilities of the commercial banks and thus creates inflationary pressures. State and local governments, however, resort to long-term financing that must meet more critical tests of the financial markets.

MONETARY POLICY

During the current recession, the stimulus to credit expansion provided by financing the deficit through commercial banks may have the somewhat useful effect of counteracting the temporary deflationary pressures which complicate the problem of recovery. When the recovery is well underway, however, the proportion of bank financing should be reduced in order to combat the inflationary pressures which will then reassert themselves.

Progress in reduction of the national debt, already suggested as an objective of fiscal policy during the coming period, would contribute toward this end. In addition, inflationary pressures could be lessened by refinancing part of the outstanding national debt now held by commercial banks and replacing it with long-term securities, sold to nonbanking investors. While this procedure may increase the cost of servicing the national debt by committing the Government to relatively high interest rates over an extended period, the cost would be much less than the inflationary increase in all the costs of Government that accompanied the failure to follow this policy during the years 1955–57.

The credit controls operated by the Federal Reserve System, through open market operations and the adjustment of rediscount rates and reserve requirements, have worked more satisfactorily since the Reserve discontinued the policy of pegging the market price of Government securities in 1951. Prior to that time, the willingness of the Reserve to buy such securities at a fixed scale of prices largely surrendered control over back reserves into the hands of holders of Treasury obligations.

Since the accord with the Treasury, the credit policy of the Reserve has been administered with as much success as can reasonably be expected. The complexity of forces operating on the volume and velocity of credit circulation are such that the timing and effectiveness of Reserve actions cannot always be perfect. However, on balance it would appear that the problem would be made more difficult rather than easier if the scope of Government credit controls were enlarged.

It is particularly important to avoid any attempt at direct control over consumer credit, which has proved itself sufficiently responsive to indirect control through the commercial banking system. To interfere directly with the terms on which consumers make these purchases would be to upset the operation of the free economy in much the same way as price and rationing controls did during the war.

CREEPING INFLATION WOULD MEAN RUNAWAY RUIN

From these considerations it is clear that the Government would contribute more effectively to the growth of the economy, and to reducing the frequency and severity of economic recessions, if its fiscal and credit policies were directed toward more vigorous support of economic stability and less encouragement to inflation.

Too much credence has been placed by the Nation's policymakers in the mistaken concept that a gradual inflationary trend, sometimes known as creeping inflation, should be accepted as necessary and desirable in order to achieve and maintain full employment goals. Nothing could be further from the truth.

If creeping inflation were accepted as a permanent feature of American economic life, it would not create jobs; it would only feed on itself in a rising spiral of costs and prices. To accept creeping inflation instead of using every possible means to combat it would be to apply to our economy the greatest of all inflationary pressures—the pressure of inflation psychology. Expecting continued prices increases, businesses and individuals would have a continuing incentive to spend their money before its value depreciated further, and would thus be tempted into a flight from money. The inadequate volume of purchasing characteristic of the current recession would be replaced by an increasingly excessive rate of spending, with far more destructive effects. The volume of savings would continually diminish, cutting off the only real source of investment funds. The efforts of businesses to continue expanding the volume of production and improving the attractiveness of their products, so as to maintain high levels of employment, would require continued expansion of money and credit. Thus the inflationary spiral and the profitless prosperity would be accelerated toward inevitable collapse.

The effects of supplying such a flight-from-money temptation would thus be not to promote greater employment but greater inflation, and creeping inflation would rapidly become runaway inflation. This is the true nature of the danger now facing the Nation.

It is true that high and rising levels of employment may, if national policy permits, be accompanied by inflation. Such inflation should not be mistaken for a cause of full employment, but should be recognized as an effect of misguided policy. As such it must be combated by public support of appropriate measures to curb the monopoly power of labor, cut down unnecessary spending, and reform the tax structure, in order to permit the continued economic progress which the people of the United States justly demand.

GENERAL MOTORS CORP.,
Detroit, Mich., March 24, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States, Senate, Washington, D. C.

MY DEAR SENATOR BYRD: In this letter I shall endeavor to give you my thinking with respect to the vital matters affecting our economy detailed in the questionnaire accompanying your letter of February 17, 1958. Noting the long list of persons to whom you have addressed similar letters, many of them experts in various fields, I have concluded that I could be most helpful to you if my observations were confined to subjects which I can discuss on the basis of my own knowledge, observation, and experience. I have adopted your suggestion that the questionnaire be used merely as a guide and have arranged my material to give it some degree of cohesion and continuity. The only questions I have not answered directly are those relating to the monetary and fiscal policies of the Federal Government.

I. UNITED STATES ECONOMIC GOALS

Most people agree, I believe, that a country should have certain goals or objectives toward which it should strive. These long-term goals provide the basic criteria by which to evaluate short-term problems and judge proposals for their solution. Most of us also would agree that the economic objectives mentioned in your questionnaire—(1) price stability; (2) stability of production, demand and employment, and (3) economic growth in production, demand, and employment—are among the most significant goals of a free economy.

Perhaps I should explain my interpretation of the word "stability." I would define "price stability" as the maintenance of a level trend of the price averages. On the other hand, I do not envision "stability of production, demand, and employment" as a leveling of these factors. Stability in this context means the avoidance of serious interruption to a rising trend—in other words, steadiness.

Ideally, no priorities should be established in seeking these three goals. We should strive to achieve a high rate of economic growth with a minimum of cyclical instability in production and employment and with a stable price level.

We must recognize, however, that all three goals are interrelated and can be in conflict at any given time. Our experience in this country, as well as that of the free nations of Western Europe, has been that if one or perhaps two of these goals are achieved for a period of time, it is at the expense of the others or other. A period of rapid economic growth is likely to be accompanied by increasing prices and be followed by a period of recession. On the other hand, a period in which prices are stable is not usually a period of growth. If too much emphasis is placed on eliminating fluctuations in production, demand

and employment, growth probably would be inhibited and prices would rise.

Opinions may differ as to the priorities that should be attached to these objectives of national economic policy. This in turn affects the evaluation of current trends and the approach to current economic problems. In the United States we have tended to give priority to economic growth. Historically, we have been successful in achieving a high rate of growth and a rising standard of living, but at some cost in terms of stability.

In my opinion, this has resulted in the greatest good for society. Ranking all three of our objectives of economic policy, I would place them in the following order of priority:

1. Economic growth in production, demand, and employment.
2. Stability of production, demand, and employment.
3. Price stability.

ECONOMIC GROWTH

There are many reasons for assigning first priority to economic growth. Both our population and our labor force are increasing. We can look forward with assurance to a continuation of these trends. If we were to do no more than provide the present standard of living for future generations, total annual output would have to increase.

Americans, however, have never been satisfied with such a limited goal. The desire for a higher standard of living broadly diffused through all parts of our society has been a driving force in our economy. Accordingly, if we are to meet national needs, the first essential is an economic framework which encourages economic growth and stimulates and rewards the investment on which our growth so directly depends.

While I believe that improving the standard of living of all our citizens is a sufficient reason for attaching first priority to economic growth, there are also other important reasons. As a nation, we are allocating a substantial portion of our effort to military defense. If, as now seems likely, our defense budgets are increased, the maintenance of a substantial rate of economic growth is even more urgently required.

Economic growth is necessary to provide investment opportunities for savings. Growth is also necessary to insure the most efficient use of our labor force under conditions of rapid technological advance.

STABILITY OF PRODUCTION, DEMAND, AND EMPLOYMENT

The maintenance of stable employment and production at high levels was established as national policy in the Employment Act of 1946, with responsibility assigned to the President to recommend action to the Congress to insure that this policy is made effective.

A problem arises, however.

Let us agree that prolonged periods of depression make it impossible to achieve a high rate of economic growth. On the other hand, some sectors of the economy are bound to move ahead faster than others, and the very processes of growth have periodically resulted in temporary imbalances as between inventories and sales or capacity and consumer demand. Typically, recessions in the United States have been of short duration and have served as periods for making essential readjustments in inventories and in the allocations of labor and capital.

The problem is one of providing the economy with the opportunity to make these essential readjustments as a basis for further growth, at the same time taking steps to assure that the decline in economic activity does not gain momentum and thus retard growth. To those who might suggest that the problem rather is to make such readjustments unnecessary, I would say that a solution to the problem so stated would of itself inhibit growth.

There is, however, in this area a proper role for Government to play. At a later point I would like to suggest Government action appropriate to the current recession.

PRICE STABILITY

The problem of maintaining a high rate of economic growth with full employment and also of maintaining price stability is extremely complex. The period since the close of World War II well illustrates this.

The period has been, first of all, a period of rapid growth to meet the more pressing deferred needs of the Nation. Our industrial base has been significantly broadened, and the level of living of our population has been increased. Much more remains to be done, but this in no way detracts from the outstanding accomplishments of American industry during the past 10 years.

The decline in the purchasing power of the dollar has been the second significant postwar trend. There is general agreement, I believe, that, in the postwar period through the Korean war, the price inflation was primarily the result of an intense demand for goods of all sorts, coupled with an increased supply of money arising out of our war financing. In the past 2 or 3 years we find no grounds for attributing the inflation to these factors.

I believe the principal inflationary factor in this period has been the leverage that powerful labor unions have been able to exert on wage rates and particularly on fringe benefit costs as a result of labor shortages caused by high-level employment. The increase in labor costs has been much greater than the increase in national productivity. Union power, unrestrained by the antitrust laws, is now greater than ever before.

This growth of power is not a new trend. What is new is the full realization of the economic effects of legislation enacted some 20 years ago.

There are few who would argue that inflation in any significant degree is desirable. Whether a full-employment policy necessarily implies price inflation depends in part on the degree of union power which our society is willing to tolerate. There is also the question of what we mean by full employment.

If it is our national policy to "shore up" every local area of unemployment and to strive for such a high level of employment as to create chronic labor shortages which unions can exploit, trends of the past 3 years suggest the direction in which we shall continue to move. A certain amount of flexibility of both labor and capital is essential to the efficient allocation of resources in a free economy. A full employment policy that creates chronic labor shortages forces wages to rise faster than productivity and interferes with the efficient adjustment of our productive resources to the changing needs of our economy.

Our objective should be to set our full employment goal and our Government policies so as to facilitate, not interfere with, these socially desirable shifts. If we do this and if we take action to establish a balance of power between unions and management, I believe there is a reasonable chance that long-term stability of price levels may be achieved.

II. Current Economic Trends

The present recession developed out of a major capital goods expansion which followed a period of very active demand for new housing, automobiles and other consumer durable goods. The expansion had resulted from a combination of three factors: shortage of capacity, optimism over the prospects for economic growth, and the development of many new products and processes. Capital programs were accelerated by rising prices and the rising cost of financing.

The expansion came to an end as a result of the increased tightness of money and the completion of many projects. While the level of new capital investment remained high during most of 1957, the peak in new commitments had been reached early in the year. A factor that contributed to the downturn in business activity was the wage-cost push which began to squeeze profits. Still other contributing factors were: a sharp reduction in defense orders; a decline in demand for United States exports following a sharp rise in 1956 and early 1957 aggravated by the Suez crisis, and the start of an inventory readjustment as it became evident that there were no longer any shortages of raw materials.

As a result of these changes in the underlying trend of business, employment was reduced in some areas, and confidence was weakened. Consumer spending, especially for durable goods such as automobiles, was affected, and the pressure to reduce inventories increased. During the fourth quarter of 1957, the loss of confidence become contagious, and inventory reduction became a widespread policy. Finally, as the recession in industry gained momentum, the secondary effects of reduced employment and lower incomes began to be felt in a further curtailment of business and consumer spending. Many people adopted a "wait and see" attitude, and the drop in both business and consumer spending in many areas became greater than warranted by the loss of purchasing power.

Business recessions begin because of maladjustments or lack of balance in the various parts of the economy. It is characteristic of most recessions that they correct themselves. We must work against developments which destroy confidence and thereby needlessly prolong the period of correction. This period usually continues until balance is restored, but frequently there is an overcorrection.

A good example is inventory reduction carried to the point where inventories are too small to meet even the reduced demand existing during a recession. This almost guarantees the ending of the recession and the beginning of recovery, but it is likely to involve unnecessary unemployment.

Business and consumers, acting by themselves, are unlikely to resume spending in a recession until they have reduced their debts and have to buy to replenish depleted or wornout stocks or until their confidence in the future is restored. In a severe recession, their ability to buy is steadily reduced. At some point, therefore, it is necessary for the Government to take steps to restore confidence.

The present recession, as I have pointed out, has now reached a stage where some of the unnecessary secondary effects are beginning to be felt, even though the great majority of consumers are still working and earning and spending. The problem is to stop further overcorrection without preventing the adjustments which are necessary for resumption of sustained high-level production and growth.

Some reduction of inventories was admittedly required to correct an unbalanced position. In many industries capital investment cannot be resumed on a large scale until the market grows up to present capacity. This takes time. Meanwhile, however, there are other areas of the economy—particularly in the services and in new products—where there are still shortages of labor and capital.

The role of the Government, it seems to me, is to take steps to restore confidence and insure the maintenance of purchasing power while these necessary and desirable shifts and adjustments are taking place. It can do this, first, by appropriate monetary action, second, by accelerating authorized Government expenditure programs and, third, by lowering taxes.

The first steps have already been taken. The monetary policy of the Federal Reserve has been reversed to make money available for borrowing at lower rates. Various measures have been adopted or recommended to step up Government spending programs previously authorized.

The simplest and most effective move, in my opinion, would be to cut taxes across the board until the recession ends and the curve of business activity has clearly turned upward. Not only would tax reduction have the double advantage of speed and of providing more purchasing power without any immediate effect on costs or prices, but it would also have the tremendous psychological effect which is so necessary to restore confidence. Such a move would necessarily and properly require a further temporary increase in the debt limit.

By increasing purchasing power, Government action along the lines recommended above should not only generate renewed confidence but also provide an economic climate conducive to the free movement of labor and capital.

Finally, it is essential that nothing be done to discourage business investment in new products and processes, because it is in this area that the seeds for future growth are sown. Business has a responsibility to do everything it can to stimulate demand by bringing out attractive new products, by giving the consumer greater values and by aggregessive selling.

THE INFLATION-UNEMPLOYMENT PARADOX

A widely noted aspect of the current recession is the fact that the cost of living has continued to rise. I believe that the explanation of this seeming paradox that at times inflation and unemployment exist side by side in our economy lies in the critical factor of timing. Industries in our economy do not experience increases and decreases in demand at the same instant; nor do various elements in the economy all change at once. There are varying time lags in the process of adjusting to a new set of economic conditions, some of them covering quite a long period.

The term "rolling readjustment" has been used to describe earlier recessions since World War II in which production in some industries was expanding and in others was declining. The current readjustment is being felt primarily in the industrial sector of our economy—in manufacturing and mining. Within this sector, producers of capital equipment and consumer durable goods have been particularly hard hit. At the same time, consumer expenditures for nondurable goods and services appear to have been well maintained. In the wholesale price index, there has been no increase, on the average, in industrial prices since the end of 1956, while farm products and foods have risen substantially. In the consumer price index, the price of services (which has no wholesale equivalent) has been rising steadily throughout the last 18 months. This is essentially the result of higher labor costs.

ESCALATOR CLAUSES AND PRICE STABILITY

General Motors, as you know, has had long-term agreements with unions representing its employes since 1948. These agreements include a wage formula consisting of a cost-of-living allowance to adjust the buying power of an hour's work in line with changes up or down in consumer prices and an annual improvement factor wage increase to improve the buying power of an hour's work in line with the average increase in the productivity of the country as a whole over the long term.

It is my belief that these so-called escalator clauses are neither inflationary nor deflationary. To the extent that the cost-of-living allowance is increased, this is a result of inflation not a cause. Wage increases granted by General Motors under the annual improvement factor serve to keep our employes abreast of the long-term increase in our country's standard of living.

There is another point I would like to make in connection with the improvement factor. Insofar as productivity does increase, it is achieved by technological progress, better tools, methods, processes and equipment and a cooperative attitude on the part of all parties in such progress. It is proper therefore that increased productivity be shared by our employes, our shareholders and our customers.

Quite aside from their monetary aspects we believe that our long-term contracts have been beneficial in many ways. They have freed our employes from the threat of strikes for the full term of these longer contracts; they have assured our plants of a dependable work force and our customers of a continuous flow of products. In dealing with large unions, it has been our view that this arrangement is better than to have short-term contracts which, lacking escalator clauses, keep the workers, the management and our customers in a state of uncertainty and unrest. It is doubtful that wage rates would have increased any less had we followed this latter practice. Thus, it is our conviction that our employees, our shareholders, and our customers have all benefited from these long-term contracts.

THE EFFECT OF PRIVATE DEBT ON STABILITY

There is nothing inherently wrong about debt if it is incurred wisely. In some instances it results in an improvement in a borrower's standard of living beyond the limits of his own present income. Debt is also a necessary accompaniment of investment. If the borrower is able to use the borrowed funds productively, increasing indebtedness merely represents the shunting of resources not currently needed for consumption into the production of business and individual capital equipment.

Ordinarily, growth in the total debt, public or private, should be closely geared to the volume of accumulating savings. In addition, the quality of the debt is highly important—such things as the soundness of a borrower's affairs, the purpose for which he has borrowed and the terms of the debt contract. Still another factor to be considered is the impact of changing business conditions.

There are those who contend that the growth of private debt has become a threat to the stability and vitality of the economy. I do not believe that this is so. If we include corporate and other business debt and residential mortgage debt as well as consumer credit, the increase in total private debt in the last 2 or 3 years has been little if any faster than the growth in national income. Furthermore, the ratio of private debt to national income at the end of 1957 was not as high as in 1940 or during the 1920's. A substantial part of the debt increase has been associated with the purchase of homes and with the increased sales of consumer durable goods, particularly automobiles. In neither instance does the assumption of debt involve entirely new obligations since for some buyers there is a substitution of mortgage payments for rent and of car installments for public transportation costs.

Looking specifically at installment credit, the burden of repayment still appears to be well within the capacity of the average American family. By and large, sellers and purchasers have exercised good judgment and have succeeded in maintaining installment credit on a sound basis. The concern expressed by some a year or two ago was not justified.

Growth in debt does tend at times to amplify fluctuations in business because debt does not always grow at a constant rate. Sometimes the variations in debt and in income complement each other, but sometimes they do not. Even so, borrowing and lending are still necessary conduits through which the largest part of the country's savings finds productive employment.

THE EFFECT OF GOVERNMENT SPENDING AND TAXATION ON THE ECONOMY

There is no question but that spending by Government and the taxation necessary to support such spending are increasingly important factors affecting economic trends. While this is true of spending and taxation by all levels of government, I propose to limit my comments to the Federal Government.

The persistent expansion of the area and magnitude of Federal spending for nondefense purposes requires, even under present conditions, constant scrutiny by Congress of the individual items of the budget. The desirability of each item should be judged by its contribution to the national welfare in relation to its cost in taxes. It is still true that Federal spending should not take the place of private spending or of State and local government spending.

Acceleration of expenditures for essential Government projects is, as I have indicated, desirable at this time. However, it is still necessary to spend wisely. Each new proposal should be considered on its own merits.

Turning to the matter of taxation, we all recognize that our present tax structure is the product of topsylike growth. Federal individual and corporate income taxes and Federal excise taxes have been subject to successive rounds of modifications and rate increases to meet emergency conditions. The result is a structure which often distributes the cost of Government among individuals and corporations on a haphazard basis. More importantly, it severely limits the incentive to take risks which it is essential to take if our economy is to continue to grow.

Steps have been taken over the past 5 years to reduce some of the inequities in the Federal Government's tax structure. Permitting a more realistic depreciation of capital equipment for tax purposes is a case in point. The first steps have also been taken toward removing the inequitable double taxation of dividend income.

Beyond this, there is need for a thorough review of the entire structure of Federal taxes. However, the fact that such a need exists should not, in my opinion, divert our attention from the present urgent necessity of an across-the-board reduction in tax rates.

The above represents my best thinking on the topics you asked me to discuss. I trust it will prove helpful.

May I wish you all success in your study. It is the hope of all of us, I am sure, that out of it will come recommendations which will help substantially to maintain a strong and sound economy that will undergird our continued progress as a free nation.

Yours sincerely,

H. H. CURTICE.

METROPOLITAN LIFE INSURANCE CO.,
New York, N. Y., May 5, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: As requested, I enclose my reply to the questionnaire sent with your letter of February 17.

I trust there is no objection to my setting forth in this covering letter a few general thoughts on the problems raised, in the light of which are framed the answers to your committee's questions.

During the 18 years preceding the summer of 1957, we experienced an extraordinary period of expansion. Most of this period could be characterized as a boom. This boom was brought about by a combination of factors dating back to the earlier depression period of the 1930's. The pent-up demand which accumulated during that early period was substantially augmented during the war years that followed.

During and subsequent to the war, we made greater technological advances than in any previous period in our history.

This period was also one of substantial inflation. Historically, wars have always brought about inflation; as illustrative, I attach a chart on prices originally prepared by the United States Department of Labor and brought up to date by subsequent figures from the same source.

Underneath these extraordinary forces was the continuous, natural, long-term growth of our economy.

During this period, in general, demand exceeded supply both of material and labor. It was only natural that labor would attempt to make as many gains as possible. The increase in real wages amply demonstrates its success. It was natural also that increased costs, including labor costs, would be passed along to the consumer, in the form of increased prices, just as long as he was willing to pay them.

The current recession is the natural readjustment from such an extended boom. It is fortunate the boom was not pushed further as, in such a case, the drop would have been greater and the period of adjustment longer.

The question is, What can be done to bring demand back to meet the supply on a sound basis without starting another round of inflation?

One may be sure that, in a profit-motive economy, all segments of business, faced with the present situation, are attempting to put their own houses in order. However, the committee's questions seem to point more to what actions Government can and should attempt.

In considering this, it seems to me that it would be helpful to have clearly in mind the relative parts that each contributes to the whole. The United States Government is playing a larger role in the economy today than even before, except in time of war. The Federal Government's expenditures in 1957 amounted to almost $80 billion, and yet this is only 19 percent of the gross national product of 434 billions. Nevertheless, Government operations are so great and have such a psychological impact that what Government does is of tremendous importance.

However, it would seem that the real key to improving the situation rests in the actions of those responsible for the remaining 81 percent of the gross national product. This line of reasoning is not intended by any means to say that Government has no role to play. It can and does play an extremely important role in ironing out the peaks and valleys. The dangers lie, however, in the fact that in a natural desire to do something to assist in the situation, Government can take action inimical to business. In order to bring about immediate temporary gains, Government can unintentionally prolong the recession; it can take actions which, in the long run, may make even more difficult our essential objective of overcoming future inflationary tendencies.

The worst depression our country has ever had was the one from 1930 to 1939. During that period, we ran a Government deficit in every fiscal year but one, totaling nearly $24 billion. Our total unemployment ranged from 9 percent to 25 percent of the labor force, and in 1938 and 1939, the end of the period, it was still running at 19 percent and 17 percent respectively. Today it is said to be 7.7 percent. In the circumstances, I am not convinced that deficit financing is the way to bring the country out of a recession.

Of course, no one wishes to see people without jobs if they are willing and able to work. In today's society we must see to it that at least a reasonable minimum standard of living is provided by American business, or, if necessary, through Government aid, to take care of those who are out of work and unable to take care of themselves. But the worst thing that could happen to this country would be a continuation of the inflation we have been experiencing since World War II. It would be far, far worse than a few months of modest recession and the limited, temporary unemployment that is currently taking place. History has amply demonstrated that in periods of drastic inflation everyone, with the possible exception of a few international speculators, suffers tremendously, but those who suffer the most are the working people.

In combating the present recession, I believe the Government can play its greatest role in encouraging a sound monetary policy and, if necessary, assisting in the extension of unemployment insurance. It can also speed up the timing on those projects which naturally fall within the governmental sphere and which must be done sooner or later anyway. It can also cut unessential Government spending and conduct its operations as efficiently as possible, thus keeping its finances on as sound a basis as possible.

Our country is basically sound today. There is a very substantial backlog of savings. Generally speaking, individuals are not too overextended with debt. The way out would seem to be harder and more efficient work by all of us, which plays its role in lowering costs. In general, capital automatically takes a lower return in recession periods. Lower prices are an incentive to increased purchases. These natural results should not be interfered with. They are a great help in correcting situations such as the present. Steps which lead to rigidity of costs are undesirable. We might also remember that some of our most prosperous periods have been accompanied by gradually falling prices.

In conclusion, I would stress the importance of viewing the situation in balanced perspective. The bulk of the unemployment is concentrated in the durable goods industries, such as steel and automobiles, which is the usual pattern in periods of recession. While we all have a natural and proper desire to lessen the difficulties of the unemployed, can this not best be accomplished by concentrated efforts rather than by broad scale expenditures of Government funds with all the subsequent difficulties entailed? After all, we do have, by latest figures, approximately 63 million, or 92 percent, of the labor force at work.

Sincerely yours,

F. W. ECKER, *President.*

REPLY BY FREDERIC W. ECKER, PRESIDENT, METROPOLITAN LIFE INSURANCE CO., TO QUESTIONNAIRE OF SENATE FINANCE COMMITTEE

1. Give a definition in your own words of deflation and inflation.

Inflation is that type of unbalanced economic situation which is eventually reflected in a major decline in the value of money. Deflation is the reverse.

2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

If we can avoid inflation, we shall have taken a long step toward avoiding not only deflation but recession and depression as well. Economic collapse inevitably follows inflation eventually. As a consequence, we should be constantly aware of the dangers of inflation and attempt to avoid or to slow down in boom periods those activities which are of an inflationary nature.

In periods of recession, such as the present, there are particular dangers in attempting to correct too quickly a temporary decline by taking hasty and improvised steps which, in the long run, lead to much greater and more serious troubles and sow the seeds for future inflation, creeping or otherwise. The Honorable William McC. Martin expressed the desirability of avoiding creeping inflation far better than I could when, in discussing this subject before your committee on August 13, 1957, he said:

"No greater tragedy, short of war, could befall the free world than to have our country surrender to the easy delusion that a little inflation, year after year, is either inevitable or tolerable.

"For that way lies ultimate economic chaos and incalculable human suffering that would undermine faith in the institutions of freemen."

If a certain level of prices can only be maintained by added doses of inflation, it is far better to let those prices fall and reach their natural level than to continue the antidote.

With regard to the legislative portion of the question:

(*a*) It would seem desirable to write explicitly into the Employment Act of 1946 what is said to be there implicitly, viz., that the administering Government agencies have a responsibility not only to attempt to maintain high employment but also to avoid inflation.

(*b*) Another policy of utmost importance is to keep the Federal Reserve System from again becoming subservient to Treasury dictation. Of course, it should cooperate, but Treasury policies should not be forced upon it. The long period of pegged interest rates before World War II was a strong inflationary force until the March 1951 accord. Senator Paul Douglas, a member of this committee, gave an excellent exposition on this subject on the floor of the Senate in 1951 (Cong. Rec., Senate, Feb. 22, 1951, p. 1521).

The accord of March 1951 is working well today. I am not sure that any further legislation is required on this point in order to assure the continuance of the accord. However, a declaratory resolution amounting to a reaffirmation of Federal Reserve Board autonomy might well serve to ward off any future attempt to make the Board again subservient to the Treasury Department.

(*c*) The economics in the executive branch of the Government advocated by the several proposals of the two Hoover Commissions should be advanced.

(*d*) The enactment of the bill sponsored by Senator McClellan and 70 other Senators, providing for a joint committee on the budget with its own staff, would seem most appropriate. Although passed by the Senate last year, it awaits House action.

(*e*) The President should have the power of item veto in appropriation bills. This power is available to the governors of some 40 States. With government taxation as heavy as it is these days, surely the closest control is warranted.

(*f*) Consolidation of appropriation bills and other suggestions for tightening up the appropriation and expenditure processes would seem to have much merit also.

(*g*) Some provision for reduction of the national debt should be included in all Federal budgets. In recent years of high prosperity, there has been a conspicuous failure to reduce the national debt. It is recognized, of course, that in certain periods of recession, this may not be possible. Obviously, there are times when the Government might have to operate with a deficit, but certainly in good times we should reduce the debt by some amount, even if it is only 1 percent per year.

(*h*) It is not wise to avoid debt limitation by excluding capital expenditures from the budget (such as for post offices, etc.). We shall have to pay out more in taxes in the long run by leasing such properties than by including the capital expenditures in the budget.

(*i*) It is suggested that unwarranted increases in social security benefits add to inflationary forces. In this and other connections, attention is invited to the statement of February 1958 of the life-insurance business on this subject entitled "Sound Policy for Social Security." (Retained in committee files.)

3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942 to 1957. (You may wish to divide the period into two parts, 1942–50 prior to the accord, and 1951–57.)

For a number of years before the accord of March 1951, monetary policy was directed primarily toward pegging the market interest rates on Government securities at low levels. The effects of that policy carried through the entire financial structure—private as well as governmental.

Whatever may have been the need for such rigid support of Treasury securities throughout World War II, and the question is moot, maintenance of an inflexible interest-rate policy thereafter was harmful because of its inflationary effect.

The pegging of interest rates at low levels virtually sidetracked other objectives of monetary policy. It resulted in tremendous acquisition of Treasury securities by the Federal Reserve. An overall effect was to provide huge additions to reserves of commercial banks, thus inducing them to expand credit to their customers readily—even though certain credit-restraining actions were taken at times.

The inflationary influences of that policy, together with the inflationary results from heavy Government deficit financing through banks before and during the war, have been prevalent through the economic system for a long time afterward and probably have played a part in bringing about the postwar inflation from which our country has been suffering. In fact, their potentialities probably have not been entirely dissipated even yet. Actually, the low costs of Treasury financing proved to be high costs to the Government and to the economy as a whole, in the light of the ensuing inflation.

The freeing of interest rates permitted by the accord in 1951 contributed in an important way to greater economic stability. Since that date, monetary policy has been appropriately operative. While occasionally one might have some differences of opinion on timing, the overall objectives and operations have, I believe, been splendid and have met with considerable success.

While monetary policy by itself cannot be expected to do the whole job of keeping our economy in balance, it can help considerably in creating a healthy climate for economic life.

4. Beginning in August 1956 there was an increase in the consumer price index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

Inflationary trends had been so solidly set in this country that the indications of a slowing up in business have not yet had very much effect on the consumer price index. These trends, which have continued into 1958, are due to such factors as these:

(1) It took longer than expected in our free and expanding economy to fill the demands brought about by war shortages—so much longer that many, in appraising the demand, assumed without warrant that it was due to the natural expanding economy rather than to the fulfilling of pent-up, wartime demands. It also took a longer time than expected for portions of the economy to be infected with the inflated prices already evident elsewhere.

(2) Inflation which had been forced into our economy during the depression and war years was still exerting an effect and continued to contribute to the fall in the value of the dollar.

(3) War controls on rent had been removed very slowly so that their adjustment to the rest of the economy was still playing an important part in the upward trend of the consumer price index.

(4) Price supports in the farm area, drought in certain cattle-producing areas, and freezes in the citrus-growing areas all played a part in the continued uptrend of prices.

(5) Personal incomes continued to rise even after output started to ease off more than a year ago. Built-in wage escalation in certain union contracts contributed in part to this rise in income.

(6) The fact that increased costs could be reflected in increased prices, and goods still sold, undoubtedly played a part in adding the increased cost to the sales price as long as it could be passed along to the consumer. The final test, of course, is the consumer's willingness to pay.

(7) Some economists had written profusely on the inevitability of continued inflation and too many businessmen believed them and made their plans and took concrete steps accordingly. When trends continue in one direction for a substantial period of time, it is human nature to feel that the trend will continue indefinitely.

(8) Increases in wages have not been offset by corresponding increases in productivity.

(9) Until 1956, the retail prices of some goods had been declining for a few years. This was partly attributable to productivity gains. This helped to offest the rising changes for services and thus the Consumer Price Index was kept fairly stable between 1952 and 1956. However, by 1956, the rise in wage costs had begun to exceed productivity gains. This, plus the tremendous demands of 1956 and the boom psychology, forced the retain prices of goods upward. This upturn, on top of the rising charges for services, forced the Consumer Price Index to new highs.

5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

Through the types of securities offered, and the terms and timing of the offerings, debt management can have a great variety of effects. It can starve or deluge certain parts of the investment market; it can diversely affect commercial bank reserves, the money supply, the liquidity positions of individuals, and businesses, the interest rate structure, saving, etc.

One important aspect is the interference that debt management gives, at times, to free operation of Federal Reserve policy, even though Government securities are no longer so fully supported as before the accord of March 1951. It is well recognized that Federal Reserve policy actions are limited in some degree when consideration must be given to impact on Treasury debt operations.

Frequent refunding operations also often disturb and interfere with corporate and State and local government security financing. Better spacing, with a larger part of the debt in longer maturities, will help relieve that situation.

One other disadvantage in having so large a portion of debt in short-term (bank medium) type securities is that our economy is subject to rapid changes in interest rates, and in periods of tight money the service charges can rise very rapidly when so large a portion of the debt is involved.

It is the announced intention of Treasury Secretary Anderson to continue to work toward the goal of having a larger portion of our debt in longer term maturities.

Refunding also can shift ownership of Treasury securities among Federal Reserve banks, commercial banks, and other—with great differences in effects.

Without attempting to describe the mechanics by which these effects occur, I would emphasize the importance and variation thereof.

Nevertheless, debt management policy should not be a primary tool of monetary policy The main objective of debt management should be to improve the fiscal position of the Government. If, meanwhile, it can aid Federal Reserve policy without neglecting its fiscal policy objective, so much the better.

6. (*a*) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand and employment.
3. Economic growth in production, demand, and employment.

(*b*) With respect to these 3 objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—especially during 1957.

(*a*) Our desire is for an economic growth as constant as possible, supported by demand, which will provide the maximum practicable employment. However, this can be best be achieved with price stability and without inflation. Even then, in a free economy, we are bound to have periods when demand exceeds supply and vice versa. Price fluctuation is one of the means by which balance in these areas is restored.

If we rely on inflation to provide a continuous increase in demand and constant full employment, we are not only doing a great disservice to large segments of our population now (the aged, those on fixed incomes, and those dependent upon them, of whom there are many more than in the ranks of the temporarily unemployed), but our economy will ultimately be thrown out of balance to such an extent that a disastrous relapse will eventually occur.

(*b*) Since World War II, and especially during the 2 or 3 years culminating in 1957, our growth has exceeded the rate sustainable for a protracted period. What has been interpreted as "growth" is really, to a considerable degree, a strong cyclical boom which inevitably brings an aftermath of recession such as we are now experiencing. Sound economic growth is bound to reappear. However, price stability will be sacrificed in the future if we do not at least tolerate, and even encourage, some price decline now. Short-run flexibility in prices is essential to the maintenance of reasonable price stability and stability of employment in the long run.

7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

Of course, there are areas of expenditures which can only be at the Federal level—defense, etc. However, to the extent possible, I believe Government spending should be at the State and local levels since, being closer to the grassroots, it provides for better control by those who pay the bill. I recognize, of course, the need for pacesetting, and that the ability to pay is different in some sections of our country than in others. Nevertheless, these arguments can and at times have been overdone. Federal Government spending is now at too high a level for the long-run stability of our economy.

High taxation is inimical to the development of free enterprise, which has built this country. It deprives the individual of just rewards for his labor and thus inhibits initiative and in time reduces all to a level of mediocrity. Because of the advantages available to those who evade taxes, it also, unfortunately, gnaws away at morals. It is a common attribute of human nature to say: "Well, if he can get away with it, why shouldn't I?"

It is recognized that, under present circumstances, support of government through heavy taxation is essential. However, since the burden is such a heavy one, there is all the more reason that every item should be scrutinized with the objective of cutting out every unessential expenditure program, and essential should have a pretty restrictive meaning.

High government spending results in high taxes and too frequently in the growth of government debt. It encourages inflation. We cannot neglect spending if it is genuinely essential for national survival. However, rather than directed by government, manpower and capacity may well be better utilized in producing the goods and services which people can freely afford to buy.

As soon as possible our entire Federal tax system should be reviewed. Much has been incorporated on the basis of war necessities which is detrimental to the best development of our American way of life.

8. Give you opinion of the effect on our economy of current Federal, State, and local taxation.

The real core of the tax problem is that taxes are too high in general—too high for long-run economic stability and orderly economic growth. Right at present we must endure the situation, but we should be able to look forward to the time when a reduction of taxes along with a balanced budget can be achieved.

High taxes cut into amounts that might otherwise be saved by individuals and businesses to finance a larger share of capital outlays than is the case at present. They also discourage the accumulation and investment of venture capital. Business decisions are too much influenced by tax aspects alone. High taxes foster tax evasion and tax dodging.

There is something fundamentally wrong with a tax structure that penalizes hard work, risk taking, and achievement.

9. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy, and then relate them, one to the other. Please discuss these policies stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

I agree with the testimony given by Federal Reserve Board Chairman Martin, who is far better qualified to speak on this subject than am I.

I refer to his statement before your own committee August 13, 1957, at pages 1229–1234 in part 3 of your Investigation of the Financial Condition of the United States.

It seems to me that monetary and credit policy should be relied upon principally to help regulate inflationary and deflationary pressures. The first objective of fiscal policy should be to operate Government affairs on a fiscally sound basis. It is difficult for me to conceive of emergencies where that primary objective should be subordinated in an attempt to regulate the condition of the whole economy. Such use of fiscal policy is more apt to be a palliative rather than attacking the fundamental causes of any maladjustment.

10. (*a*) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank credits.) Also please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

(*b*) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

(*a*) The monetary system of the United States appear to me to be operating well. Consequently, I have no suggestions to make with respect to it.

(*b*) I would make the following comments with regard to our fiscal system:

(1) It would seem desirable to further the studies which I understand are now being made with regard to the better apportioning of sources of revenue between the Federal, State, and local governments.

(2) At the present time approximately four-fifths of the Federal Government's revenue is derived from personal and corporate income taxes. It would seem desirable, if possible, to utilize some other form of taxation rather than to rely on the income-tax approach for so large a proportion of the whole.

(3) As mentioned elsewhere, it would be most desirable to see to it that in prosperous years our Federal debt be reduced.

11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

(*b*) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

(*a*) While there may be a paradox in the short run, in the long run, rising prices can be expected eventually to price the product out of the market. Then the reduced demand brings about unemployment. Escalator clauses and other factors, such as drought and frost, are still playing a temporary role in the current situation.

(*b*) I cannot overemphasize my belief that a gradual inflationary trend is not desirable, nor is such inflation necessary to achieve and to maintain what normally should be considered full employment.

Gradual or "creeping" inflation is bound to bring about an inflation psychology which eventually will develop into rampant inflation and ultimate collapse. Commonsense, and the lessons of history, are unanimous in leading to this opinion. Once inflation psychology gets started, Americans would be quick to grasp the idea that it may well continue. What are reasonably intelligent men to do? Most would turn their ready cash into tangible goods, with the expectation that the value of the goods would increase, and the value of cash in the bank decrease.

Another obvious step to hedge against inflation would be to borrow as much as possible in order to buy goods—again with confidence that the goods could be sold for more than they cost, and that the loans could be paid off with correspondingly less goods than were bought with the proceeds. That is the A B C of inflation, but what does it do to the economy? It is not necessary to spell that out. It is obvious that in the end the one who suffers the most is the workingman. He does not have the reserves, nor the credit to borrow, in order to buy the goods. Furthermore, under such circumstances, the Government would not be strong enough financially to come to his aid. That is the history of inflation all over the world. We cannot afford to ignore these universal lessons.

We are most fortunate, in view of the inflation we have experienced, that an inflation psychology has not as yet permeated the country. Should that ever come about, the result would be disastrous. The time to stop a forest fire is before it gets started. That is why it is so essential that, in the current minor recession, we do not kindle inflationary flames which may be impossible to extinguish in the future.

12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy.

I doubt whether the growth of private debt has become a threat to the stability and vitality of the American economy.

Corporate debt does not seem to me to be excessive.

I suspect that we may have gone too far in lowering or eliminating downpayments, in increasing the terms of Government insured or guaranteed mortgage loans on homes. Only after a longer testing period shall we really know the answer. I think it sound to take these actions in periods of depresison or recession. However, in the boom periods of prosperity, credit should be tightened up. Otherwise, we merely inflate costs. I recall very little evidence of tightening in boom periods.

While consumer debt does not seem to have gotten seriously out of hand, its expansion may well have played a part in the present recession. It is natural, under present circumstances, that each individual reappraise his own situation. In a period when some have lost their jobs and many are no longer receiving overtime pay, we all very understandably become more cautious. Those with jobs may well and properly feel that before committing themselves to further time payments, they would like to get their present obligations paid off. This would seem to be a pretty sound objective both for the individual and for the future of business as well.

13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy.

The answer to this question is so dependent on public psychology that I do not believe an answer can be given based on mathematical indices.

In the first place, with our present system of reporting, all such indices are quite late. Trends may well have changed before we receive definite figures. We just have to use our best judgment in the light of the figures we have and a feel of the situation.

While I would not rule out entirely a tax cut if the situation became bad enough (which I do not anticipate), I am less than enthusiastic regarding its advantages in the present situation. To cut taxes when expenditures are such that we would still have a balanced budget is one thing. However, with present tax rates it would appear that we are facing a budget deficit in fiscal 1959, and to increase that deficit in the hope that it would play a significant part in stopping the recession is quite problematical. The one thing we know is that it would increase the Federal debt just that much more. We must pay that debt ultimately or pass it along to our children. I do not think that things are so bad today that we should shift that burden to others.

I would certainly agree that basically taxes are too high and that they should be cut as soon as it can be done on a sound economic basis. Such a tax cut should include a reform of the basic tax structure. One such plan is set forth in the Sadlak-Herlong bills, which would gradually reduce all bracket rates over a period of time without narrowing the tax base.

I do not think that public works should be undertaken just for the sake of spending money. If they are necessary, and would be done sooner or later anyway, it would be well to undertake them now.

When people are out of work, all of us, of course, have a great desire to do something to help them. However, if possible, we ought to be certain that we do something which will largely accomplish the result intended and not something which stores up more difficulties for the future. I find it difficult to overlook the history of the 1930's.

14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to, or producing inflation?

Directly, deficit spending by the Federal Government has not been a major factor among the forces contributing to monetary expansion during the period since World War II. For the most part, deficits were not financed by expansion of commercial or Federal Reserve bank credit. They were financed largely by nonfinancial corporations and individuals.

Monetary expansion within the period was very largely the result of borrowing by individuals and business. Indirectly, Government deficits did contribute to inflationary pressures. Financing of Government deficits by individuals and businesses absorbed funds which might otherwise have gone to finance a portion of the requirements of private enterprise which were financed by commercial banks.

15. Can full employment goals be attained while maintaining a dollar that has relatively stable purchasing power?

The answer to this question is "Yes"—if "full" be defined, not literally as a perpetual 100 percent, but as reasonably perpetual and reasonably near 100 percent. However, overfull employment, which we have had, cannot be maintained together with a dollar which has stable purchasing power. Overfull employment leads to lack of individual productivity.

A certain amount of labor turnover, and other temporary "frictional" idleness—or "labor float," as it is sometimes called—is bound to be present in a free-exchange economy.

It seems to me that high employment can be attained and sustained only if we also have as a major objective the relatively stable purchasing power of the dollar.

16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

I doubt that escalator provisions are compatible with economic stability. I am strongly in favor of wage earners having opportunities to increase their income. However, it seems to me that increased income should come about because of increased responsibility or increased productivity.

Escalator clauses appear to be designed to compensate for past increases in prices or productivity, but they are also vehicles for prolonging into the future past inflationary pressures, thus perpetuating a vicious circle. There develop situations wherein demand-supply conditions call for a price reduction in a particular product. Yet a wage escalator in the industry concerned helps prevent such concessions to the consumer and the employment gain which could have resulted. The fact that such automatic raises set a pattern which nonescalated enterprises feel they must follow puts even more of the economy in a position where it not only hesitates to cut prices but may even be forced to lift prices.

17. List and briefly discuss what you consider the causes of the present recession, and what should be done to terminate it.

The causes of the present recession are the result of a natural reaction to the almost continuous inflationary boom we have been experiencing since the termination of World War II.

During the depression prior to World War II, and during the war period, there accumulated a very sizable demand for a great variety of goods. This was further augmented by a substantial increase in family formation subsequent to the war. The demand ranged all the way from housing to all kinds of consumer goods. In a free enterprise system, business should and must expand to meet the demand. Before the demand was met the Korean war engendered another war economy and extended still further the time at which supply and demand could be brought into balance. As in all such periods following wars, inflationary forces were very strong.

Under such circumstances, it was natural that strongly unionized labor should take the oportunity to increase wages—the higher levels were reflected in nonunionized areas as well. In view of the strong consumer demand then in evidence, industry did not hesitate to pass along such increased costs to the consumer by way of increased prices.

This sequence might be reversed and the claim might be made that the increase in price level caused the increased demand for higher wages on the part of labor. This may be true. However, irrespective of which came first, we were definitely in an inflationary spiral. This spiral continued for so long that many felt justified in assuming that we were in a new era of continually rising costs, prices, and demand.

The backlog of war-induced demand was finally satisfied and increased production in some areas outran the normal demand at the price levels then current. Production naturally had to be cut back; some unemployment followed. In a situation such as this, it is natural for people to become more cautious. Considering the height to which we went, consumer purchasing has held up amazingly well. That is because the economy is fundamentally sound; people have a good backlog of savings and unemployment insurance is playing its allotted role.

We are striving now to secure again a balance between demand and supply. This does not happen overnight. It would seem that this balance must be achieved at a lower level than heretofore. I trust it will be achieved on a basis from which we may build soundly and thus reach higher levels of production and standards of living than ever before. It would be the greatest mistake to attempt to achieve this balance through inflationary means. Inevitably this would lead eventually to a drastic collapse.

Now, just what can and should be done to get us moving ahead again on a sound basis? Unfortunately, there is no easy solution. It will come about through a combination of factors. Business and the consumer are far larger factors than is Government. Business can expand its market through lowering prices. Where this has been tried, it has achieved results.

This may well mean that profits will have to be reduced until the economy starts forward again. In the meantime, at least overhead should be covered. It may mean that there will have to be some wage and salary cuts. Certainly it means that everyone should work a little harder, produce a little more for the wages they receive, but if prices come down, no real hardship will ensue.

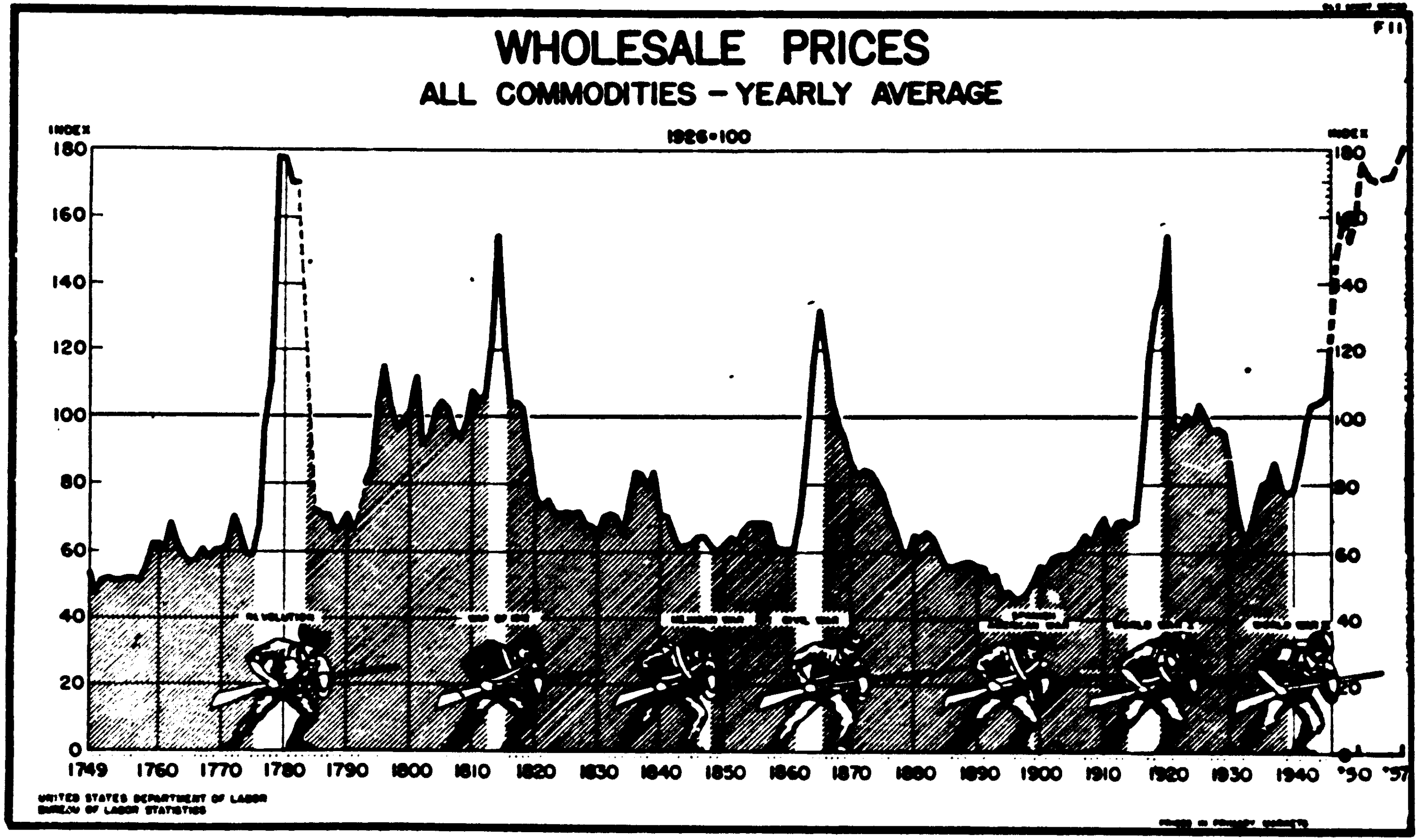
If, on the other hand, we are rigid with respect to prices and wages, we may well prolong the period of adjustment to the detriment of all. I do feel strongly that the individuals and the businesses willing to take the temporarily unpleasant medicine will be the first to recover. The consumer is the key to the situation.

Now, as to Government: First, to the extent that our present business and unemployment insurance does not take care of the unemployed, Government must. Our objective should be to get business going again. Of course, we would all like to take action which would do this, but the difficulty is to do it in a manner which will not inject inflation in our economy which will plague us later on. The first steps are to expand the availability of credit and to lower its cost. Both have already been taken. Since, of course, we must retain our competitive military strength to avoid war, we must spend whatever is necessary to accomplish this—not spend for the sake of spending, but spending what is necessary. We presumably are doing this.

Third, it would seem entirely appropriate to speed up all governmental programs which are a requisite part of Government operations, but not just spend for the sake of spending. We tried that in the 1930's and it did not work. Let us not make that same mistake again.

The country is fundamentally strong. Individual businesses throughout the United States are trying to solve their own problems. Let us give them an opportunity to do so and not encourage their running to Washington every time the going gets tough. What they do can be at least four times as effective as what the Federal Government does, and if they are led to believe that the Federal Government will solve their problems, they may not do anything.

The greatest danger today is that in the natural desire of Congress to help the situation they will take steps that do more harm than good. As an example, I would mention that in the Housing Act recently passed, the provision for Government and FNMA loans may well mean that taxpayers will eventually have to foot a bill of from $1 billion to $1.5 billion, plus the interest on this sum. This is completely unnecessary. There are ample funds available among mortgage lenders to meet all demands. Obviously, if Government funds are made available at a slightly lower cost, Government money instead of private money will be used, but the taxpayer instead of private enterprise will foot the bill and, more important still, private enterprise may well reduce its facilities for making such funds available—which may have a more lasting effect than the $1 billion involved.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UNITED STATES DEPARTMENT OF LABOR
BUREAU OF LABOR STATISTICS

THE NORTHWESTERN MUTUAL
LIFE INSURANCE CO.,
Milwaukee, Wis., April 15, 1958.

Hon. HARRY F. BYRD,
United States Senate,
Committe on Finance,
Washington, D. C.

DEAR SENATOR BYRD: Supplementing my letter of April 7, I am happy to enclose an original and two carbon copies of the completed questionnaire of the Senate Finance Committee.

I greatly appreciate your invitation to participate in this study and believe that it can be constructive.

Sincerely yours,

EDMUND FITZGERALD, *President.*

REPLY BY EDMUND FITZGERALD, PRESIDENT, NORTHWESTERN MUTUAL LIFE INSURANCE CO., TO QUESTIONNAIRE OF SENATE FINANCE COMMITTEE

1. Give a definition in your own words of deflation and inflation.

Inflation is a rise in the general level of prices; deflation is a fall in the general price level.

2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

Federal monetary and fiscal policies, if wisely and courageously administered, can bring to bear the forces necessary to achieve reasonable price stability. It is important that the Federal Reserve, the Treasury, Federal lending agencies, and Congress coordinate their policies toward the common goal of price stability.

The responsibilities of the Federal Government to help to maintain a stable price level should be further clarified. The Federal Employment Act of 1946 should be amended to include this responsibility as a specific objective of public policy.

Since prices are affected by costs, and wages are a major factor in determining costs, the inflationary effect of the power of labor to secure wage increases in excess of increases in productivity should be given careful congressional consideration. Further, wage rate rigidity tends to limit flexibility of prices which can be helpful in limiting economic swings.

3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942 to 1957. (You may wish to divide the period into two parts, 1942–50 prior to the accord, and 1951–57.)

The policy of pegging the price of Government bonds and thus increasing the money supply by keeping interest rates at an abnormally low level was not a satisfactory program. While requirements of national security may have made it excusable during wartime, it constituted an inflationary course in the immediate postwar era.

Monetary policy, since the accord, has been generally constructive. It is only with the wisdom of hindsight that we can say that on balance a more prompt and vigorous policy of credit restraint on the part of the Federal Reserve might have had a moderating effect on the excessive credit expansion that brought on the 1955 boom.

4. Beginning in August 1956, there was an increase in the Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

Concurrent increases in the demand for goods and services on the part of consumers, business, and Government were greater than the national product available. An overexpansion of credit in 1955 and wage increases in excess of increases in productivity had led to increased consumer spending power. The easy credit had also put pressure on the economy by facilitating new highs in business spending for plant and equipment. Finally, increased expenditures at all levels of Government competed for the supply of goods and services available.

5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

The effect of frequent Treasury borrowing when the economy is operating at high levels is to force the Federal Reserve to pursue a less restrictive monetary policy than might otherwise be followed. Greater price stability could probably be achieved if the Treasury took steps to rely more on long-term issues thereby having less impact on the Federal Reserve monetary policy.

In managing the Federal debt, it is desirable that the obligation should be placed, as far as possible, in the hands of investors other than banks. Selling Treasury securities to banks when national resources are fully employed can only result in an inflationary increase in the supply of money.

6. (*a*) Discuss in their relationship to one another and according to your judgment of their relative importance, the following 3 objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand, and employment.
3. Economic growth in production, demand and employment.

(*b*) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

(*a*) The objective of price stability should be on a par with the objective of full employment and a growth of productivity which will maintain and increase our standard of living.

(*b*) The continued failure of our economic measures to achieve reasonable price stability is the most significant and challenging trend of the last decade.

7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

While it would be desirable if State and local spending could be curtailed to ease the local tax burdens, it is questionable whether this would have an appreciable effect on the national economy. On the other hand, some restraints in Federal spending might have built up a Treasury surplus which would have had an anti-inflationary effect. Instead, the Federal Government continued to spend as much as, and more than, tax receipts and thus added to inflationary pressures. The Federal Government should take advantage of times of high prosperity to reduce or eliminate operations of questionable long-term economic soundness as farm price supports and certain veterans support programs. National defense expenditures are vital, but in periods of prosperity it is unsound to permit deficit financing if it is to be eventually paid for by the most inequitable of all taxes—the inflation tax.

8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

The antiquated nature of State and local taxation in the face of necessary expenditures at these levels of government has resulted in increased demands for Federal subsidy for State-local programs. State and local tax revision is sorely needed to preserve the efficiency of balancing taxation and expenditure at each level of government. The Federal tax structure also needs changes to remove inequities, to provide the incentives essential for economic growth and to encourage increased national savings which under conditions of full employment are the only noninflationary source of funds for new capital formation. However, tax reform must start with reduced expenditures.

9. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy, and then relate them, one to the other. Please discuss these policies stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

Monetary policy relates to the management of the Nation's supply of money as carried out by the Federal Reserve System. Fiscal policy relates to Federal taxation, expenditure, and debt management.

The Federal Reserve's monetary policy may be used to restrain inflation by forcing an effective contraction of bank credit and the money supply through open market operations, increases in the discount rate, and increases in bank reserve requirements.

Fiscal policies are generally too inflexible to provide quick counters to inflationary or deflationary tendencies in the economy. For the long run, tax rates should be set to balance expenditures and provide some margin for debt retirement in times of high employment. While the pursuit of positive counterinflationary debt management policies would be difficult, effort could be directed to the reduction of short maturity issues since such activity is at cross purposes with Federal Reserve monetary restraints.

10. (*a*) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank credits.) Also please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

(*b*) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

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(*a*) The monetary system of the United States as managed by an independent Federal Reserve System is fully adequate. It would be desirable if the activities of other Federal lending agencies were coordinated with the Federal Reserve so that all Government agencies would act consistently with monetary and other stabilization policies. However, under no circumstances should the independence of the Federal Reserve be impaired.

(*b*) While the fiscal system of the United States is adequate to provide for economic growth while maintaining price stability, it would be helpful if the President could veto individual items of an appropriation bill. The adoption of performance budgeting would be an important step in strengthening the fiscal system.

11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

(*b*) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necesary) to achieve and maintain full employment goals?

(*a*) There is no ready answer to this question. It may be that there is a lag relationship between increasing unemployment and resultant lower prices which is yet to be realized. It may be that for a time there can be rising labor costs in the face of falling demand because of increased union demands. It is not likely that the condition can exist over a long period of time.

(*b*) A gradual inflationary trend is undesirable and not necessarily a concomitant of full employment. Where it exists, monopoly power of both industry and labor should be curtailed so that wage costs and prices can be kept in line with productivity increases.

12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy?

Although the growth in private debt in 1956 and 1957 may have been excessive, continued growth in private debt is inevitable in an expanding economy. The Federal Reserve should, through its general monetary policies, influence the rate of growth of private debt. Cooperation of all the lending and loan agencies of the Federal Government with the Federal Reserve is essential.

13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy?

It is hard to say at what point the Federal Government should move in major ways to counteract a downturn in the economy. Generally speaking, there should be clear signs that the recession is something more than a moderate adjustment. In this respect, the temporary recessions in 1949 and 1954 can serve as guideposts.

14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

On balance, deficit spending by the Federal Government over the past decade has not been carried out on a scale to contribute greatly to inflationary pressures. However, instead of even approaching deficit spending, the Federal Government should have been able to stabilize Government spending and thus generate surpluses as tax revenues grew with the expanding economy. Instead, increasing Government expenditures in the face of increasing private demand tended to produce inflation.

15. Can full employment goals be attained while maintaining a dollar that has relative stable purchasing power?

These two goals need not be contradictory. High employment can be had along with reasonable price stability. This is demonstrated by the period 1951 through 1955 when the country experienced both high levels of employment and relative price stability.

16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

Escalator provisions in wage and other contracts contribute to the cost-price spiral. Therefore, they are not compatible with achieving economic stability.

17. List and briefly discuss what you consider the causes of the present recession, and what should be done to terminate it.

The present recession was caused by the interaction of many forces including:

1. Very high business inventories relative to demand.
2. Rapid curtailment of Government spending at a time of decreasing private demand.
3. Rapid increases in plant and equipment and consumer durable expenditures in 1955, 1956 and 1957 accompanied by a large expansion of credit.

To terminate the recession, monetary policies should be eased to promote private spending, and Government spending should be increased to take up some of the slack in private demand. If the situation continues to deteriorate, substantial temporary cuts in personal income taxes and an accelerated program of necessary public works should be initiated to stimulate the economy. Advance planning should provide that remedial tax measures and increased public expenditures can be quickly reversed so that they will not contribute to inflationary pressures when recovery gets underway.

THE CLEVELAND TRUST CO.,
Cleveland, Ohio, March 25, 1958.

Hon. HARRY F. BYRD,
Chairman, United States Senate Committee on Finance,
Senate Office Building, Washington, D.C.

MY DEAR SENATOR: I admire you so tremendously and appreciate all the sacrifice, and storm and stress you have gone through, trying to save something in our economy.

Answering your form letter of February 17:

1. The popular definition of "inflation" is a rise in prices and the cost of living. Technically, however, inflation is the pressure which causes prices to advance, rather than the rise itself.

One should distinguish between the so-called "classic" type of inflation and the "creeping" variety. In the past, the former has been due to huge deficit financing by governments, usually during and after major wars. This rapidly swells the money supply and results in too much money chasing too few goods, with the consequent bidding up of prices. In the United States, each great war has generated a great inflation reflected in a violent price rise.

The creeping inflation of the last 2 or 3 years has occurred chiefly because wages (including fringe benefits) have increased faster than productivity, or output per man-hour. This rise in wage costs per unit of production causes management to attempt to offset higher costs through higher prices, in order to keep a margin of profit.

Historically, the conditions producing a big inflation have also produced a business boom, high employment, and speculation. Eventually such booms have collapsed into deflation, poor business, and reduced employment. In such deflationary periods the supply of goods exceeds that of money, bringing liquidation at falling prices as in 1921.

Inflation is not always associated with commodity prices. There was no noticeable advance in commodities in the late 1920s, yet there was a monumental inflation of stock prices followed by the worst deflation ever experienced in the United States.

2. In trying to avoid inflation or deflation, the following methods are helpful.

(*a*) Avoidance of continual heavy deficit financing by the Government. This does not preclude deficits to stimulate the economy in poor times, provided that surpluses are achieved in good times.

(*b*) Aiming monetary policy at preventing the money supply from becoming either too large or too small, relative to the needs of normal economic growth.

(*c*) Avoiding wage increases in excess of advances in output per man-hour.

Concerning laws, labor unions have become big business as well as corporations, and should therefore be brought under the antimonopoly laws. They should also be subject to regulation as to financial statements, and use of dues and welfare funds.

3. From 1942 to 1950 the Federal Reserve System was committed to the purchase of Government bonds at par, and could not exercise adequate credit control.

In my opnion, the System on the whole has done a good job of credit regulation since the accord of March 1951. In 1952 and up to mid-1953, when business was rising, it followed a policy of restraint. This was superseded by credit ease during the 1953–54 recession. Credit restraint was again applied in 1955, 1956, and most of 1957, when the trend of gross national product was upward. Perhaps the System switched to easy credit too soon in 1953, as stated by Federal Reserve officials themselves. The precise timing of such changes is difficult.

Concerning 1955–57, it is true that credit restraint failed to prevent creeping inflation—i. e., wages rising faster than productivity. But if an easy-money policy had existed, inflation would no doubt have been greater and might have brought an old-time speculative boom.

4. The principal factor in the decline in the purchasing power of the dollar in 1956–57 was wage increases in excess of gains in output per man-hour, which caused an upward pressure on prices.

5. During the current business recession, a budget deficit—through either tax reduction or increased spending—would be antideflationary. For the longer outlook it would tend to be inflationary unless a budget surplus is achieved when business activity again approaches a new high level. The inflationary potential would be reduced to the extent that Treasury issues for new money were sold to investors and not to commercial banks. Also, taxpayers should be relieved of the burden of supporting waste, extravagance, and inefficiency in the operations of the Government.

6. (*a*) I am not quite clear as to whether No. 2 means stability without growth, or stability (as opposed to ups and downs) in the pattern of growth.

Assuming the latter, the ideal would be steady growth with a stable price level. So far this has never been accomplished except for relatively short periods.

(*b*) Since World War II we have escaped a major depression like 1920–21 or 1930–33. In other words, during the decade 1947–57 the fluctuations in economic growth were moderated, though not eliminated. It should be recognized, however, that a succession of stimulating factors occurred—e. g., catching up with postwar shortages, the rapid rise in defense spending in the Korean War, and the boom in business capital outlays in the past few years.

As to the most recent 2 or 3 years, it seems to me that the most significant factor in economic growth was the boom in business spending for new plant and equipment, coupled with extensive research and development of new and better products and methods. The main reason for rising prices was the wage-price spiral, as already indicated. Late in 1957 the growth trend was temporarily halted with the onset of the third postwar recession. Capital outlays turned down; overcapacity became evident in various industries; inventory liquidation commenced because stocks on hand had gotten out of line with sales; and consumers, being well stocked in general with durable goods, were price conscious and less inclined to borrow for the purchase of automobiles, furniture, appliances, etc.

7. In terms of the gross national product, current Federal, State, and local spending are plus factors because they are showing a ris-

ing trend during the present business recession. But in terms of a private enterprise system, reliance in the long run must be placed on business initiative and resourcefulness, rather than on governmental spending. The rise in our standard of living has been based on industry's ability to increase production per capita, i. e., to turn out more goods for more people.

8. Current tax rates tend to discourage the initiative of persons in the higher income brackets. Depreciation allowances for business concerns are inadequate. The capital gains tax tends to freeze securities in strongboxes; if reduced, it might actually produce more revenue through increased volume of sales to realize profits.

9. Fiscal policy deals with Federal receipts and expenditures—the Federal budget—and the management of the public debt. Monetary policy regulates the amount of reserves of member banks at the Federal Reserve banks, which in turn affects the amount of bank credit available. The two should work in harmony; e. g., if credit restraint is the proper policy at a given time, the Treasury should avoid inflationary deficit financing. Both fiscal and monetary policies should encourage increased saving. Investment growth should be financed by the use of savings rather than by excessive bank credit, because the latter increases inflationary pressures. A lengthening of the average maturity of the Federal debt is desirable, to avoid too-frequent trips to the money market which tend to hamper the carryout of monetary policy by the Federal Reserve System.

10. (*a*) Good results depend more on how the monetary system is managed than in the system itself. Through a long period of trial, dating back to 1914, the Federal Reserve has developed into a satisfactory system of credit regulation. It should retain its independence of judgment, and always be free from political influence.

(*b*) Here again it is more a question of management. Improvement could be made through tighter budget control, closer supervision of the budget by Congress, and better coordination of budget policy with tax policy.

11. (*a*) When business is declining, hourly wage rates remain rigid or even advance through escalator clauses. Management therefore tries to maintain prices. Even so, sales decrease and profits are squeezed. To make dollars of income match dollars of outgo, the latter is reduced through lower dividends, shorter workweeks, layoffs, and postponement of plans for capital expenditures.

(*b*) The idea that a gradual inflationary trend is desirable (or necessary) is a dubious doctrine. It means a serious erosion of the buying power of savings over a period of years. Also there is danger that the public will catch on, and attempt to convert money into goods before the purchasing power of the dollar declines further. In this way creeping inflation would become a gallop.

12. Long-term growth of private debt is not alarming, but is a normal feature of economic growth. However, the rate of expansion in recent years has been rapid and could probably not be sustained. When recession comes and incomes are reduced, the debt burden becomes correspondingly heavier. People therefore reduce their purchases, particularly of durable goods like automobiles, until their debt is worked down. As an example, heavy borrowing on installment enabled the public to buy nearly 8 million new passenger autos in

1955. Otherwise, some of those cars would have been purchased in succeeding years. With 1955 cars still in good condition, many owners are not buying 1958 cars.

13. If a recession does not go too far, Federal action may not be required. If a major depression is threatened, the Government is committed to act. A tax reduction would probably bring quicker results because it could be made effective immediately and thus raise buying power all at once. The difficulty with increased Federal spending on public works is in the timing. There are inevitable delays, and the results are likely to come along in driblets, which may be insufficient to turn the tide. Some actions, such as the speeding up of military orders already planned, can be helpful.

14. The deficits during the Korean war had an effect on rising prices during that period. Little effect since then, except indirectly through spending for military hardware which furnishes protection but is not available for civilian economy.

15. I doubt if completely full employment is possible over a period of time. But it might be possible to keep unemployment at a minimum of 2 or 3 percent of the labor force, and still maintain a relatively stable dollar, if wage increases were limited to not more than the advances in output per man-hour and if the Federal budget were kept approximately in balance.

16. No.

17. Among the more important causes were:

(*a*) Downturn in business outlays for new plant and equipment.

(*b*) Too much inventory buildup.

(*c*) Slump in residential construction.

(*d*) High level of consumer installment debt plus ample quantities of durable goods (autos, appliances, furniture, TV sets, etc.) in consumers' hands. Result—postponement of purchases of such items until debt worked down.

My very best to you.

Sincerely,

George Gund, *President.*

STANDARD OIL CO.,
New York, N. Y., May 1, 1958.

Hon. HARRY F. BYRD.,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: Mr. M. J. Rathbone, to whom you sent your letter of February 17, has not yet returned from an extended business trip abroad, and I thought I would write you rather than defer our reply any longer. In doing so, I have taken your suggestion that we regard the list of questions as a guide and, rather than answer them point by point, have sought to express my views as a businessman on the major issues which they encompass.

An evaluation of the financial institutions of the United States and of measures to be taken in dealing with the current situation should be viewed in the perspective of our longer range economic objectives, and not from the standpoint of expediency. Otherwise we may create more problems than we solve. Because of this, I have devoted a considerable part of this letter to the long-range aspects of our economy in addition to dealing with the present recession.

All of us recognize that the basic purpose of any economic system is to fulfill, as much as possible, the needs and desires of all the people whom it serves. I know you will agree that in practice the system which we have in the United Staes, despite imperfections, has done this far better than any other system yet devised. Therefore, I believe our primary objective should be to preserve the fundamental competitive, enterprising characteristics of our system. We should not, of course, reduce our efforts to strengthen it, but we must constantly guard against courses of action which, in the long run, may impair or destroy the very thing we seek to improve.

Our Nation has been wise in recognizing that individual freedom and the spiritual and material benefits which flow from it should not be interfered with lightly. While modern life makes the intervention of government in individual daily lives unavoidable, such intervention should be kept to a minimum. In its economic aspects, it should aim primarily at the establishment of a climate which will give maximum free play to competitive economic forces. For this reason, I feel that monetary and fiscal measures which apply to the business community as a whole are usually better than specific controls, since they give the greatest scope for countless individual decisions within a general framework and do not depend on centralized decisionmaking. In avoiding such centralization, I think it is important to keep in mind the need to reverse the disturbing trend of recent years during which the Federal Government has continued to take over areas of jurisdiction and functions previously regarded as the province of the individual States.

In my view the following economic objectives are important both in themselves and to the preservation of our system:

(1) Growth in the output of goods and services, not merely to keep pace with the growth in population but, more importantly, to provide a rising standard of living for all.

(2) An institutional climate in which labor, capital, management, and the consumer all have an opportunity to obtain a reasonable share of the fruits of improved productivity.

(3) A high average level of employment and a high average level of utilization of our capital equipment.

(4) Avoidance of the erosion of the purchasing power of money through long-run price inflation.

There are, of course, other aspects of national policy which have far-reaching effects on our economy and on its survival. Paramount among these are an adequate national defense and an international economic environment in which the nations of the free world can grow and prosper. The importance of these is such as not to require elaboration.

I think the United States has done a reasonably good job of working toward at least some of the above objectives in the postwar years. From 1947 to 1957, total output of goods and services rose by about 45 percent in dollars of constant purchasing power. Despite a large rise in the population, real output per capita increased 21 percent. These increases, which have simply extended the gains which have been going on for generations, were achieved without any serious business cycle fluctuations. For example, up to this year, unemployment during the postwar period averaged only about 4 percent of the labor force, and even in the worst years of 1949 and 1954, it did not average above 6 percent. Progress toward the attainment of these objectives was made, however, at the expense of price inflation; consumer prices, for example, rose more than 25 percent in this period, a rate of rise which I believe we can ill afford for the long run.

In evaluating the results of the past decade, it may be worth keeping in mind that in the Employment Act of 1946, the achievement of a high level of employment was singled out as an objective of economic policy. By implication, the objective of avoiding inflation, as well as the other objectives mentioned above, were regarded as of lesser importance. I fully believe, however, that we should regard all four of these goals as being of the same order of importance. Admittedly, it is a difficult job to strike a proper balance between them; if one of the objectives is regarded as paramount, at least one of the others may suffer. The experience of the past decade bears this out. There is, nevertheless, no necessary reason why a reasonable balance cannot be achieved, and our policies should aim at finding this balance. As a first step in this direction, I recommend that the Employment Act of 1946 be amended to identify national policy with a fuller and more balanced set of economic objectives.

In my view, the evils of inflation should be given special attention. Continuing inflation is detrimental to our long-run growth because it destroys confidence in the future, causes real hardships for a large number of people and dissipates the will to save, which is important for financing our capital requirements. For many of our industries it raises the prospect of being priced out of important export markets. Our present inflation is the product of many factors including, particularly in recent years, wage increases in excess of overall gains in productivity. Labor, capital, management, and the consumer all have a stake in this, and in the long run all stand to be harmed if any one group has an unequal bargaining advantage. This is one of the principal reasons for my feeling there is need for placing legal checks and balances on the powers of labor organizations. The formation of national and international unions by trades and by industries, and their federation into huge combinations, especially when supported by compulsory union membership and the checkoff system, has resulted in a concentration of power which can, and has, threatened the health and progress of our economy.

As far as antirecession measures are concerned (and I am still speaking in terms of fundamental strategy for the years ahead), it must be recognized that each recession is different and for that reason most steps taken must vary with circumstances. While forces which come into play gradually as needed, such as unemployment compensation, have a cushioning effect, I think we should continue to rely principally on discretionary measures. The most important of these are in the areas of monetary and fiscal policy. Much has been made in recent years of the reduced effectiveness of monetary policy, but I believe that control over the supply of money and the conditions of credit can, if properly used, be a highly useful tool in shaping the economic environment. The two principal fiscal tools, i. e., variations in government outlays and changes in tax rates, can also be effective. In using both types of discretionary measures, however, careful thought must be given to their long-range effects and not solely to the more immediate results.

To the extent that Federal, State and municipal government spending on useful and planned projects can be accelerated to fight a recession this should be done. Nevertheless, stepped-up public works outlays which cannot be easily curtailed once recovery gets underway should be avoided, for these carry the potential of increased inflation later on. For this reason and because it is not easy to carry an assortment of public-works projects on the books for emergency use only, accelerated spending on such projects is probably of only limited usefulness as an antirecession device.

Federal, State, and municipal governments can make their greatest contribution in this area by so programing public works as to allow a reasonably stable outflow of funds over the years. Outlays on schools, roads, and the like should be based primarily on a careful assessment of the Nation's changing requirements and resources. So handled, they would provide a steady underpinning to the growth in the economy. This should be the primary concern. Only those anticyclical changes in the rate of outlay which are consistent with this purpose should be undertaken. Along the same line, recessions should not be used as pretexts for instituting social reforms; these should be decided upon deliberately on their own merits and in the light of long-range goals and costs.

In a similar manner, business concerns should program their capital projects over time in a steady spending stream consistent with their own long-range objectives. This, too, would underpin demand for and growth in the Nation's fixed capital equipment which is necessary for economic expansion and for improvement in the standard of living. Business should keep its sights on realistic long-range objectives and should avoid the excesses of wishful optimism during boom years which lead to overinvestment in new capacity. It should also avoid a panicky slashing of capital investment at the first sign of a recession. In a recession, business, instead of passively trying to ride it out, should aggressively fight it through flexible pricing policies and more aggressive selling tactics. Efforts should be made to sustain capital expenditures by shifting emphasis from expansion to cost reduction and to the introduction of new products. I think that an ever-increasing number of businessmen are recognizing their responsibilities in all these areas and are backing their convictions with action.

A general tax cut as an antirecession tool can sometimes be helpful. However, this measure, as is also true of public works, carries with it the possibility of intensifying inflationary pressures. Consequently, at any particular time there must be a careful weighing of the relative needs of stimulating the economy and of fighting inflation.

I think that for the long run, however, we should not lose sight of the fact that taxes, by their nature, are restrictive in their effects on economic activity. Over the years we should seek to reduce both tax rates and the magnitude of all Government spending in relation to total spending. We should strive to do this in an orderly fashion so that over an extended period of time the Government budget will be kept in balance.

I strongly believe we are badly in need of a reform in our overall tax structure, including corporate, excise, and personal income taxes. For example, with respect to the effects of personal income taxes, I am convinced that in large measure many of the advances which have been made in our national standard of living have had their origins in the creative efforts of unusually talented individuals. Until quite recently these people had the prospect of substantial financial reward as one of their incentives. But with the advent of steeply progressive income tax rates, this incentive has been greatly impaired. We have drifted too far from the concept of relating financial reward to results and too close to the concept of relating it solely to effort. Another pressing reason for tax reform lies in the need to assure an adequate flow of risk capital into new ventures. I have in mind not only the entry of more firms and individuals into existing industries, but also the entry into completely new fields where the risks and losses are bound to be high. In many instances, the tax structure now in effect reduces the potential payoff of success to a point where the risks are not justified. Moreover, if there is no improvement over a period of years, there will be a further decline in the opportunity for accumulation of risk capital, and thus even the question of making a choice as to its investment will tend to become academic.

Recessions, difficult and even painful as they may be, do serve the function of shaking out of the economy excesses and abuses which have crept in during previous boom periods. Business organizations and labor groups must be kept responsive to the needs of the consumer. We should strive for this flexibility while minimizing the economic waste which accompanies recessions, even though it may be impossible to achieve complete success.

In view of the many and complex difficulties which exist in all areas of economic policy, it is vital that we give our best thoughts to the matter. I should think it a wise step, therefore, if some sort of economic commission were appointed with the responsibility for making specific recommendations on steps which might be taken by business, labor, and government to promote steady progress toward attainment of sound economic goals. Such a group should consist of individuals of outstanding knowledge and integrity drawn from government, business, labor, and the academic world.

I would now like to turn to the question of the recession in which we find ourselves today and outline briefly the measures which I believe might be taken to overcome it.

I think that business should intensity and broaden its efforts in the following areas:

(1) Undertake aggressive sales campaigns.

(2) Improve products and reduce costs so as to be able to offer the consumer better quality, lower prices, or both.

(3) Carry forward capital expenditure programs at a reasonably high level in lines where excess productive capacity does not presently exist or where there is a reasonable expectation that excess capacity will be substantially reduced in the next year or two.

(4) Be outspoken in conveying to the general public and to employees information: on the measures which business is taking to fight the recession; on the fundamental overall soundness of our economy; and on the bright outlook for long-term growth.

For the Federal Government, in addition to the steps already taken, I think:

(1) There should be a step-up in the timing of expenditures for those Government projects which have already been approved on their own merits. However, expansion of expenditures through the undertaking of new projects of dubious merit should be strongly resisted.

(2) A percentage reduction across the board in personal income taxes should be considered if the decline in consumption continues much longer. Reduction or removal of selected excise taxes should also be considered at the same time.

(3) Action should be taken to urge the individual State governments to extend the duration of unemployment compensation benefits, but Federal funds should not be used for that purpose.

Thank you for providing this opportunity to pass along my views on these most important issues.

Sincerely,

EUGENE HOLMAN.

SWIFT & Co.
Chicago, Ill., March 25, 1958.

Senator HARRY F. BYRD,
Senate Office Building,
Washington, D. C.

MY DEAR SENATOR BYRD: Mr. Jarvis, to whom you addressed your inquiry requesting expressions of opinions on vital matters affecting our economy, referred the questionnaire to me and I have reviewed with him the attached answers. I trust you will find them useful.

Very truly yours,

H. B. ARTHUR.

ANSWERS TO INQUIRY OF SENATOR HARRY F. BYRD, SENATE FINANCE COMMITTEE (FEBRUARY 17, 1958)

1. Give a definition in your own words of deflation and inflation.

Inflation is an excessive and unsustainable expansion. It is an expansion that is usually attended by increases in prices and expansion of monetary and credit instruments. These aspects of the economy expand more rapidly than do the production and flow of real goods and services. Deflation is the converse of inflation.

2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

Many stabilizers (both those that are built in and those that are affirmatively managed) exist in the United States economy. Governmental activities are only an adjunct to other forces. I believe that present laws are adequate for the most part although there are some built-in unstabilizers in our progressive tax system and elsewhere. Fiscal and monetary measures are the most appropriate and powerful governmental instruments for affirmative management actions by the Government. The great danger in governmental policy is the very strong bias of nearly every political pressure in the direction of letting inflation run because it feels good, even though it may have harmful longer run effects.

3. Comment generally on the monetary control policies of the Federal Reserve System as exercised with the following years: 1942 to 1957. (You may wish to divide the period into two parts, 1942–50 prior to the accord, and 1951–57.)

On the whole, it seems to me that the Federal Reserve System has operated with reasonable intelligence, although its soft money policies in the period 1942–50 undoubtedly reflected a willingness to absorb a certain amount of inflationary credit expansion as a part of our abnormal wartime condition.

4. Beginning in August 1956 there was an increase in the consumer price index each month through September 1957, thereby causing a

decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar.

There were no doubt many factors contributing to the decline in the value of the dollar during the period August 1956 through September 1957, although I am inclined to put greatest emphasis upon the "cost-push" effect of wage increases.

5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

The public debt is high. It forces a substantial portion of the flow of our national resources into the servicing of that debt. At the same time it is an element that would permit a firm debt management policy to exert a considerable influence upon the future expansions and contractions of our economy. This is one of the powerful tools for economic management and it requires the utmost of sound judgment and professional integrity for its proper handling.

6. (*a*) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand, and employment.
3. Economic growth in production, demand, and employment.

In respect to our national economic policy, the three objectives mentioned in your question are all-important and all of them are closely interrelated. Perhaps the ultimate objective is that of maintaining economic growth with a reasonable degree of flexibility in the short run rather than such rigidity as will not allow us to accommodate ourselves to change. Price stability is rather a result than a cause; it reflects how well and how constructively the other objectives have been attained.

Many efforts have been made to establish by law statistical or rule-of-thumb criteria, including such terms as "full employment" or "parity," each with more or less definite statistical specifications. Such yardsticks are almost invariably targets for political pressures on the part of those seeking, as it were, to raise the temperature by lighting a match under the thermometer. Since these criteria are subject to pressures that are almost certain to be unstabilizing and inflationary, the only feasible procedure would seem to be the placing of broad powers in the hands of authorities whose sole responsibility is the public interest and who are insulated, as far as humanly possible, from the continuing pressures.

(*b*) With respect to these 3 objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

My only comment on postwar and recent experience is that we have granted such special privileges to certain elements in our economy that we have created a chronic pressure toward imbalance, both in the wage market, and in our international economic relations. In spite of these qualifications, we have made very substantial progress since the war in developing some basis for confidence that the sort of collapses that occurred in 1920 and 1932 are not the great threats they formerly were.

7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

I do not believe that Federal, State and local government spending should be carried on for the sake of doing some spending. It is rather a matter of performing necessary governmental services and this should be the controlling criterion. The timing of spending can possibly be made countercyclical in its impact but the danger is that it will merely be progressively expansive once it is unleashed in the guise of a countercyclical weapon.

8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

Taxation is the way we pay our bills. I believe that the method of taxing should be basically economic rather than socialistic or egalitarian in its focus. As to the level of taxes, we should pay our bills and reduce our debts, except in periods of emergency. Taxes ought not to be used to curry favor or to penalize the unpopular.

9. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy, and then relate them, one to the other. Please discuss these policies stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

No comment.

10. (*a*) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank credits.) Also please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

On the whole, our monetary system seems adequate. The rigid discipline of the traditional gold standard may have been so inflexible as to produce periodic collapse. On the other hand, it is unfortunate to have nothing but discretionary declarations as the basis for confidence in making long-time commitments in monetary terms. Perhaps the latter is the best we can do but it requires the establishing and cherishing of a tradition of monetary integrity which unfortunately has proven most difficult to maintain under any form of government.

(*b*) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

No comment.

11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy.

It does not seem to me like there is even a paradox in having inflation and unemployment at the same time since inflation may be purely monetary—a matter of marking up price tags—whereas unemployment may be a direct result of having put prices out of reach of those whose jobs and incomes depend upon a continuing movement of goods.

(*b*) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full-employment goals?

We should never accept creeping inflation. We may get it as a result of other forces and against our wills, but to prescribe it or to accept it can readily be as fatal as the opening of Pandora's box or the adoption of a dope habit.

12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy?

I am not nearly so concerned with the extent and the unstabilizing impact of the growth of private debt as I am with the need for us to analyze it more carefully and to secure full information about its volume and the points at which it will exert pressure under conditions of stress and change.

Apparently, consumer installment credit is much more stable than people had assumed and isn't something that leads to breakdown and mass repossessions, at least in periods of moderate readjustment. Mortgage credit is undoubtedly much less vulnerable than in the 1920's before the common practice turned to amortized mortgages.

There are, however, many forms of credit which are less publicized and may contain some cause for concern. I am referring to such things as sale and leaseback practices, supplier or customer credits in various kinds of agricultural and business operations, the practice of equipment leasing, etc. I have no conviction that these practices are unsound or dangerous at the present time. I am much concerned, however, that there is so little known about their magnitude and significance. Many leaseback arrangements impose an obligation on the lessee which is as rigorous as a bond or note, but the principal amount does not, in many cases, appear in published balance sheets. Similarly, we know that large losses have been incurred in past periods of stress in various intermediate financing operations, whether it be in the provision of earth moving equipment in the construction industry or feed loans to farmers.

The above is primarily a plea for better information and study.

13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy.

I see no fixed point that can be defined in specific terms. Certainly, massive Federal programs should be delayed until obvious excesses have had time to be assured of correction—otherwise only greater future grief will be stored up by the measures your question implies. Moreover, any truly constructive action should include solid incentives as well as cushions, palliatives, and relief. Among incentives, I would include those measures which would provide more attractive investment opportunities and profit prospects.

14. How much of a factor, in your opinion, has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

Deficit spending has, of course, been a contributing factor. However, much of the deficit spending that has shown up in the past decade in the form of inflation was actually spent or "planted" during the war itself. In other words, there was a great deal of spending and many commitments that could have been mopped up or liquidated in the early postwar period when deferred individual and corporate spending were being expanded so rapidly.

15. Can full employment goals be attained while maintaining a dollar that has relative stable purchasing power?

This depends upon whether we are willing to be realistic and recognize that full employment, as we measure it statistically, has to allow for somewhere between 3 and 5 million who will be classified as unemployed even though for practical purposes we have a fully employed labor force. With this modification, plus a realistic recognition (particularly by labor unions) that wage rates cannot be pushed up faster than total national productivity without resultant price inflation, it would be possible to answer your question in the affirmative. However, these are pretty important reservations.

16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

Certainly the question is not one of logical incompatibility since escalation—meaning the adjustment of wage rates to changes in the price level—would be neither helpful nor harmful if we had general economic stability, including stable prices. However, if escalation is established on a one-way basis, like a ratchet, then it is going to introduce an important unstabilizing bias.

17. List and briefly discuss what you consider the causes of the present recession, and what should be done to terminate it.

To date the present recession does not seem to have gone beyond the point of healthy correction that any dynamic economy ought to expect to go through from time to time. We are correcting various kinds of excesses and so long as we avoid the impact of too many simultaneous corrections and a resultant cumulative decline which feeds on itself (without correcting anything), we need do little more than provide psychological assurances that powerful weapons are available to prevent the excesses from running unchecked in the direction of contraction. This is about where we are now. It imposes a delicate and difficult task for any governmental instrument that attempts to govern the balance wheels. This is perhaps the greatest danger we now face—that control policies may backfire or go awry.

CHICAGO, ROCK ISLAND & PACIFIC RAILROAD CO.,
Chicago, March 25, 1958.

Senator HARRY F. BYRD,
Chairman of the Committee on Finance,
United States Senate, Washington, D.C.

DEAR SENATOR BYRD: I have your letter of February 17 in which you ask me to give you my thoughts and opinions about certain vital matters associated with our economy.

I am not a trained economist. Particularly, I have not made a study of the phases of the economic situation which are presented in questions 2, 3, 5, 6, 9, and 10 (*a*) of the list of questions which accompanied your letter. I believe that I am competent to answer with a greater or less degree of accuracy the other questions which were presented by you.

Question 1: A short time ago (before receiving your letter), I read a booklet entitled "The Economics of the Money Supply." The first paragraph of the introduction to this booklet read as follows:

"A dollar is always a dollar, but sometimes it is alleged that it is a 50-cent dollar. The reference, of course, is to its purchasing power. This varies depending primarily on Government policy with respect to expenditures, taxation, debt management, and credit expansion."

While in the paragraph above, the statement is made that the purchasing power of the dollar varies depending primarily on Government policy, there was nothing in the booklet itself to indicate that any other factors had any influence at all on the purchasing power of the dollar.

Prices should, according to the booklet, rise or fall with increases (inflation) or decreases (deflation) in the quantity of money or credit. During the past few years, I think that prices have responded to inflation as, according to the theory, they should. But I do not believe that, on the deflation side, the theory would operate as freely or extensively now as it did in prior years to cause reduction in prices. Support of some prices, high taxes, high debt charges, high costs of production, and the increase in the number of wage earners covered by wage contracts which would be protected by every power at the command of the labor organizations would operate as forces against a reduction in prices and wages, even if the supply of money and credit should decrease. If they did not prevent reductions in prices, these forces would tend to diminish, following and not preceding or accompanying price reductions.

Over a long period of time, a reduction in the supply of money or credit might result in some reduction of prices, but I am satisfied that the pressures mentioned above would make most difficult, if not impossible, a substantial and immediate reduction of prices. After all, prices cannot go below the cost of production for very long. The length of time prices could remain below cost of production would vary from enterprise to enterprise. (One alarming fact—alarming from the point of view of the Treasury of the United States—is that reductions in prices without reductions in the costs of production will reduce income-tax payments.)

Questions 4, 11 (*a*), 15, 16, and 17: I will comment on the paragraphs numbered above at the same time because I think they are directly related.

In my opinion, the increase in the consumer price index of the past 2 or 3 years has been caused by a combination of a number of factors, including past money and credit inflation, demand for goods, large capital expenditures, Government spending, and wage increases and fringe benefits exceeding increases in productivity. Consequently, prices of intermediate products increased. Price increases in many industries affected materal costs in other industries. Prices of materials and services were increased to the ultimate consumer.

I would like to take the railroads as an example of the effect which wage-and-price increases have had. In November of 1956, all the railroads made agreements with employee organizations calling for hourly wage increases of 10 cents and an additional 2½ cents per hour for health and welfare benefits or in lieu of such additional benefits in November of 1956; of 7 cents in November of 1957; and of an additional increase of 7 cents to be in November of 1958. The agreement also called for increase of 1 cent an hour for every increase of one-half point in the consumer price index. These cost-of-living increases have already amounted to 8 cents per hour, and it is apparent that a further cost-of-living increase will be due May 1, 1958. To date these increases have totaled overall 27½ cents an hour, or over 12 percent.

These wage increases of 1956–57 were, however, the last of many wage increases since the end of the war. Since 1945, the last year of the war, wages per hour paid for, including payroll taxes and health and welfare benefits, have increased about 155 percent while prices of materials and supplies used by railroads have increased 106 percent. (The 106-percent increase reflects only average prices during the year 1957, not the prices at the end of the year.) During this period of time, gross-ton miles per hour paid for increased about 46 percent. Revenue for hauling a ton of freight 1 mile increased by 50 percent. During this period, capital expenditures of nearly $13½ billion resulted in great economies in operation and in vastly increased efficiency which enabled the railroads to do as well as they have in the face of these increased costs.

Of course, increases in cost of materials and supplies and wages affect different industries in different ways. The railroads pay out close to 52 percent of their gross revenues in wages, payroll taxes, and fringe benefits, and a little over 20 percent for materials and supplies. Many other industries pay out smaller amounts for wages and larger amounts for materials and supplies. Thus in a period of advancing wages and prices, the effects on the cost of producing the end product of an industry, services or materials, will vary.

The railroads were unable during the period from 1945 to pay these wage increases and price increases out of income at the then levels of their freight charges and passenger fares and, as a consequence, they have from time to time secured permission from the Interstate Commerce Commission to increase their freight rates and passenger fares to some extent, even those increases which they have secured have not sufficed to provide the revenue to pay the increased wage bill and the increased prices which they have had to pay for their materials and supplies, and to yield a fair return on their investment after paying income taxes.

The railroads were required to dispense with as many employees (since 1945 the number of employees has decreased over 30 percent) and to curtail such purchases as they could, but even the combination of reduction of employees, reductions in purchases, increases in efficiency due to large capital expenditures and increased freight rates and passenger fares have not been sufficient to enable them to meet the increased costs and to earn a fair return.

The story of the past 12 years is this: Basic industries raised their prices as a result of their increased wage and material costs; the prices of other commodities went up as a result of increases in their material and wage costs; the costs of operation and prices of retail and service industries went up; the consumer price index went up; employees of many industries got wage increases by negotiations and employees of some industries got, in addition, automatic increases based on the upward trend in the cost of living—and thus going the full circle—the increases in wage and material costs resulted in higher prices to the final consumer and these prices influenced the consumer price index, producing another round in wage and material cost increases so that inflation fed on itself.

So long as the condition exists of increases in wages and additions to fringe benefits uniform across the board in all industries—basic, consumer goods, retail and service—without relation to increases in productivity of those industries and hence their ability to absorb the wage increases without increasing their prices and with many wage levels tied into the cost of living, I see no end to inflation.

The fact is that some employers can raise prices as high as the traffic will bear while others, such as the regulated railroads, cannot. Competitive forces also prevent companies in some industries from raising prices. Their only defense is reducing expenses by reductions in purchases, reduced inventories in some cases, and in the number of employees. The railroads are prevented from raising their fares and charges as they will both by competition and government regulation.

Again, railroads have obstacles in the way of reducing expenses which other industries do not have. A company which has several plants can close down whole plants and concentrate the operations at a few of the plants. A company having several production lines handling the same product can close down one or more of the production lines. In many cases the railroads cannot reduce expenses because of the requirements of law that they maintain certain facilities and services and, again, must maintain large parts of their properties however little use may be made of them. Thus the tracks must be maintained even though traffic falls off. With so many of the expenses of a railroad fixed, opportunities to reduce their expenses are limited. This explains why with the reductions in gross revenues in recent months, the drop in net income of the railroads has been most drastic and proportionately much greater than the drop in gross revenue.

I think that the explanation of the seeming paradox that at times inflation, and its resulting high prices and wages, and unemployment exist side by side in our economy is that increases in wages and in the prices of the materials they use affect all employers. The dollars of the employer can go only so far in paying wages. The end result is that the employer's dollars simply have to be divided among fewer people and unemployment results. Again, certain segments of the population cannot or will not pay the high prices and reduce their purchases. Production and employment drops.

I know that the statement I made in the paragraph above is true in the case of my railroad. We have just so many dollars to spend for employees. As wages are increased, the number of employees to receive these dollars must decrease or our dollars will run out.

Again, it is paradoxical that prices are rising in this period of reduced buying and rising unemployment. I think the explanation is that the forces which cause increases in costs are still operating.

I do not believe that a gradual inflationary trend is desirable or necessary to achieve and maintain full employment goals. To the contrary, as prices go up, certain segments of our population cannot or will not pay the higher retail prices and certain companies cannot absorb the higher costs or sell at the higher prices needed, production will drop, and with this decrease in production employment will drop.

For yet another reason, a gradual inflationary trend is, in many cases, not conducive to full employment. This phase of the matter is one of the most perplexing problems facing industries, and particularly railroads. Theoretically, depreciation charges deductible for income tax should furnish enough money to buy a new machine or a new building when replacement time comes, but in a period of rising prices the amount recovered through depreciation will not buy a replacement; indeed, in many cases, the amount recovered through depreciation will not equal the downpayment on a replacement (I recognize that the replacement in many cases is a larger and better built article than the original but the principle still holds true because a replacement in kind would cost more). Taxes being what they are and profits so low that they do not provide funds for replacement, new capital must constantly be secured and, in the case of many industries including the railroads, this capital must be borrowed since equity capital cannot be secured. The result is that in these industries, capital improvements, including replacements, are held at a minimum. This higher and higher cost of replacement is a constant brake on employment.

Finally, rising prices impair or, if the price rise is steep enough, destroy capital—and the best example of this is the E-bond. After paying tax on the $25 profit on an E-bond bought in the 1940's, the proceeds of the E-bond is worth little more, if any, than two-thirds of the original investment of $75. Shrinkage or destruction of capital by inflation is certainly not conducive to good conditions and full employment. There is only one way in which improvements can be made and expansion obtained with outside funds and by means of which people can be employed, and this is through use of the savings of the general population. Why save if inflation will eat up the savings?

Further, there is no such thing, in my opinion, as gradual inflation. It will, as I pointed out above, feed on itself at an accelerating pace.

I do not know that full employment goals can be attained and maintained always while maintaining a dollar that has relative stable purchasing power but, I believe, for the reasons which I stated above, that there are insurmountable obstacles to maintaining full employment with a dollar which is always decreasing in purchasing power.

Escalator provisions in wage and other contracts are not compatible with achieving economic stability for the reasons which I have given in discussing that fact that inflation feeds on itself.

I know the argument is made that wage increases must keep step with the increases in the cost of living in order to sustain purchasing power; however, with further increases in the cost of living following the wage increases, the whole scheme is self-defeating.

Questions 7, 8, 10 (*b*), and 13: I have heard the argument that high taxes and spending by the Government of the money secured by high taxes is deflationary because it leaves the American taxpayer with less money to spend unwisely. Personally, if spending produces high prices, I cannot see what difference it makes, so far as prices are concerned, by whom the money is spent.

I am also certain that the Rock Island Railroad could spend money, more money than it is spending, on improvements and additions and betterments to its property which would produce greater good, not only for the railroad but also its employees and the shipping public, than is produced by many expenditures of the same and larger amounts of money by Government, Federal, State, and local.

In my opinion, the taxing policy of the Government, Federal, State, and local, is inflationary. Our local taxes are a fixed item of expense which must be met. They are met in our case by as efficient economic operation of the railroad as possible, by reduction in the number of our employees, or by higher freight rates. Our efforts along this line have not proven successful.

The income tax is especially burdensome. Every time we save a dollar in our expenses, the Government gets 52 percent of the result of our efforts. This is indeed discouraging. There is, of course, another side of the coin. In times of prosperity there have been many expenditures made on the theory that the Government would pay for 52 percent of the expenditure. On my railroad, we have fought this tendency constantly. I think from what I have heard and read that it has been more widespread in other industries than in the railroad industry because for many years the railroad industry has not been prosperous and has desperately needed the 48 cents.

In your question 13, you asked at what point the Federal Government should move in major ways, as tax cuts and/or large increases in public works, to counteract the downturn in economy. A reduction in taxes would put more purchasing power in the hands of the people. A reduction in taxes, however, without reducing Government expenditures could mean only an increase in public debt. However, the proposals of which I have heard call not only for tax reductions but also for increased spending by the Government. If, in addition to reducing taxes, the Government should increase its expenditures, this would be even more serious because it would mean still further increases in the public debt. The interest charges of the Government would increase. All hope would be abandoned of ever reducing the public debt.

The situation discussed in the paragraph above is one which, in my opinion, has been brought about by the policy of the Government to tax at the highest possible limits in times of prosperity, but at the same time spend all of the income, paying nothing toward a reduction of the debt, and then in time of recession, having little or no option as to what it ought to do.

Questions 12 and 17: I think the cause of the present recession is our overspending—overspending by the Government, over expansion by industry and overspending by a lot of people, many of whom have borrowed money to buy things which they didn't need. Prices finally got out of line, inventories built up, the wants of many people for many things seemed to be satisfied, production exceeded demand, and people stopped buying. Many citizens, because of the fact that they borrowed to buy what they have bought, had no cushion. In part, this reduction in buying may have been psychological and may have been uncalled for. It was preceded by widespread questioning as to the length of the boom and when it would stop. Psychological or not, however, the buying did stop.

Some prices have come down. Some companies have abandoned their fair price standards and agreements. Apparently profits in general will suffer, but with the reduction in prices, buying may pick up. However, profits being what they are, a shrink of those profits cannot produce any great or lasting reduction in prices. Profits are essential to our capitalistic system.

I am sorry to say that I do not know how to stop the recession. I do say that adopting many of the panaceas proposed—increased Government spending, reduced taxes merely to leave more money with the taxpayer without reduced Government spending, in particular, a combination of increased Government spending and reduced taxes, wage increases for the alleged purpose of giving increased purchasing power to one segment of the population, for instance—might appear to stop it. However, these steps would simply create another inflationary condition and another and worse recession.

Very truly yours,

D. B. JENKS.

SEATTLE-FIRST NATIONAL BANK,
Seattle, Wash., March 25, 1958.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: In reference to your letter of February 17, I am pleased to enclose a reply to your questionnaire in connection with the Senate Finance Committee's investigation of the financial condition of the United States.

I feel that it is most important to mention that the financial system of our country today is certainly not the same as existed when our economy was much smaller, say, prior to World War I. The commercial banking system is now a smaller percentage of our total financial structure than it was a decade ago, and it seems very desirable, therefore, that in order for the Federal Reserve Board or other supervisory authorities to have more effective control of our monetary system, the operations of nonbank type of financial institutions should be brought within the supervisory scope of national monetary policy. As I indicated in reply to one of the questions, I believe that the Federal Reserve Board has done a very admirable job, with the legal limitations imposed and the tools available; however, it could be much more effective by controlling the volume of a broader monetary base.

We appreciate the opportunity of participating in your study of this most important subject, and if I can be of any further assistance, please let me know.

Very truly yours,

FRANK E. JEROME, *President.*

REPLY TO SENATOR BYRD'S QUESTIONNAIRE BY FRANK E. JEROME, PRESIDENT, SEATTLE-FIRST NATIONAL BANK, SEATTLE, WASH., MARCH 25, 1958

1. Inflation is a rise in price level; deflation is a decline in price level.

2. It is not possible to avoid inflation and deflation completely. They can merely be moderated; and it becomes a matter of judgment whether price stability takes priority over economic growth and stability of production and employment. Fluctuations in the price level can be moderated by (1) a compensatory budget policy—deficits when deflation is the problem and surpluses when prices are rising, (2) monetary controls which encourage or discourage the extension of credit, and (3) a better balance between the statutory rights of management and labor. There should be an elimination of monopolistic practices by labor as well as by industry. The goal should be to maintain a fair relationship between wages and the productivity of labor.

It would not be desirable, nor would it be possible in a free-enterprise system to avoid moderate ups and downs in price level which are part of a constant pattern of adjustment. Furthermore, there is the intangible but nonetheless real factor of public confidence. The psychology of the businessmen and of the consumers is bound to play an important role in determining the direction in which our economy will move at any particular time. A method for controlling this element of public psychology would be necessary if business fluctuations were to be entirely eliminated, and such a method has yet to be devised.

3. From 1942 to 1950 the Federal Reserve System was concerned primarily with maintaining a firm price for Government securities. This may have been a necessary policy during the war years, but in peacetime it introduces a rigidity into the money market which is strongly inflationary in its impact. Since 1951 the "Fed" has made intelligent use of normal tools of monetary policy as a restraint in boom times and an encouragement to credit extension in recession periods. The supervisory authorities have done an excellent job since 1951 with the legal and economic controls at their disposal, especially when consideration is given to the limitations imposed upon monetary control by fiscal policy and the implications of the Employment Act of 1946.

4. This most recent inflationary thrust apparently was due to increases in wages at a rate in excess of increases in productivity, combined with an attempt to maintain profit margins by passing these cost increases on to the consumer. This wage-price push has only recently become the most prominant inflationary factor. During and immediately after World War II the major influence was increase in the money supply through rapid expansion of the Federal debt. Subsequently a rapid growth of private debt brough a similar result.

5. The management of the public debt, in terms of the types of issues sold, their maturities, etc., has a very important influence upon banks, and other financial institutions which hold a substantial share of their assets in Government securities. The phrase "national credit structure" probably needs further definition. We have the Federal Reserve System and the commercial banks where the effects of the management of the public debt would be more clearly reflected. However, the national credit structure must be deemed to include savings banks, savings and loans associations, life insurance companies, Government lending agencies, credit unions, small-loan companies, and a host of other elements.

There is no question but what the current public debt has great effect on the commercial banking system of the country. The effect is a good deal less, however, when the United States Government obligations are being marketed on "free" market rates rather than artificially controlled rates. Thus, at the present time, the management of the public debt (as opposed to its increase or decrease) is just one of many items to consider in determining the supply and demand of money and the resultant interest rate. The management of the current public debt is on a sound basis at the present time.

6. (*a*) All of these objectives are desirable, yet undue emphasis on any one could defeat the other two. The most important of the three is economic growth because economic growth means future increases in production and consequently improved living standards. The second objective, stability of production, demand, and employment, would have to be ranked next. By this we mean stability around

a rising trend line. Price stability, too, is important, but it has to be sacrified in part if it prevents economic growth or enforces excessive or prolonged unemployment.

In discussing the relationship of the three listed objectives of economic policy in the United States, it appears that economic growth depends upon the economic freedom enjoyed in this country. Freedom to make a profit in our economic system necessarily includes the freedom to have a loss or go broke. The freedom to produce in unlimited quantity necessarily includes a right to produce too much or too little in the form of goods. Overproduction or underproduction are relative terms, since they are always relative to the consumption of goods. The latter in turn is dependent upon the purchasing power of consumers, advertising and sales effort, and various other factors. As long as we have the freedom of production in a free economy rather than in a managed economy, we are bound to have periods of relative overproduction or underproduction which will have their effect on prices and employment in our economy.

If we were to place price stability as our primary objective, we would have to move much closer to a regulated economy with direct price and wage controls and the like. Freedom is also a relative concept, but we cannot have our cake and eat it too. We cannot both have freedom and be free from the implications of that freedom at the same time. The relative advantages of a free and therefore dynamic economy greatly outweight the advantages of a shackled and limited economy.

In reaching this conclusion, we are aware of the fact that with freedom in the economy there will be times when there are persons unemployed. It would be desirable to have freedom from unemployment along with a free and dynamic economy, but these two objectives are not always completely compatible. Adequate unemployment compensation for those persons thrown out of work with swings in our free economy might be the best solution to this problem. Such a remedy would be preferable to a more regulated economy.

The use of monetary control, and to some extent the management of the fiscal policy of the Treasury, are excellent types of indirect methods of control to use for the purpose of preventing extravagant inflation or deflation, while leaving our economy free and not "managed."

(*b*) Over the entire postwar period the objective of economic growth has been achieved beyond our fondest expectations. Stability of production, demand, and employment has also been maintained. The recessions of 1949 and 1954 were neither severe nor prolonged. The one objective which has suffered has been price stability. The current recession is in part a reaction against rising prices, and the temporary instability in production, demand, and employment is a means of slowing the price inflation. This probably means also a somewhat reduced rate of economic growth.

7 and 8. Spending and taxation must be considered together because the most important effects are felt when spending exceeds taxation, or vice versa, the former being inflationary and the latter deflationary. Apart from this rather obvious conclusion, the following additional observations may be made about Government spending and taxation:

(*a*) Heavy Government spending, as now, tends to be inflationary even with a balanced budget. This is true because the money spent by

Government is a more effective stimulus than the same money in the hands of the taxpayers who would save at least a portion of this money; also, because a substantial portion of taxation shows up in the form of higher prices. The latter is particularly true with respect to the corporate income tax since corporations measure their profits in after-tax terms and the tax becomes an element of cost which is passed on to the consumer.

(*b*) Heavy Government spending is a stabilizing influence in the economy since it does not fluctuate for the same reasons nor necessarily in the same direction as the spending of business and individuals.

(*c*) Government expenditures have some influence both pro and con on economic growth. Heavy taxation clearly tends to discourage the expansion of business and industry. On the other hand, Government expenditures for research in military and nonmilitary fields are a contributing factor in continued growth.

(*d*) Federal, State, and local taxation has exceeded 30 percent of national income in recent years. A more rational and less discriminatory tax system would release more money for discretionary investment by private citizens and help develop our free economy. It seems logical that a tax system which would give more incentive to ambitious entrepreneurs would help to develop a large economic base from which to draw the tax funds for necessary Government expenditures.

9. Fiscal policy relates to the budget, taxation, and management of the public debt. It involves such things as the budgeting process, appropriation backlogs, rate of expenditure of funds, and the sale of Government securities. Monetary policy, on the other hand, relates to the availability and cost of money and credit. On the fiscal side clearly the most important single question is whether the budget runs a surplus or a deficit. Even within a given budget, however, the timing of expenditures within the year, e. g., the speedup or slowdown of military procurement, can have quite a short range effect on the economy. The decisions of the Treasury with regard to the types of securities issued, particularly their maturity, has a good deal of effect on the availability of funds in the short-term versus the long-term market since Government securities are such an important element in both markets. Monetary policy is administered principally through three devices: the reserve requirements enforced on member banks of the Federal Reserve System, the discount rate of the Federal Reserve banks, and the open-market operations of the Federal Reserve in purchase or sale of Government securities. These can be quite effective devices for limiting the supply of credit and increasing its cost during a boom period.

By increasing reserve requirements, increasing the rediscount rate, or by selling in the open market, the Federal Reserve System has a method of reducing the loan potential of the commercial banks in the country. Of course, an increase in reserve requirements after many banks are approaching the "loaned-up" position would be a very harsh tool to use and could force disastrous liquidations of assets. If reserve requirements were on a more reasonable basis to begin with, such as the reserve plan advocated by the ABA, then reserve requirements could more properly be raised to help absorb large excess reserves at the beginning of an inflationary threat. An increase of the rediscount rate or selling in the open market are better tools to implement credit restriction after the inflationary trend has gained impetus. This would result in local banks screening their loans and making fewer of them. This would have a discouraging effect on expansion of business and consumer expenditures and would tend to reduce the threat of inflation. It is not so certain that the monetary controls are effective on the downturn, since the mere fact that credit is available does not mean that people will have either the need or the courage to borrow.

Selective control by the Federal Reserve can also be used to combat inflationary tendencies in particular segments of the economy. Raising margin requirements is an effective method of curbing unhealthy speculation in the stock markets. Regulation X on real estate credit and Regulation W on consumer credit may have to be utilized again in the future to avoid excessive expansion in these fields. The impact of selective controls, which affect all lenders, does point up a weakness in general monetary controls. As was pointed out in the answer to question number 2, the commercial banking system is only one portion of the national credit structure. The money and credit flowing outside the commercial banking system are not directly subject to general monetary controls. The expansion of funds handled by financial intermediaries such as life insurance companies and savings and loan associations tends to diminish the effectiveness of the general monetary controls of the Federal Reserve.

10. Both the monetary and fiscal systems of the United States today are substantially adequate. The budgeting process is extremely complicated and tends to escape control. Unfortunately there seems to be no simple solution to this problem.

11. (*a*) The paradox of inflation and unemployment existing side by side is not one which has ever existed for long, nor is it likely to. So far as the current situation is concerned, it is well to remember that we have cushioned the effect of wage losses by unemployment compensation payments. This is a very desirable thing, but it also cushions the reduction in demand which would force price adjustments. Another factor is that management policies in the large industries such as steel and autos have been directed and are directed at the present time to maintaining prices even with decreasing demand. This causes delay in the normal functioning of supply-demand factors.

(*b*) We need not accept a gradual inflationary trend as desirable or necessary. It may be that some further inflation is inevitable in the next few years, since the working age group in the population is not now increasing as fast as the total population, and will not be doing so until we begin to get the benefit in the labor force of the increased birth rate during and after World War II. The relatively short labor force of the past decade has resulted in increased bargaining power for labor and has been a part of the wage-price spiral.

It would have to be conceded that a degree of inflation might be necessary if the country were going to avoid any degree of unemployment at all. It would be our preference, however, to substitute unemployment compensation to an adequate extent, maintain a free economy, and endeavor to maintain a sound dollar so far as this was consistent with a growing economy. There would be swings in the value of the dollar, but our other objectives do not necessitate a constant weakening in the purchasing power of the dollar.

12. Private debt in the years since World War II has increased much more rapidly than the growth of the economy. This clearly is a

situation which cannot continue indefinitely. It has tended, however, to restore the normal historical relationship between private and public debt, and in fact we probably can afford to have private debt increase at a faster rate than gross national product for some time in the future. The over-all debt situation is not alarming. In some areas, notably installment credit, the increase has been too rapid at times and in effect has borrowed against the future. This certainly was the case with the rapid increase in installment credit in 1955. On the other hand, the amount of Government debt, and especially the probability of its increase rather than its payment, may eventually become a threat to the stability and vitality of our economy.

13. The Federal Government should be very cautious about moving in a major way to counteract a downturn in the economy. The operation of the Federal Government on a deficit basis will definitely have an inflationary effect. The long run threat our economy faces is inflation. Any rash moves now would fan the fires of the ultimate long-term threat. There is danger of being panicked into major actions like a substantial tax cut, or a big public works program, in order to pull ourselves out of a recession which will correct itself in a matter of months. Too rapid or drastic action could very easily put us back on the inflation treadmill which we were walking a year or two ago. No one, however, can be completely certain that the analysis of this recession as a healthy correction, not too deep or prolonged, is a correct one. Roughly the danger signals would be a reduction of 15 percent in industrial production or 5 percent in consumer demand, or an unemployment level of 10 percent. These are subjective judgments which are difficult to defend or to apply in a particular situation.

14. Deficit spending by the Federal Government since the end of World War II has had some inflationary effect, but the great increase in debt during this period has been in private debt. While Federal Government debt increased by $20 billion from 1950 to 1957, consumer debt and real estate mortgage debt increased by a total of over $100 billion during the same period. It is well to point out, however (a) that we have failed to reduce the national debt substantially during good times, and (b) that the war-time increase in the Federal debt, and particularly its monetization through the banking system, provided the base for postwar inflation.

15. Both full employment and stable purchasing power are relative terms rather than absolute. In both cases there must be moderate fluctuations, and with this understanding, they are consistent with each other. Full employment can be maintained while maintaining a dollar of stable purchasing power. The concept of full employment must be flexible enough, however, to encompass a level of unemployment and job turnover which avoids competitive bidding for labor that raises labor costs more rapidly than productivity.

It is going to take a change in public thinking, however, if both goals are going to be attained. At the time of every business downturn there will be pressure to ease monetary controls and to follow a deficit financing program by the Government. Recent history shows that when the crisis is past Congress will continue to spend all of the tax money and still may not operate on a balanced budget. Then when the next downturn in business comes, there is further deficit spending. We are going to have to face up to the situation of allowing our economy to right itself through its temporary recessions or to reducing the public debt in times of relatively full employment if we are going to maintain the value of the dollar. As long as we continue deficit spending and never make any more than a token effort at repayment in good times, then we will have continuing inflation over the long pull.

16. Escalator clauses tied to the cost of living are not necessarily incompatible with economic stability. They endeavor to protect the employee against influences in the economy beyond his control. Escalator clauses which involve a productivity factor, on the other hand, are unsound if they allocate all of the benefits of increased productivity to labor and make it impossible to reduce prices. This clearly has an inflationary impact. Moreover, it must be recognized that the opportunity for productivity increases is greatest in manufacturing enterprises where this sort of escalator clause is most prevalent. If relative price stability is to be achieved, it will have to be through a combination of lower prices for manufactured goods where productivity can be raised, and higher prices for services where the productivity factor is pretty well fixed.

17. The major reasons for this recession are reductions in expenditures for capital goods and business inventories. These in turn reflect a rapid increase in productive capacity and the reluctance of consumers to absorb the increased output at current prices. In a large sense, what we are undergoing is a rebellion against rising prices. This is an inevitable reaction to the inflation of recent years. We apparently have reached the low point of the recession, although no substantial recovery is indicated for several months. No immediate action to terminate the recession seems advisable. If the forces of recovery are not self-generating and action is required at a later date, a substantial tax cut would probably be most effective and least disruptive to the normal functioning of economic forces.

KAISER ALUMINUM & CHEMICAL CORP.,
Oakland, Calif., April 7, 1958.

Senator HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: I appreciate your invitation for me to express views to the Senate Finance Committee concerning financial and economic problems of the United States. There is one thought I should like to add to the vast expert and detailed comments your committee has assembled.

I believe that the beast of deflation can be worse than the beast of inflation in the consequences inflicted upon the people.

Therefore, it is vital that policies of credit and other governmental regulations not be carried to the point of artificially creating deflation and depression.

It is my firm conviction that the American people should continue, for generations to come, making tremendous forward progress throughout our economy—in industry, business, standard of living, science, the new industry of discovery, and in all fields of supplying more and more things for more people.

So positive steps should be taken to keep business, industry, and employment constantly expanding. That is the true destiny for America—expansion and growth—with always higher levels being achieved in the economy.

My sincere wishes that your committee may make some real and lasting contributions to the Nation's welfare and strength.

Sincerely,

HENRY J. KAISER.

THE B. F. GOODRICH CO.,
Akron, Ohio, April 1, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: Your letter of February 17 addressed to Mr. W. S. Richardson, who retired last August, requested comments concerning the definition of inflation and deflation, monetary and fiscal policies, and other vital matters affecting our economy.

I have attached to this letter my own comments and answers to the questions which you raised. If additional comment or information is required, you may be assured of my full cooperation.

Very truly yours,

J. W. KEENER, *President.*

1. Give a definition in your own words of "deflation" and "inflation."

Inflation or deflation is manifested in price changes. The usual definition of inflation or deflation is simply in terms of the price increases or decreases that have occurred during a given period. This type of definition is convenient and meaningful—the concept is readily understood. Actually, inflation or deflation is the complex economic-political process by which price changes occur. The useful definition of these terms must include an attempt to describe the economic process involved.

Starting first with the idea of inflation or deflation as a price change, several basic questions must be answered—for example, which prices are increasing or decreasing? The consumer usually defines inflation in terms of a rise in the cost of living or in terms of his income buying less goods and services. The manufacturer views inflation from a different viewpoint. More than likely he will define inflation in terms of price increases for those items that he is purchasing—raw materials, machinery, labor, etc. Both the consumer and the manufacturer may be aware of upward and downward movements in prices for specific items but the term inflation is generally applied only when the total dollar amounts available for spending purchase a smaller total quantity of goods and services. Thus, for the economy as a whole, inflation results when the amounts available for spending by all groups, including both earned income and borrowed funds, outrun the physical supply of goods and services.

It is my opinion that the term inflation should apply to any price increase for a given quantity of a particular good or service which does not reflect a commensurate increase in the quality or utility of that good or service. The severity of the inflation problem, then, is measured by the number and relative importance of the goods and services for which prices are increasing. For example, the decline in food prices from 1952 to 1955, probably the major factor in the relative stability of the overall cost of living during these years, tended to obscure the substantial rise in prices for many types of goods, and especially services.

In analyzing the inflation process, much of the confusion as to the cause of rising prices stems from the failure to consider the problem from the standpoint of both the manufacturer and the consumer. The manufacturer traces inflation to rising costs, since from his viewpoint inflation is manifested in rising prices for the goods and services which he buys. Moreover, rising costs largely refer to rising labor costs since employee compensation accounts for more than 70 percent of all national income originating in manufacturing industries. Employment costs for a single manufacturer may represent only one-third of the total costs for that firm but rising labor costs are reflected in the higher prices than the individual manufacturer must pay his suppliers for their products.

Incidentally, inflation from the viewpoint of the manufacturer has been a much more serious problem in recent years than inflation from the standpoint of the consumer. The cost of living rose 7 percent from January 1955 to January 1958, whereas during this same period, average hourly earnings in manufacturing industries increased by 14 percent (with little increase in output per man-hour to offset these additional costs), general-purpose machinery prices were up 25 percent, construction costs rose 13 percent, and overall industrial prices increased 10 percent.

This is the cost side of the equation. As costs to the manufacturer increase, these higher costs must be reflected in higher prices charged by the manufacturer if a reasonable profit is to be returned, and if the individual firm is to remain in business. The other side of the coin is, of course, demand—the ability and willingness of the consumer to pay the higher price. Unless the demand for the manufacturer's product is sufficiently strong, the price increase will not be effective. If the list price itself is not reduced, then the net price will be reduced through larger discounts, freight allowances, higher quality, more services, etc.

When prices rise because of inflationary wage increases (wage increases resulting in higher unit labor costs) only a portion of the consuming public enjoys an increase in income to support the higher price levels. Persons on relatively fixed incomes are forced to curtail purchases of some items. The ability of a manufacturer to pass along higher costs in the form of higher prices depends upon the strength of demand for his product relative to alternative items and the competitive structure of the industry in which he competes.

The facts indicate that manufacturers generally have been able to pass along in higher prices only a part of the cost increases. Corporate profits after taxes, for example, are estimated in 1957 to represent only 5½ percent of national income as compared with an average of 8½ percent during the years 1947–49. Because of the economic power and unrestricted freedom of organized labor, the manufacturer in effect has been forced into the position of transferring purchasing power from the shareholder to the wage earner, from persons with fixed incomes to the wage earner, and from creditors to debtors.

Inflation can, of course, originate on the demand side of the equation. A sudden rush of consumer demand, usually financed by debt creation, may result in higher prices. Demand-type inflation such as that following the invasion of South Korea may result in a sudden increase in profits. However, experience has shown time and again that the demand-type inflation is short-lived. Pressures for higher wage rate boost costs and supply is soon increased to handle the spurt in sales volume. On the other hand, inflation originating on the cost side is the far more persistent problem. There are no automatic adjustments to offset the effects of unrestricted use of economic power on the part of organized labor or the long-range favorable demand situation for the services of labor.

Inflation, then, is really the interaction between those forces making for higher costs and the ability and willingness of the consuming public to pay the higher prices.

In attempting to define inflation and deflation I have concentrated on the inflation problem. It is my opinion that inflation represents the far greater threat to our national well being. This is not to say that in the future we will not be faced with economic declines such as at present but the cost rigidities which are a part of our economic structure tend to limit price declines. The factors limiting the magnitude of price declines during a business downturn seem to be far more effective than the factors limiting price increases during a rapid upswing in business.

I would define deflation as a reduction in the price of a particular goods or service which has the effect of reducing either labor or property income. Theoretically, prices for many types of goods could be reduced on a long-term basis as a result of increasing productivity. An increase in output per man-hour with a smaller percentage increase in hourly wage payments would result in lower unit labor costs which, in the competitive process, would result in lower prices. The process of distributing productivity gains through lower prices rather than increasing wages or profits would not result in a decrease in income but would represent a gain in real income for the general public. A price reduction, based on increasing efficiency of industry, would not be defined as deflation.

If prices are reduced because the physical supply of goods and services has outrun the amounts available for spending, the result will be lower money income. A lack of effective demand will reduce profit margins, lower production volume, and finally reduce total wage and salary payments. In a situation of relatively fixed wage rates the reduction in wage and salary income results mainly from reduced employment.

2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

The basic problem is not simply to avoid either inflation or deflation but to accomplish these ends without enacting a political strangehold on the competitive enterprise system and thereby eliminating economic progress. For example, I cannot conceive of any form of legislation which could be enacted in time to be effective in avoiding the demand-type inflation—a rise in prices resulting from a spurt in consumer demand. Perpetual price controls, consumer credit regulations, etc., would indeed be a drastic penalty to pay in order to avoid a situation which is soon corrected in the normal competitive process.

The same applies with respect to the problem of deflation. Shifts in consumer demand may temporarily result in an oversupply of a particular goods or service. Governmental programs to insure that prices for particular goods and services do not decline must inevitably result in a controlled economy.

There are, however, certain actions which the Federal Government and the Congress can take to discourage wage-push inflation. These actions, however, will require a fresh approach to the inflation problem. We have been attempting to deal with the problem of wage-push inflation by monetary and fiscal measures. Increases in reserve requirements, rediscount rates, tax rates, etc., however, do not deal with the real cause. They represent rather an attempt to create a counter-push by squeezing businessmen so that they will, in turn, resist inflationary wage demands. Experience of the past has shown that neither economic contraction nor industrial strife, both of which can result from this approach, have been effective as anti-inflation programs. The obvious answer is to diminish in some way the degree of economic power exercised by organized labor—reduce the pressure at its source.

To accomplish this end, it will not be enough merely to attach a few amendments to the existing body of antitrust legislation. Antitrust legislation and the usual Federal regulatory agencies were designed and operate to protect the general public from various abuses. However, present labor legislation and those agencies charged with the administration of this legislation really function to preserve legal immunities and economic power enjoyed by labor organizations and their leaders at the expanse of other groups of citizens. What is required is a new body of labor law which will shift the emphasis from the present policy to that of protecting the public from abuse by organized labor.

I do not advocate the diminution of economic power of organized labor to the point of destroying the collective-bargaining process. The threat of abuse stems mainly from the immunities of labor unions from laws and regulations which apply to everyone else, including business concerns. Roscoe Pound, former dean and professor emeritus of the Harvard University Law School, in a recent publication of the American Enterprise Association, summarizes these immunities as follows:

"1. Substantial elimination, as against labor organization, of what in practical effect is the assured method of enforcing the law applicable to everyone else.

"2. Refusal of labor organizations to be treated as legally responsible organizations by becoming incorporated and so legally tangible entities.

"3. Not distinguishing unlawful action by labor organizations, their leaders and their members, done outside of the employer-employee relation, from practices in that relation.

"4. Committing all matters affecting labor organizations to an administrative agency instead of confining its jurisdiction to matters involved in the employer-employee relation."

It is my opinion that legislative action to eliminate the immunities enjoyed by labor unions is the vital step which we as a Nation must take in order to avoid continuing wage-push inflation.

From a long-range viewpoint, the Federal Government can help avoid inflation by following monetary and fiscal policies which promote economic growth. I define economic growth largely in terms of the increasing efficiency of American industry. The postwar experience has shown that the American economy has a long-range growth potential of 3-4 percent a year; that is, the gross national product adjusted for the effects of inflation will increase on a trend basis by 3-4 percent a year. Only a fraction of the increase in our national output, however, results from the increasing size of the labor force. The bulk of economic growth stems from the ability of industry to increase the volume of goods and services produced per man-hour of labor. Increased investment in modern plant and equipment makes possible the rising trend in productivity.

The most significant contribution that business leaders can make in the fight against inflation is to be constantly on the alert and act on opportunities to improve productivity. Long-range planning of capital expenditure programs, now widely used throughout American industry, will help to promote more stable economic growth.

As long-range objectives, national monetary and fiscal policies should be determined with a view to balancing the Federal budget and to providing for a growth in the money supply consistent with our economic potential. This does not mean that in a given circumstance the budget should be balanced at all costs, nor does it mean that monetary policies should always be expansionary in character.

Our primary goal must be now, and for some years to come, to maintain a strong defense posture. However, most Federal expenditures are by their very nature inflationary in effect since they add less to the productive capacity of the Nation than would be achieved if the same volume of spending were accomplished in the private economy. It does seem possible, even at the present time, that a gradual reduction in Government spending could be achieved in many nondefense programs, particularly subsidies of various kinds, which promote high prices.

When tax reductions become possible because of increased revenues under existing tax rates or because of a reduction in expenditures, the tax reductions should be designed so as to maximize long-range beneficial effects. A major problem which faces this Nation is that of providing sufficient incentives to be more efficient, to add productive capacity, to make the necessary effort from which economic progress comes. The progression in personal individual income tax rates serves to promote inflation and to restrict incentives. Also, there exists the myth that business taxes are in some way paid out of profits without affecting the individual tax burden. In the final analysis, only individuals pay taxes. Corporate income and excise taxes represent costs of doing business and hence are reflected in general price levels. A balanced program of tax reduction should provide for a cut in business taxes as well as individual taxes.

3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942-57.

In retrospect it is clear that too large a portion of the Federal expenditures during World War II were financed by debt creation. During the fiscal years 1942-46 only 48 percent of the $382 billion of Federal expenditures were financed by taxes. The result was a sharp increase in the money supply from $74.2 billion in June 1941 to more than $171 billion by June 1946. Monetary policy during World War II seems to have had one purpose: to facilitate financing of the war effort without regard to the postwar problems that were being created. The result was that monetary policies during the early postwar years could hardly be effective in controling price inflation or in stimulating business activity during the 1948–49 downturn. As long as the Federal Reserve System was required to support the prices of Government securities, monetary control policies were bound to be largely ineffective.

The accord with the Treasury made it possible for monetary policy to be effective in restricting growth in the money supply relative to the increase in physical output of goods and services. The switch from tight money to easy money in 1953–54 was taken in anticipation of a downturn prior to the fact. Experience has shown that a switch to easy money does not in any way assure an upturn in business activity but the switch can set the stage for another round of inflation when an upon turn does occur. The basic problem is, of course, that monetary controls can produce contraction in business activity, but it is possible to have a contraction in business activity with price inflation still continuing.

The recent turn of events supports this statement. It is possible that monetary policy in recent years has been to restrictive, thereby contributing to the sharp decline in industrial production in the past 12 months. From the fourth quarter 1954 to the fourth quarter 1957, the gross national product increased by almost 18 percent. During this same period, the total money supply increased by less than 9 percent, and if time deposits are excluded from the calculation, the increase was only 3 percent. Yet during these 3 years, the cost of living rose by 6 percent and industrial prices were up almost 10 percent.

4. Beginning in August 1956 there was an increase in the consumer price index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

The rise in the Consumer Price Index from August 1956 through September 1957 may be traced to three basic sources:

1. The 7½ percent rise in retail food prices from March 1956 to September 1957. (Food prices get a weight of almost 30 percent in the Consumer Price Index.)
2. A continued uptrend in prices for services included in the Consumer Price Index.
3. The 6 percent rise in straight-time average hourly earnings in manufacturing industries during this period with little, if any increase in output per man-hour to offset the additional costs.

The relative stability in the Consumer Price Index in the 5 years prior to August 1956 was based to a large extent upon the decline in food prices which started early in 1952. In spring of 1956, however, this trend was reversed; rising prices for services and many types of goods were no longer offset by lower food costs, thereby pushing the entire index upward.

According to the United States Department of Labor, higher wage rates in 1956 were not offset by productivity gains as in previous years. In the rubber products industry, for example, it is estimated that output per man-hour in 1956 was actually lower than in 1955, yet sizable wage increases went to organized labor during this period. The rise in prices was, of course, made possible by the generally strong level of demand in most segments of the economy during 1956, particularly demand for capital goods. The sharp increases in plant and equipment expenditures during that year were accompanied by sizable increases in construction and machinery costs.

5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

Management of the public debt represents an important tool of monetary policy. When the debt is managed so as to increase the average maturity of the marketable debt, the Treasury is competing with corporate, State, and local government and mortgage borrowers for a limited amount of funds. The effect of lengthening the average maturity is to tighten the money market. A move in the other direction is consistent with an easy money policy.

Clearly, the management of the public debt should at any given time be consistent with the objectives of other instruments of monetary policy. The long-range objective of debt management should reinforce the long-range objective of fiscal and monetary policies to promote economic growth and price stability.

A gradual lengthening of the average maturity of the debt is desirable. At times, however, a temporary reversal of the long-range objective may be necessary. The lengthening in the average maturity accomplished since October 1957 has been consistent with the tight money policy during a period of sharp business contraction.

6. (*a*) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand, and employment.
3. Economic growth in production, demand, and employment.

(*b*) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

It is my opinion that the primary objectives of economic policy in the United States should be:

1. Economic growth in production, demand, and employment.
2. Price stability.

Comments on the economic polices of the United States since World War II and in recent years are included in answers to previous questions. As a general comment, the economic policies of the United States must stress growth above everything. Certainly balanced economic growth will not be accomplished unless a solution to the problem of persistent pressures on costs is found. Economic growth with rising costs and rising prices will mean that large numbers of people in our economy will not be able to share in the benefits of such growth. The growth rate itself will be limited by this fact.

There will be little, if any, progress for those who are not in a position to increase their incomes, at least in line with the rising price level.

I do not believe that we must accept a gradual inflationary trend as either desirable or necessary in order to maintain full employment or to insure economic progress. Arguments in favor of creeping inflation are not at all convincing. There is no evidence that a gradual rise in price level will in itself insure growth. Moreover, a creeping inflation of only say 2 percent a year becomes a serious inflation in a matter of a few years—22 percent in 10 years, and almost 50 percent in 20 years. Those who advocate a gradual inflationary trend as necessary provide us with no criteria as to the extent of the inflation that should be permitted—whether it should be 1 percent, 2 percent, 3 percent a year, etc.

7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

Certain comments with respect to the effect on our economy of current governmental spending and taxing programs have been included in the answers to some of the above questions.

The effect on our economy of governmental spending and taxing programs is summed up in the fact that Federal, State, and local government purchases of goods and services account for 20 out of every 100 dollars of our gross national product and that the total of all government spending equals nearly 30 out of every 100 dollars of national income. Federal Government purchases account for 11½ percent of our national output and State and local governments for about 8½ percent. These percentages indicate the extent to which governmental agencies make decisions which affect the allocation of our national production and economic resources.

State and local government expenditures are tied closely to the trend in population and to shifts in population. In the past 10 years these expenditures have shown a steady upward trend. The bulk of outlays for these governmental units are for school and highway purposes which are certainly necessary from the standpoint of promoting long-term economic progress.

Federal Government spending has proved to be far more volatile, mainly because of changes in the level of defense expenditures. The sharp downswing in defense spending in 1953 was undoubtedly a major factor contributing to the business decline at that time. I believe also that the sharp cutback in defense orders in the last half of 1957 has been an important factor in the current economic decline. If it was possible to smooth out the rate of Government order placement, at least during the fiscal year, there would be an important contribution to a more stable economic growth.

9. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy, and then relate them, one to the other. Please discuss these policies stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

Fiscal policy deals with the amount, the type, and the timing of governmental spending and taxing programs. Fiscal policy can be and has been an important vehicle for shifting the distribution of income in the United States—for altering the allocation of our Nation's economic resources.

The net effect of fiscal policy, is, of course, reflected in the balance between expenditures and revenues—the deficit or surplus position. A moderate cash surplus exerts a mildly contractive influence and often is helpful in pursuing a policy of price stability. A long-term objective of a balanced budget with a moderate surplus to accomplish a gradual reduction in the Federal debt would seem to represent a sound policy.

Monetary and credit policies, of course, deal with the supply of money and the amounts and terms of available credit. I have commented earlier as to the effectiveness of monetary policy in controlling inflation or avoiding deflation. It is imperative that we do not overestimate the ability of either fiscal or monetary measures in themselves to expand economic activity. The soundest way to foster economic growth is to adopt those fiscal and monetary policies which are consistent with maximum effort in the private economy.

It is not possible to be categorical about specific monetary or fiscal policies which would apply in all situations. In a sharp business downturn it is possible that certain fiscal measures will have to be adopted on a temporary basis to stimulate a return to reasonable levels of business and employment. These temporary fiscal measures may or may not be consistent with the policy of attempting to solve the long-term inflation problem.

10. (*a*) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank credits.) Also, please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

(*b*) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

I have no additional comment on this question.

11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

(*b*) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

I believe that inflation and unemployment can exist side by side in our economy for reasons discussed in the answer to question 1. The answer basically is that not all prices increase or decline at the same time. At any particular time, the price of labor may rise relative to the price of other items. This in turn boosts unit production costs which puts pressure on final prices. The higher price for the product or service may restrict the growth of the market for the product or service with possible result of a decline in production and employment.

12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy?

It is my opinion that the growth in the private debt in recent years does not pose a threat to the stability or vitality of the American economy. There has, of course, been much concern expressed over the rise in consumer debt, particularly in 1955, as a result of the sharp increase in automotive sales that year. There is no question that at a particular time a boom in consumer credit and a boom in business borrowing will contribute to inflation and that on the downside, a sharp reduction in borrowing by either business or consumer will aggravate the situation.

As a general rule, the consumer has done an excellent job in handling his accounts, even in a situation of serious business decline. In the two previous postwar recessions, consumer credit actually increased, providing an important anchor around which the business upturn was eventually achieved. It is possible in the present decline that consumer credit will contract but there are no magic formulas by which the actions of consumers can be predicted or changed. A restrictive monetary policy can be helpful in discouraging speculative excesses in borrowing during boom conditions and an easy money policy may encourage debt creation during a period of business decline.

13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy?

There are no precise statistical measures which indicate at what point the Federal Government should take action to counteract a downturn in business by reducing taxes or increasing expenditures. To evaluate the trend in general business conditions we find it necessary to examine trends in many statistical series—unemployment, production, consumer income, retail sales, etc. Our viewpoint as to trend of business in the months ahead is really a matter of judgment as to what these individual trends portend. The danger of using a single guide to action, such as 6 percent of the labor force unemployed, is that such a measure does not consider who is unemployed, how long have they been unemployed, is the increase in employment the result of a large influx into the labor force (which for statistical purposes is poorly defined), a decline in employment opportunities, etc.

14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

Federal Government deficits have not been a major factor contributing to inflation since World War II. In fact, for the period since World War II, taken as a whole, the Federal Government has run a small cash surplus. This does not mean that governmental spending and taxing programs have not encouraged inflation.

15. Can full employment goals be attained while maintaining a dollar that has relative stable purchasing power?

The answer to this question depends upon the definition of the term "full employment goals."

In a free economy the allocation of economic resources is largely determined by consumer choice manifested in millions of individual spending decisions. Mobility of labor and capital from company to company in the same industry and from industry to industry is required at all times in order to adjust production higher and lower with changes in consumer demand. Shifts in consumer demand are frequently sudden and the adjustment in production is not immediate, with the result that both labor and capital in a particular situation may be temporarily unemployed. If the consumer is to be allowed free choice in the expenditure of his income, then it is impossible to guarantee him 100 percent employment at all times. Thus, full employment in the sense of a job for everyone can only be attained in a completely state-directed economy. Such a concept is not only incompatible with a free society but it is also incompatible with the maintenance of a stable dollar.

The problem then, is to achieve a balance between the maximum employment of our economic resources on the one side, and the goals of a free society and the maintenance of a stable dollar on the other side. This is the kind of balance, however, that does not lend itself to precise calibration terms of a percentage of the labor force that is unemployed. For example, should Government action be taken to increase employment when unemployment is equivalent to 4 percent, 5 percent, 6 percent, et cetera, of the labor force? There is wide disagreement on this point.

The matter is further complicated in that the interpretation of available statistical information on unemployment is uncertain. The Department of Labor reported that on February 28, there were 5,170,000 unemployed, but this figure included approximately 700,000 persons who had not been working in 1957, in many instances wives and children in families where the major wage earner had been laid off. Also, the unemployment figures include persons who ordinarily work part time, such as wives, but who are not seeking, nor would they accept, fulltime employment.

These are the problems with which Congress wrestled in drafting the Employment Act of 1946. As a result, this legislation was not formulated on the premise of a 100-percent-employment goal, but instead provides that it is the continuing policy of the Federal Government to use all practical means to create and maintain employment opportunities for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power in a manner calculated to foster and promote free competitive enterprise.

It is my firm conviction that economic progress can be achieved without accepting a gradual inflationary trend and that reasonably full employment of our economic resources can be achieved while maintaining a stable dollar, provided we find some solution to the problem of wage-push inflation.

16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

By their very nature, escalator provisions in wage contracts insure that those covered by the contracts will receive wages at least in line with the trend in price levels. In inflation situation, those persons whose incomes are relatively fixed will suffer a loss in real purchasing power. In fact, a transfer of purchasing power from persons with relatively fixed incomes to those in a position to obtain cost-of-living adjustments takes place. The long-term labor contract with the annual improvement factor and the escalator provision are relatively new in business experience. The full economic implications of these provisions are by no means clear though they have served to foster wage-push inflation. It does seem likely that in view of the trend of business at present and in view of the limited increase in output per man-hour in recent years, businessmen will carefully evaluate the possible advantages to be gained in granting contracts including these provisions in the future.

17. List and briefly discuss what you consider the causes of the present recession, and what should be done to terminate it.

Comments as to the major factors in the present business downturn are included in answers to previous questions. With respect to governmental programs which might be desirable in these circumstances, I am of the opinion that it would be the best part of prudence to defer major governmental action temporarily. It is quite possible that the trend in business activity is now bottoming out with the possibility of healthy gains in the level of business activity by the end of 1958. Some further easing in the monetary situation seems desirable. There is a possibility, however, that just at the time when business turns upward, significant shifts in monetary policy, sizable tax cuts, and a huge Federal deficit will all result in setting the stage for a serious round of inflation in 1959 and later.

J. WARD KEENER.

O

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INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES

COMMENTS OF EXECUTIVES OF CORPORATIONS IN RESPONSE TO THE QUESTIONNAIRE

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE
EIGHTY-FIFTH CONGRESS
SECOND SESSION

CHAPTER 3

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F. W. WOOLWORTH CO.,
New York, April 14, 1958.

Hon. HARRY F. BYRD,
Committee on Finance,
United States Senate,
Washington, D. C.

DEAR SENATOR BYRD: Reference is made to your letter of February 17, with which you enclosed a list of questions to which you desired answers, pertaining to the economy of the country. I have prepared answers to your questions and enumerate them herewith in the order in which they appeared on the list which you sent me:

1. I would define inflation as a general rise in the price of goods and services, whereas deflation represents a general decline in these prices.

2. It is questionable whether we can avoid periodic intervals of inflation and deflation under our free enterprise economic system. It would appear that under this system we will continue to have cycles, ups and downs in business. However, along with these fluctuations, it is safe to predict that free enterprise over the long term will continue to produce a rising standard of living and economic growth.

If the evils of inflation are to be avoided, at least, in part, then all the areas that contribute to inflation should be considered. A few of these contributing factors are corporate tax laws which encourage debt financing because the Government pays half the interest cost; wage boosts in excess of productivity; demands for more Federal, State and local facilities and services, regardless of the condition of the market for men, money and materials.

3. In the sense we use the term monetary control today, to limit excesses on both the up side and down side in general economic trends, one could almost say that monetary control did not exist in 1942–50. We ran a pegged bond market to make World War II and the Korean war financing as cheap as possible for the Treasury. Direct controls were introduced to restrain consumer competition for goods. Under emergency war conditions, this form of monetary control has its place.

In the light of hindsight, one might be critical of one or another Federal Reserve Board moves and their timing during the 1951–57 period. The August 1957 discount rate boost was unfortunate, and the 1954 hypodermic, under the influence of the same kind of recession, political pressure that we see today, helped foster the 1955–56 excesses that have largely produced the present recession. However, in spite of the Board's occasional miscues, its operations by and large deserve public commendation.

4. Considerable factors in the decline in the value of the dollar during the period August 1956-September 1957 were:

(1) The rise in farm-food prices due to the farm price support and related programs.

(2) The rise in unit labor cost out of proportion to productivity gains.

(3) The delayed catchup in rents with other prices as controls were relaxed.

(4) The rise in the price of services which involve labor predominantly.

5. Without meaning to sound overly critical, what has been done in the area of Federal debt management might be described as opportunistic. Should not periods of boom be used to reduce war credit debt? Should not periods of favorable bond market conditions have been used to anticipate future bunching of maturities? Should not demands on the Treasury for public works projects be minimized in boom times? Members of the Senate and the House must assume responsibility for the fact that certain of the measures they pass force the Treasury, the Federal Reserve Board, and other prudently managed Government agencies to depart from sound practices. Given acumen and objectivity on the part of our lawmakers, the public debt imposes no threat to our national credit structure or to the United States economy. In fact, properly administered, the public debt is an instrument for economic growth.

6. (*a*) It would appear that economic growth is our most important national objective. Such growth, based on a rise over the long term in per capita real income, means a rising standard of living for everyone.

(*b*) Since World War II, we have faced a relative shortage of workers. However, vast corporate investments in new plant and equipment have increased productivity. Without this stepup in productivity, inflation could have been quite out of hand.

The downswing in 1957 can probably be traced to the following: Monetary policy; repudiation of payments against defense contracts; fright freeze in placing defense orders inspired by sputnik and the business correction of the 1955–56 overstocking.

7. Government is the economy's biggest single customer. This should answer the question. However, one might add that construction spending by Government should be planned as much as possible to dovetail, not compete with private investment. The coming 2 to 3 years would appear to put an added burden on public investment as private investment takes the breather needed to absorb heavy 1955–57 outlays.

8. Taxes inevitably find their way into the price structure. For this reason, high taxes have an inflationary effect.

9. A growth economy, of course, is much to be preferred as against a stable economy. As for reconciling the dual objectives of monetary and fiscal policies. This, I believe, has been dealt with under paragraphs 3 and 5.

10. (*a*) Our present monetary system seems well geared to support a private enterprise economic society and to promote growth. As it has since the inception of the Federal Reserve System, experience should continue to improve the capabilities of monetary controls. This should provide adequate groundwork for maximum cooperation with the Treasury Department in handling its problems. But it would appear that a great deal needs to be done by the Federal Reserve Board to acquaint public and business bodies with its objectives and the plans for achieving them; and by these same public and business groups in accommodating their financial programs to the demands of the national monetary policy.

(b) Previously covered.

11. (a) Two reasons might be given for this seeming paradox:

(1) The Bureau of Labor Statistics last year published the results of a study that acknowledged what many have pointed out for a good part of the postwar period—that the rise in labor costs, in excess of productivity increases, has been the main inflation stimulus. Prices thus remain firm to rising, irrespective of employment levels. Escalator clauses and 3-year contracts contribute inflexibility features that add to the paradox.

(2) Unemployment affects primarily workers in factories and mines, and these now represent roughly only 1 out of 5 members of the United States work force. The vast remainder in banking, Government service, retail and wholesale trade outlets, and services, all maintain their need for things and relatively undiminished capacity to pay for same.

(b) It is not a matter of choice any more. As long as the Employment Act of 1946 remains on the books, we have the basis for persistent inflation. This act which requires the infusion of artificial stimuli to maintain full employment, tends to impede healthy readjustment even during a period of moderate downswing. However, we are all morally bound to work to minimize unemployment and the distress it can bring. This is a social luxury and luxuries usually demand something extra in the way of price. The extra price, in this case, is inflation, paid for by the consumer in rising living costs.

12. Rising private debt is a characteristic of and essential to the growth vitality of the American economy. Our businesses and people require the credit to create and buy the goods and services that go with a growing population and a rising standard of living. But debt admittedly is a leverage factor in business cycles and it might be well to examine the manner in which our tax laws encourage business debt creation and penalize moneyraising via equity financing. However, despite occasional periods of excess, rising personal debt is an essential and sound factor of United States economic growth.

13. This question encompasses a range of problems, assumptions, and possible antidotes that defy a general answer. Due to the fact that we have not utilized the boom years and the low-bond yield periods to reduce war-created Federal debt, and that the war-created tax structure was not realined to something much closer to a civilian economy, we have not left ourselves the flexible range of action that might best deal with recession tendencies.

Not having done these and other rational things, we now feel compelled to act expediently, if not wisely. It would appear that the least damaging in terms of the long-range inflation threat would be a further cut in reserve requirements by the Federal Reserve Board and a 1-year, 10 percent personal and corporate income-tax cut.

14. It would be difficult to isolate Federal deficit financing since World War II as a main inflationary force. By not having a long-term retirement program for war debt and by delaying so long after the Korean war started to impose controls, we fostered inflation. Federal deficit financing unquestionably contributed to inflation pressures, but it was probably more of a piece with other directly related causes such as farm price supports, etc.

15. There is some question as to what might be full employment under various conditions. If we cannot eliminate cycles of sharp in-

ventory accumulation and decumulation, standards of employment must be measured by the period in which we are then operating. In a large measure, however, we can approach minimal unemployment with relatively stable prices if we embrace the comprehensive attack on inflation forces as outlined above, under paragraph 2.

16. In wage contracts, combined cost-of-living plus annual productivity boosts are not matched by productivity increases, in many instances. The escalator feature usually applies in labor's favor on the rise but gets frozen into the basic wage rate before the employer can benefit during a recession period. Much more serious, the patterns of pay and cash fringe benefits set in the auto, steel, and other large industries, where price advances to customers and productivity may combine to cover most if not all the wage cost increase, tend to force other industries and companies to conform even though economically not situated to do so. These things not only do not contribute to economic stability but may have built into our wage-price structure troublesome inflexibilities.

17. The 1955 consumer durables goods boom and the 1956 capital goods boom represented a tremendous surge of economic forces within a 24-month period. Some excess of easy money in 1954 contributed to these conditions. Subsequent tight money moves were aimed at correcting these excesses. Progress was being made along these lines when the economy was gravely affected by:

1. Effects of the economy drive on defense spending beginning in the second quarter of 1957.
2. Sputnik not only jarred national complacency, but aggravated the effects of reduced payments against defense contracts by a virtual stoppage in defense-order placement for a time.
3. Then came the Asiatic flu and similar ailments that put a large part of the American population in bed for days at a time in the fourth quarter of 1957.

These random developments helped to create an economic "air pocket" under us in the fourth quarter of 1957 that accelerated the inventory decumulation. Possible remedies would seem to be: Less official reassurance; less capricious handling of defense order placements and payments, and accelerated order placement now to make up for the 1957 lagging; a further cut in reserve requirements; and, if needed, a 10 percent 1-year personal income tax cut, with commensurate easing in the business tax burden.

Respectfully yours,

JAMES T. LEFTWICH.

THE FIRST NATIONAL BANK OF CHICAGO,
Chicago, Ill., April 10, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: There are enclosed comments on the various questions which you recently forwarded to me in connection with the Senate Finance Committee's inquiry entitled, "Investigation of the Financial Condition of the United States."

I have followed your suggestions in preparing my replies. In some instances, therefore, the questions were used largely as a guide, and in other cases my replies were limited to specific aspects of the questions. I also have kept the answers brief, though a much more extended treatment of many of the subjects would have been possible.

You were generous to ask for my opinion, and I appreciate your courtesy in inviting me to contribute.

Respectfully yours,

H. J. LIVINGSTON, *President.*

1. Give a definition in your own words of "deflation" and "inflation."

I generally think of these terms in relation to the cost of living and the purchasing power of the dollar. When the amount of goods and services that a consumer can buy with a given number of dollars is reduced because of a rise in the price level, inflation has occurred. Conversely, when an increased quantity of goods and services can be purchased for a given sum of money, because of a decline in prices, deflation has occurred.

In more specific or measurable terms, I think of deflation and inflation as a discernible downward or upward trend, respectively, in the consumer price index. The word "trend" should be emphasized, for a rise in the index 1 month followed by a corresponding fall in the next month should not be considered as an inflationary move having been offset by a deflationary one. A persistent movement in one direction or another is necessary before one can decide which way the economy appears to be heading.

2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

Short of actual price and wage controls, which are undesirable in a peacetime economy, a stable value for the dollar is not something which can be brought about by some simple mechanistic method. It is more nearly a byproduct of general economic activity and the interplay of the market forces in a free society.

Monetary and fiscal policies can be helpful in stabilizing prices by careful timing of countercyclical measures. For example, an excess of dollars when productive resources are being utilized at near capacity levels will bid prices up. Similarly, an increase in spendable income by reducing the income tax of consumers is one method of combating a recession.

In the use of monetary or fiscal procedures for attaining price stability, I am inclined in most circumstances to prefer monetary instruments of control, and the indirect or general monetary tools to the direct and selective ones. Monetary tools are usually less blunt and more flexible than fiscal techniques. The monetary implements are sufficiently flexible and adaptable to be highly useful, provided other segments of the economy—government, business and labor—also discharge their respective responsibilities for price stability.

Monetary weapons are perhaps most effective in mitigating inflationary pressures. On the other hand, deflationary forces often require something more than monetary measures, however forcefully the latter may be applied. Thus, even very low interest rates will not encourage borrowing and investment if a high degree of pessimism prevails in the economy. In this situation, fiscal measures may be desirable.

With respect to the actual monetary tools available, I would ordinarily prefer the maximum use of the indirect tools, such as open market operations, discount rates, and reserve requirements, rather than direct controls. The former are less personal in that they make their effect felt through broad market forces.

Since labor union policies and business price practices also contribute to the elusiveness of price stability, the role of Government, short of price and wage controls, should include educating, persuading and encouraging statesmanlike behavior on the part of labor and management. Such action should aid labor and management in reconciling and compromising their differences for the welfare of the entire economy.

Price stability, in my judgment, is not the exclusive responsibility of Government. On the contrary, it is a responsibility that must also be shared by management, labor, investors, consumers and every segment of our economy, and each must discharge its responsibility if price stability is to be achieved.

3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942–57. (You may wish to divide the period into two parts—1942–50 prior to the accord, and 1951–57.)

From 1942 to 1945, the primary objective of the United States Government and of the entire country was to win the war. As a result, adopting measures to facilitate war financing by the Treasury was necessarily the overriding objective of the Federal Reserve System. This was accomplished by Federal Reserve support of the prices of Government securities. In the process the Federal Reserve System created the additional credit necessary for the banking system to purchase Government bonds during the war. Under these circumstances, conventional credit controls became relatively ineffective. On the other hand, central bank support of the Treasury in its financing operations was of paramount importance.

From 1946 to 1951, the Federal Reserve continued its policy of supporting the "pattern of interest rates" for Government securities, although from time to time "pegging" was modified, first by dropping completely the support of short-term securities, and then subsequently lowering the support price of long-term bonds.

Since the inflationary pressure of the highly liquid state of the economy was resulting in sharp rises in commodity prices, the Federal Reserve's policy of buying all the securities offered was in conflict with conventional anti-inflationary credit policy, and contributed to the inflationary pressures. However, it must be remembered that the Federal debt has risen from $50.9 billion in 1940 to $278.7 billion in 1945, and that most of the United States Government bonds were purchased by investors at the low yields that prevailed during the war. There undoubtedly were many who believed that had the Federal Reserve dropped its stabilizing operations too suddenly or too sharply a severe decline in bond prices might have resulted with substantial losses to many holders of Government securities.

There also were some who felt that the pegging operation had certain other consequences. First, it facilitated a shift in the assets of financial institutions, primarily banks and insurance companies, from Government bonds to private debt, primarily commercial loans and mortgages. Second, in the process of shifting, the bonds acquired by the Federal Reserve System created additional reserves which permitted an expansion in bank credit. Both of these factors contributed to an expansion of productive facilities and housing which helped satisfy the pent-up demand built up during the war years. However, these increases in output were not without their costs, namely, a deterioration in the value of the currency as prices rose. Unless there is some significant national emergency, it is far better for Government financing to be conducted in free markets.

Since the "accord" in 1951, I believe one of the principal objectives of the Federal Reserve System has been to carry out policies within the monetary and banking sector of the economy that are directed toward a stable price level at high levels of employment, production and incomes (as set forth in the Employment Act of 1946), insofar as possible. In my judgment, this does not mean that the System has sought to pursue credit policies that would aid economic expansion at the cost of rising prices and a deterioration of real income. Conventional monetary management calls for credit restraint during periods of rapidly expanding business activity and rising prices, and easier credit conditions during periods of reduced activity. Admittedly, and with the benefit of hindsight, the timing of Federal Reserve actions may not always have been perfect, but again there are no mechanical standards that can fairly be applied to these problems. Federal Reserve System policy decisions must necessarily be value judgments based upon the best available economic information. There are important areas in which there is often little or no precise economic information, and in other areas there is often an unfortunate lag in the availability of data.

As I mentioned in my reply to the second question, all segments in the economy must share the responsibility for price stability.

4. Beginning in August 1956 there was an increase in the consumer price index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

The years 1955, 1956, and the first 9 months of 1957 were characterized by a rapid expansion of business activity to record levels of output and consumption. This was caused, primarily, by record expenditures by consumers and business, and sustained high levels of spending by Federal, State and local governments.

All of the components of the consumer price index contributed to the increase in prices which occurred during the period August 1956 through September 1957. However, by far the greatest increase was in the price of services rather than in commodities. Services presently account for about one-third of the total index, so that the rather sharp increases in this broad component during the period help to explain the upward movement to which your question refers.

Despite substantial additions to the Nation's productive plant in 1955, 1956, and through September 1957 the demand for many items exceeded their supply. The labor force of the Nation was virtually fully employed, resulting in a favorable bargaining position for labor. As a result, increasing consumer incomes and expanding demands resulted in only moderate resistance to higher wage demands. With practically full employment, and given a choice between idle plant and an increase in wages, management understandably agreed to wage increases in a number of cases. With little likelihood of an important increase in physical output, the inevitable result of rising costs was a higher price level.

In my judgment, it is not possible to determine accurately which factors contributed most to the decline in the value of the dollar. It was, instead, the consequence of excessive activity in the economy generally. While some of the factors contributing to the rise in prices have changed in recent months, there is no evidence that once the present business decline ends that we shall not see a resurgence in strength of inflationary pressures. Consequently, the persistence of the threat of future price rises, despite present declines in production and employment, necessitates weighing with great care changes in monetary and fiscal policies.

5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

One of the objectives of Treasury debt management policy at this time is to shift an increasingly larger amount of the marketable portion of the debt into longer term maturities.

This policy could have at least two effects upon the credit structure of the United States: First, as the Treasury extends the average maturity of the Government debt, it becomes more competitive with long-term private borrowers, such as public utilities and industrial corporations. This result, however, is not of such significance that it should necessarily deter the Treasury from the ultimate attainment of this objective.

A second possible consideration is the effect of stretching out the debt on the commercial banking system. As the Treasury increases the proportion of longer-term bonds, the supply of Treasury bills may tend to decrease.

In recent months, the loan demand of banks has declined and reserves have increased, thereby affording the commercial banks some opportunity to improve their liquidity by increasing investments in short-term Government obligations. Partly as a result of this increased demand, the bill rate in the past few months has experienced one of the sharpest declines for such a short period of time in history. In these circumstances any reduction in the supply of bills which might be made as the Treasury lengthens the maturity of the debt, would tend further to depress the yields on bills.

With a large amount of the debt having comparatively short maturities, it is in general beneficial to the Treasury to lengthen the overall maturity of the debt. However, it also is necessary to maintain an optimum balance between short, medium, and long-term Government issues, in order to maintain relatively stable money markets and to provide the short-term obligations necessary for the economy to maintain needed levels of liquidity.

6. (*a*) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy of the United States:

1. Price stability.
2. Stability of production, demand, and employment.[1]
3. Economic growth in production, demand, and employment.[1]

(*b*) With respect to these three objects, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

In my judgment, price stability, providing for stability in the short run, and for growth over time, in production, demand, and employment, are equally important economic policy objectives of the United States. It is not a question of whether we desire either price stability, or stability or production, demand, and employment, or economic growth. Actually, no one of these objectives is expendable. We must have all three if we are not to have declining standards of living for an increasing population.

The postwar period has demonstrated that despite the progress we have made in economic analysis, monetary and fiscal management, and in limiting the magnitude of fluctuations in the business cycle, we have not succeeded in smoothing it out completely.

The current period of adjustment with its decline in employment, incomes, and spending is further evidence of this fact. Even though we may not have succeeded in achieving price stability and economic growth in production, demand, and employment does not warrant altering our objectives or pursuing them any less vigorously than in the past.

On the other hand, the restlessness of the business cycle may be a characteristic of an individual initiative private enterprise economic system. There are in the market place of a free society self-perpetuating economic forces that help gradually to correct maladjustments that have occurred during the previous period. For example, perhaps a wave of overoptimism has stimulated an unsustainable rate of spending and investment that must be correct if the economy is now to be brought into balance for a new period of growth and progress. Such adjustments probably are inevitable in a society of freemen where the possibility of rewards and profits is accompanied by the

[1] It is assumed that "stability" as contrasted to "economic growth" refers to smoothing the fluctuations about the rising trend line which would describe growth.

possibility of risks and losses. However, this is not to suggest that efforts should not be made to mitigate these fluctuations and to alleviate the hardships of those who become unemployed.

Perhaps the most striking trend during the years since our emergence from World War II has been the continued vigorous growth of the economy. Related to this is the dynamic role played by private investment—in furthering the growth of existing products, developing new products, and ever broadening our economic horizons. The major cost of this success has been, of course, our postwar inflation. However, with continuing improvement in economic analysis, and monetary and fiscal management, there is reason to believe that the costs due to instability can be reduced. The year 1957 marked the beginning of what is currently a test of our ability to cope with recessionary forces. Our success in meeting this challenge will present us with additional evidence of our ability to combine, in reasonable fashion, our goals of growth with minimum instability.

7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

The current rising volume of Government spending tends to sustain the level of business in a period when the aggregate expenditures of business and consumers are declining. During periods when individual incomes, consumption and employment decline, an increase in Government expenditures contributes to demand and tends to counteract and offset the drop in production and business activity. The larger volume of spending contributes to income, new orders, production, and employment. Conversely, during periods of rising private demand and expenditures, Government spending, except that which is essential, such as national defense, should be reduced so it will not create excessive demands on the economy.

However, there is no certainty that increased Government expenditures will necessarily meet the problems of a period of recession effectively. For example, even after a decision is made to increase Government expenditures, there may be considerable lag in implementing the policy. As a consequence, there frequently is the risk that by the time the results of increased Government spending are felt in the economy in the form of an expanded demand for goods and services, the decline in general business may already have ended. Thus, the increase in demand resulting from expanded Government expenditures actually may occur when the Nation's resources and productive capacity are being fully utilized as the result of an expansion in private demand that had subsequently developed.

Moreover, experience indicates that these projects for Government spending often result in far larger expenditures than had originally been intended. Furthermore, it is exceedingly difficult to reduce the level of Government spending after it has been expanded.

8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

It is widely believed that if Government spending is equal to tax revenues—that is, if Government budgets in the aggregate are balanced—there is no effect on economic activity because the Government is putting back into the economy as much money as it is taking out. However, this conclusion is not correct.

That share of Government expenditures which is used to purchase armaments, for example, contributes to the income flow of the community, but in the process no consumer goods are created to satisfy consumer demands. Thus, though the Government budget is balanced, there may actually be inflationary consequences resulting from Government spending. In general, the larger the budget, even though balanced, the greater the probable inflationary impact.

The portion of income which is diverted to Government by means of taxes is socialized. Furthermore, as a large proportion of national income passes to governments by means of taxes, the freedom of expenditure choice of individuals and private business is reduced.

A consequence of the socialization of income is the effect on the economy of Government expenditures in contrast to consumer and business spending. The goods and services purchased by Government for military purposes quite obviously differ from those that would be bought by the private sector of society. In the former instance, the manufacturers of heavy equipment, electronics, and aircraft might be most involved. In the latter case, purchases by consumers probably would be divided more equally among durable and nondurable goods industries and services, including travel and recreation.

Finally, there is the danger that increasingly higher taxes reduce incentives of the American people to work harder and to continue to assume capital risks—two necessary conditions of economic growth in a private enterprise society.

Related to the foregoing danger is the possibility that the percentage of the consumer dollar taken in taxes ultimately could rise to a level where the standards of living of the American public would actually decline because of taxpayments. Since an increasing standard of living is one of the primary objectives of public policy, taxes must not be raised to a level where a large volume of private consumption is impossible.

9. Will you distinguish between fiscal policy (embracing expenditures, taxes and debt) and monetary and credit policy, and relate them, one to the other. Please discuss these policies stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

Fiscal policy refers to the Federal Government's authority to tax, borrow, and spend in order to discharge its constitutional responsibilities. It also includes the management of the public debt.

Monetary policy involves control of the volume, availability, and cost of credit, and is the responsibility of the Board of Governors of the Federal Reserve System.

Both fiscal and monetary policy can be effectively mobilized to restrain inflationary trends, thus contributing to price stability. The inflationary effects of Government spending can be reduced by a balanced budget. If, however, expenditures exceed receipts and a deficit results, the inflationary pressures in these circumstances may be moderated to the extent that the Government is able to borrow from nonbank investors since this procedure does not result in an increase in the money supply.

Monetary policy in times of high business activity can be useful in restraining inflationary pressures by limiting the volume of credit expansion to that which is required to meet seasonal and other productive needs of the economy. By limiting the expansion of credit and the volume of money during a period in which demand is tending to outrun the supply of savings, the monetary authorities apply a brake to the economy. This should reduce inflationary pressures and limit possible economic excesses that might occur.

10. (a) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank credits.) Also please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

One of the important problems with which the monetary system of the United States will be faced in the future is an adequate supply of money to support expected higher levels of economic activity. It is generally recognized that in the past there has been a fairly close relationship between economic growth and the money supply. Higher levels of economic activity require larger amounts of money and credit. It will be necessary therefore, for the money supply to expand in the future in order to support the expected higher levels of production in the years ahead. The monetary authorities, therefore, must consider not only the current economic situation, but also must plan now to meet the future demands of the Nation. In my judgment, such monetary policy decisions, in general, often are of more importance and significance than the framework or structure of the monetary system.

(b) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

One of the desirable long-range, over-all objectives of the fiscal policy of the United States ought to be a generally reduced level of taxes. The attainment of this objective, in a very large measure, is determined by public finance and fiscal policy decisions, both legislative and executive, regardless of the particular system in effect. The following are merely typical of the problems I have in mind:

1. What is the limit to the growing magnitude of Government expenditures? The socialization of personal income that the rising trend of Government expenditures implies assumes that Government expenditures bring a greater benefit to the community and the Nation than would the individual disbursement of some portion of these tax revenues. There are no reliable criteria for determining that funds expended by direction of the Congress are better spent than when the purposes of the expenditures are determined by individual and business decisions.

2. What is the effect on incentives, over a period of time, of Government spending? Admittedly, some Government spending spurs incentives. The Government road-building program, for example, may be looked upon with favor by some industries. On the other hand, it seems clear that increasing taxes eventually must adversely affect various incentives.

3. There is always the possibility that the fiscal policies of the Government will conflict with the monetary policies of the central bank. The history of central banking suggests that the problem is not peculiar to a particular system or country.

In general, therefore, fiscal decisions are in most instances more important than a particular fiscal system.

11. (a) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

The seeming paradox of the existence of inflation and unemployment at the same time in our economy results from the fact that the two conditions are not entirely governed by the same influences or factors. Rather, they often respond to different and unrelated pressures that may be operative at the same time.

Currently, for example, the decline in industrial production and the rise in unemployment have been largely in the durable goods producing industries. This development can be attributed to reduced demands. First, business investment in plant and equipment has been curtailed from previous, exceedingly high rates. Second, consumers have altered their buying patterns, curtailing their purchases of durable goods and spending more on soft goods and services. As a consequence of these declining demands, production schedules in the durable goods industry have been curtailed and unemployment has risen in these areas.

The cost of living, on the other hand, and the consumer price index in general, which have been rising steadily for several years, have continued to edge up in recent months despite the rise in unemployment. A number of factors have contributed to this development. First, despite the drop in employment and incomes, consumer demand for goods and services has been maintained in volume close to former high levels. Second, spending by families for services such as utilities, medical care and rent, amounts to about 35 percent of disposable income. As a result, prices for consumer services in the last 8 years have risen about three times faster than prices for goods and commodities. Third, because of the nature or character of consumer spending, much of it may not be postponed or deferred. These factors in the aggregate have operated and contributed to demand pressures on prices notwithstanding the decline in the output of durable goods and the rise in unemployment.

(*b*) Shall we accept as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

I do not believe that inflation is desirable or is a necessary condition of full employment. It would be a grave error of major proportions if it became generally accepted that a gradual rising level of prices was an inevitable and necessary condition for full employment. Such a development, in my judgment, would have a number of extremely undesirable consequences. The most significant, probably would be that it would tend to discourage saving which is basic for further investment and subsequent economic growth. The problem has been complicated in recent years because our degree of tolerance of unemployment has become so narrow. While conceding that unemployment is an economic waste and socially undesirable, its complete avoidance at the expense of persistently rising prices may prove to be even more costly.

12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy?

Certain individuals and certain segments of the economy may have gone into debt to a point where any significant decline in their income may make it difficult for them to discharge their obligations promptly. However, it is doubtful that the growth of the aggregate private debt of the entire Nation in recent years has become an actual threat to the stability and vitality of the American economy.

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Savings by individuals and by business are a vital part of the capital creating process. Thus, the accumulation of savings and their subsequent investment are the means whereby a Nation's wealth grows in the form of industrial plant and income producing assets. The savings of the Nation, therefore, must continue to grow if the Nation is to expand its productive assets in the coming decades. It is widely held that capital investment expenditures should be financed primarily by the noninflationary means of mobilizing savings. Savings are channeled into productive uses by means of equity instruments of finance, such as stock or proprietorship interests, or by means of fixed obligations. The latter process involves the conversion of savings into debt instruments, that is, bank loans, bonds, and mortgages. In this respect, the growth and creation of debt also plays a vital role in the capital creation process.

In the long run, economic growth would be reversed and cumulative deflation would become a problem if saved dollars were accumulated and remained idle instead of being converted into factories, machinery, and other income producing assets. In order to transform a steadily growing supply of savings into national wealth, some individuals must be willing not only to risk their capital in equity ventures, but they also must be willing to borrow already accumulated funds.

The banking system is related to this question of debt, savings, investment, and capital creation as it is the most important credit creating agency in the country. An expansion of bank credit, so essential to the continued steady growth and functioning of a private enterprise economy, is possible only if there is a corresponding increase in debt. Debt creation by banks is one of the significant processes by which the country has increased its capital wealth, productivity, national output and income.

In the last analysis, the risk is not solely in the debt, but rather in its rate of growth compared to the accumulation of savings and equity in the community. An excessive rate of increase in the debt will create problems and subsequent periods of adjustment. For example, an inadequate rate of increase in debt may so hamper the economic growth of the Nation that the standard of living of the people fails to advance or actually declines. On the other hand, excessive credit expansion may cause an unsustainable volume of spending, overinvestment in plant and equipment, excess capacity, and price rises. A period of adjustment inevitably follows.

13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy?

In my judgment, there is no categorical answer to this question. The social sciences and economics, in particular, in contrast to the physical sciences, are not exact and are not always amenable to precise measurement. It would be a greatly different world if one could devise a formula that would clearly and precisely indicate the time and changing pattern of fiscal and monetary policy that would be appropriate under varying conditions. Unfortunately, this is not possible, and no reliable mechanistic approach to solving this question is known. Instead, the determination of appropriate policy requires a continuous evaluation of the various economic factors and indices of business activity. This, in short, involves an extremely difficult evaluation of economic forces, many of which are not clearly defined nor subject to accurate measurement, and the making of value judgments.

Furthermore, there is no adequate permanent guide or bench mark that can be used in making the monetary and fiscal decisions required to counteract a downturn in the economy. To illustrate, our degree of tolerance of unemployment seems to have narrowed considerably in the postwar period. We seem also to prefer various types of Government action rather than the economic discipline which may sometimes be necessary to correct maladjustments that develop when the economy has been excessively active.

There is, therefore, no known, or generally accepted, point in terms of unemployment, production and consumer demand that would indicate when the Federal Government should move in a major way to halt and reverse a downturn in the economy. Instead, it requires a comprehensive evaluation of the entire economy and probably should not be limited to the three factors suggested above. In the current situation, for example, the recent behavior and current level of prices should also be a part of the evaluation.

14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

In 5 of the 11 postwar years, receipts of the Federal Government exceeded expenditures and the budget showed a surplus. Of the 6 years of budget deficits, 3 occurred during hostilities in Korea. Excluding the 3 years of Korean military operations, Federal deficits occurred in only 3 of the 8 postwar years. Furthermore, the public debt increased $18 billion during the entire postwar period, or an average annual increase of $1.6 billion. This compares with the very large increase of over $200 billion in debt during the war, which was reflected in a correspondingly large increase in the liquid assets of individuals and corporations. The banking system also was in a position to expand credit considerably. These conditions, coupled with a tremendous pent-up demand for goods and services by business and consumers, occurring when output was rather limited, obviously put pressure on the price structure. Inflation was the result.

On the other hand, the comparatively moderate rise in the Federal debt in the postwar period compared with the war years, and the approximate balance in the number of budget deficit and surplus years, suggests that the postwar inflation must be attributed mainly to the very large volume of deficit war financing. However, it seems likely that if the Federal Government had been able to operate at a surplus during the postwar years, the rise in prices might have been somewhat more moderate.

15. Can full employment goals be attained while maintaining a dollar that has relative stable purchasing power?

I believe relatively full employment can be attained while maintaining the reasonable stability of the purchasing power of the dollar. Although as I pointed out (questions 2 and 11 (b)), the problem becomes increasingly difficult as our degree of tolerance of unemployment narrows. The avoidance of temporary periods of high unemployment and the attainment of orderly economic growth with a stable dollar depend upon how the community values these objectives relatively. Attaining these objectives, however, is not the sole responsibility of Government, but in addition requires, among other things, a balanced distribution of expenditures among the three primary spending units in the economy—consumers, Government, and business.

Assuming that monetary and fiscal policies are appropriate, the objectives of full employment and a stable dollar may require the various segments of the economy to modify and amend their programs. I am not suggesting that this be accomplished by Government edict, but rather by self-disciplined, responsible action of the groups concerned. For example, governments may be obliged to alter or postpone certain capital spending programs when the economy already is operating at capacity. Business might find it possible and more economical to budget its investment expenditures somewhat more evenly over the years. In 1956, business spending on plant and equipment increased 25 percent, compared to an anticipated decline of perhaps 10 to 15 percent in 1958. Labor bargaining techniques, wage demands, and pricing policies may require review and possible modification. The behavior of consumers also may be a contributing factor to economic stability and instability. It would be helpful therefore if fluctuations in consumer spending could be moderated. The above are only suggestive of some of the changes that might assist in achieving the goals of reasonably full employment and a stable dollar. All segments of the community must be persuaded to place these objectives above other competing economic goals.

16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

It is assumed that economic stability refers essentially to price stability, for we must have economic growth even to maintain present standards of living for an expanding population. It is doubtful that the escalator provision contained in wage or other contracts contributes to price stability.

I do not believe it would be economically desirable to have the escalator clauses widely used in industry. These clauses add cost rigidities in our pricing system that could cause cumulative instability in our economy. For example, if for some reason there were a sudden inflationary stimulus imposed on the economy, e. g., a war scare, an automatic wage increase would follow. This, in turn, would create new upward pressures on costs and prices, and the process of wages and prices pushing each other might become a permanent structural rigidity that would be undesirable. Wage increases ought to be closely related to increases in productivity rather than to the cost of living.

The forces of competition and the search for profit operate in such a manner as to induce businessmen to substitute other factors and methods for those which become more costly.

Improvements in technology come about in response to management's search for greater profits enforced by a lively spirit of competition. A reduction in costs is only one way of improving profits. Technology also applies to the development of new markets and new products—again in the search for profit, and forces which restrict competition and dull the profit motive are harmful to the efficient operation of a free enterprise system.

17. List and briefly discuss what you consider the causes of the present recession: and what should be done to terminate it.

Obviously, no one can say with any degree of certainty what caused the present recession. However, one factor stands out when reviewing economic developments in the past 3 years. I refer to the accelerated unsustainable rate of increase in spending that occurred in a number of areas. This is being followed by a period of adjustment during which conditions revert to a more normal rate of increase.

In the latter months of 1953, business activity began to decline. As a consequence, the Federal Reserve authorities shifted monetary policy to one of active ease. On January 1, 1954, a reduction in personal income taxes became effective and the corporation excess profits tax instituted during the Korean incident expired. As a result of these and other developments, expenditures of consumers in 1954 rose about 20 percent. Outlays for private residential building, for example, also increased, rising 22 percent above the previous year, and housing starts neared the postwar high of 1,396,000 units. A major factor here undoubtedly was liberal FHA and VA financing arrangements, as 65 percent of the housing starts in 1955 were Government insured. An abundance of credit and easier terms also was an important factor in automobile sales, and a record 7.3 million cars were sold in 1955. Total consumer credit, as a result, increased 20 percent. It became increasingly apparent, as the year passed, that such rates of increase in consumer spending were not sustainable.

In 1956, encouraged by increased profits, rising consumer income and demand, businessmen expanded facilities. Individually, these decisions were quite rational as each company attempted to increase capacity in order to make certain that it retained its share or an increasing share of expanding consumer demand. Collectively, business investment in new plant and equipment in 1956 increased 25 percent. This, again, was not a sustainable rate of increase. This spending by consumers and business was accompanied by a demand for credit. Investment spending grew much more rapidly than accumulated savings, and much of the excess demand for credit found its way into the banking system. As a consequence of these various forces, the business loans of all commercial banks in the three year period, 1955 through 1957, increased about 50 percent.

While consumer spending continued to rise in 1956 and through most of 1957, the rate of increase was considerably below 1955. In similar fashion, business investment also increased in 1957, but at a much slower rate. By the third quarter of 1957 it became apparent that some excess capacity existed and business spending plans were being pared down. Thus, with the benefit of hindsight, it can be suggested that the current recession is in part the result of an unsustainable rate of increase in consumer spending which in turn tended to stimulate too rapid an increase in capital spending. One byproduct of these two developments has been an adjustment in inventories which began to develop early in 1957 and accelerated in the final quarter. A further contributing factor to declining production was the reduction in the Federal Government purchases of goods and services and the slow down in contract payments and new Government orders that occurred in the latter part of 1957.

Such excessive economic activity inevitably is followed by a period of adjustment. During this period, it becomes the responsibility of government, first, to alleviate the individual personal hardships of those unfortunate enough to be unemployed. Second, monetary policy should be directed toward easing credit and stimulating business activity. However, some self-correction of the economic maladjustments and excesses that develop in a boom period should be permitted if the economy is to go forward on a sound basis. Should the present adjustment persist, further government action might be desirable in the form of some reduction in taxes, coupled with some alteration of the tax structure, with the objective ultimately of a lower level of government spending.

FIRST & MERCHANTS
NATIONAL BANK OF RICHMOND,
Richmond, Va., February 25, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate,
Washington, D. C.

DEAR SENATOR BYRD: In your letter of February 17, you invited me to comment on the economic condition of the United States, using a list of questions which you enclosed merely as a guide. May I say in the beginning that I am cognizant of the complexities of the financial lives of our individuals and corporations and certainly I do not think that I have the answers. I am glad to state my beliefs and hope that when added to those received from many others, they may be helpful.

For some years we have been seriously concerned with inflation in this country. Now certainly we are worried about a deflationary period. Inflation is the erosion or decline in the purchasing power of our unit of currency, the dollar. Deflation is just the opposite, where the unit of currency gains in purchasing power. Some economists have a simple definition saying that inflation means there is more money than there are goods available. Whatever the definition, the average man is concerned lest the dollar he saves today will buy a smaller amount of goods in the future.

I do not believe it will be possible for the Congress of the United States to enact laws which will prevent business cycles and at the same time allow the citizens to retain their liberties. We cannot repeal the economic law of supply and demand. If we are to have a free-enterprise system, we must have competition. In this system, periods of overbuying and underbuying are inevitable. While we cannot eliminate business cycles in a free country, we can provide certain brakes and stimulants. One of these is a certain amount of monetary control.

The Federal Reserve Board has certain powers by which it can make the money supply more abundant or less abundant. Through raising or lowering reserve requirements and discount rates to its member banks and also through certain open market operations, it can make money more or less available for banks to lend to industry and individuals. These moves by the Federal Reserve can have a tendency to stimulate business or curb a boom. They are not absolute controls. They do not always take effect quickly. For instance, no matter how cheap money might become, if business and individuals were pessimistic about the future, they could not be forced to borrow to expand business. Nevertheless, in my opinion, it is a fine thing to have these powers in the Federal Reserve Board and I believe they have been used wisely in recent years. Since the socalled accord between the Federal Reserve and the Treasury Department in 1951, there was a remarkably stable period until the middle of 1956 insofar as consumer prices were concerned. Then wage increases granted by industry and largely passed on through price increases to the consumer, caused a jump in the consumer price index. An increase in wages to labor without corresponding increased productivity is inflationary. This is an aspect of inflation which Federal Reserve powers over money cannot touch. Another is that of the Federal Budget operations.

Big Government spending seems to have become an entrenched part of our economy. Withdrawal or drastic reduction of this spending certainly would be very deflationary, if not catastrophic. Nevertheless, a gradual reduction in Federal spending would certainly help to combat inflation. The use of budget surpluses to reduce debt rather than to reduce taxes is wise during boom periods as it serves to reduce the supply of money and thus to keep prices from rising. Taxation is of course deflationary. Theoretically when our country is in a depression, taxes should be reduced in order to increase the supply of money available for spending.

You have raised the question as to which is more desirable, price stability or stability of production and employment; or whether growth in production and employment is more desirable. Of course if we could have steady employment, growth in production, and price stability we would be in a millennium. I do not see how this could come about. It has been said by some that in order to maintain full employment, which is most desirable, we must become wedded to gradual but mild inflation. I am very strongly of the belief that the advantages of full employment are more than offset by creeping inflation. I do not believe we should adopt it as a way of life. One of our great financiers has stated "Those who seek to promote maximum production and employment by creeping inflation, induced or aided by credit policy, are trying to correct structural maladjustments by debasing the savings of the people and undermining the system of democratic capitalism which we have done so much to develop." A 2 percent per year rise in prices compounds itself so that in 20 years the cost of living will have gone up 48 percent. This would certainly tend to destroy thrift and would harm the willingness to work of our people. Efficiency of production of goods would be reduced. Periodic, mild adjustments in our economy would certainly be far better, over the long run, for everybody. Certainly, in times of unemployment, the Federal Government could be expected to engage in public works and tax cuts to counteract the downturn in the economy. On the contrary, during boom periods, as I have stated before, the surplus should be used for debt reduction and not tax reduction and also there should be a minimum of public works.

I do not believe that escalator provisions in wage contracts are compatible with achieving economic stability. An increase in wages without on increase in productivity is inflationary. The inflexibility of wages, reflected in prices prevents small periodic and desirable economic adjustments.

I have not tried to answer all of your questions, first because I do not know the answers to all of them, and second because in our free enterprise system I believe business cycles are inevitable. I conclude by expressing the hope that the full independence of the Federal Reserve System and its present powers be maintained so that it can continue to provide a brake or a stimulant to business, as needed.

With assurances of high regard, I am,

Sincerely,

ROBERT T. MARSH, Jr., *President.*

SEARS, ROEBUCK & CO.,
Chicago, April 3, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D.C.

DEAR SENATOR BYRD: Enclosed you will find our response to the questionnaire which you sent to me earlier. This reply has been prepared by Mr. Arthur Rosenbaum, who is in charge of our economic research department.

The replies to the questions concerning inflation are based upon studies which Mr. Rosenbaum and his staff have been carrying on for some time. Answers to the questions on current business conditions and the economic outlook reflect the factors which Sears takes into consideration in our own planning of operations.

I appreciate the opportunity to submit Sears' viewpoint on these matters and hope that this information will be useful to the committee.

Very truly yours,

F. B. MCCONNELL.

1. Inflation may be described as a substantial rise in the general price level. Deflation, to be consistent, should be described as a substantial decline in average prices, but there is an associated connotation of declining production and rising unemployment. These were traditionally associated with declining prices but we now have declining production and considerable unemployment, yet with no reduction in the price averages; in other words, business deflation without price deflation.

2. Inflation generally results from an excess of demand in relation to the ability of the economy to produce goods and services. If, at the same time, the labor market exhibits the following characteristics: (*a*) relative tightness of supply; (*b*) strong labor organizations in leading industries, enjoying better-than-average gains in sales and profits; (*c*) automatic wage increases on a periodic basis to workers in these leading industries, which are relatively greater than the average increase in output per man-hour for industry as a whole; and (*d*) resistance to downward wage adjustments during business declines, the inflation is intensified and prolonged. The growth of inflation may be slowed down somewhat by reducing excessive demand; the Government sector can contribute by reducing spending, eliminating postponable programs and curtailing others, while maintaining tax rates high enough to yield a surplus.

The money supply can be kept from rising so rapidly as to facilitate an excessive rate of spending, by exercising the monetary powers of the Federal Reserve Board. But Government monetary and fiscal policy can do little to halt the rise in wage rates. Such efforts to restrain price inflation may result in a considerable amount of unemployment, with a greater disparity in wage rates among the different industries. We must find a way to relieve the unremitting pressure on prices caused by excessive increases in wage rates. We must also make full use of existing legislation to insure the existence of free competitive markets in which the interplay of changing supply and demand will be reflected by corresponding changes in prices.

Counterdeflationary measures would include easier credit policies and tax cuts aimed at increasing and stimulating both consumer buying and business investment. If these are insufficient, increased Government spending on a backlog of useful public works projects, held in readiness for such a contingency, should be resorted to.

3. The relative ineffectiveness of the Federal Reserve Board's powers to suppress inflationary demand through control of the amount of bank credit, was demonstrated in the 1955–57 period when the quantitative restrictions on the money supply were partially circumvented by a growing rate of money turnover. Thus spending actually increased to an excessive degree. It is doubtful that more stringent measures could reasonably have been attempted. This seems to demonstrate that monetary policy does not deal directly enough with the basic forces of inflation to warrant our reliance upon it as the main weapon against inflation.

4. Both services and commodities participated almost equally in the rise of the consumer price index during the period cited—August 1956 through September 1957. The increases in costs of such services as: home maintenance and repair work, auto and TV repairs, barber and beauty shop services, domestic service and transit fares, are primarily due to the obviously higher costs of labor involved in producing these services. Using labor in a broad sense, this statement also applies to fees for medical, surgical, dental, and hospital services. Turning to prices of consumer goods, we note first that retail prices have by and large been governed by changes in factory prices. The best available data seem to indicate that unit labor costs in manufacturing have been rising over the years.

Declining costs of raw materials prior to the recent rise had helped keep factory prices fairly stable but when raw material prices stopped declining, and even rose somewhat in 1956 and 1957, this eliminated an important offset to the upward trend in unit labor costs. Result: higher wholesale prices and higher retail prices. The common factor in the trend toward higher prices of goods and services is the long term trend toward higher prices of goods and services is the long term trend toward higher unit labor costs, which might be called wage inflation, brought about by wage increases in excess of the increase in productivity.

5. We agree with the points set forth on this subject in the article entitled "Federal Financial Measures For Economic Stability" in the Federal Reserve Bulletin dated May 1953.

6. (*a*) When prices are rising, demand, and therefore production and employment as well are temporarily stimulated. When prices are declining, buyers tend to pare orders to immediate needs, partly because of the change in inventory policy during a time of sales decline (usually associated with declining prices), but also because chances for reordering at even lower prices are good. Thus lack of stability in prices tends to exaggerate fluctuations in demand, production, and em-

ployment. The case for price stability is impressive from other independent considerations. When it appears that price stability can be viewed as a means of obtaining stability of demand, production, and employment, we must conclude that the former, price stability, is at least as important an objective of economic policy as the latter.

Price stability is an aid to sound, orderly economic growth. It reduces some of the risk involved in investing in new plant and equipment, thus encouraging a more evenly-spaced flow of capital expenditures. Fluctuations in the cost of money, entailed by measures for restraining or loosening the credit supply, are not as influential in investment planning as are changes in the actual costs of the capital goods and in the prices and prospective profit margins of the goods to be manufactured by them. Again price stability would appear to take precedence. The 3 objectives stated (perhaps qualifying economic growth by the adjective orderly), are actually 3 facets of 1 objective, a strong economy. When we try to treat the symptoms of reduced production, demand, and employment without curing the disease of price inflation, we do not restore its state of health.

(*b*) The most important factors in price trends since World War II were:

(1) The more than 100 percent increase in the money supply over the war period which provided the monetary basis for the subsequent inflation.

(2) The great increase in the bargaining power of labor due to the gains in labor organization and constricted labor supply in general. Not only have the productive age groups in the population expanded less rapidly than the dependent age groups (children and aged) but the needs of the Armed Forces and defense production have removed much of the cream of the labor force from civilian production. At the same time, prolongation of the average time spent in school has reduced the normal flow of new entrants into the labor force.

(3) The combination of labor union power and high employment has not only helped labor in obtaining greater wage concessions in leading industries but in spreading the wage increase pattern faster and more thoroughly throughout industry generally. Even though it may be debatable whether the increases in wages and other benefits obtained by steel and auto workers, for example, justified the amounts of price increases, the increases in employment costs generally have outstripped the gain in production so that unit labor costs in general have been rising.

(4) Correction of inflated prices which would bring about an earlier revival of demand and employment from depressed levels is hindered by the "stickiness" of labor costs. In fact, automatic increase provisions in labor contracts covering many more workers than at any time in the past, may actually result in even higher unit labor costs.

The most important influences upon production, demand, and employment since World War II have been:

(1) The backlog of consumer needs for durable goods and residential construction built up from the pre-war and World War II periods, partly financed by savings during World War II, was mainly responsible for the production boom in the early prewar years.

(2) The high rate of Government spending initiated by the Korean war.

(3) The great increase in number of families after the end of World War II, laying the basis for a continuing high level of demand for durable goods and homes for many subsequent years.

(4) The great expansion in mortgage and consumer debt which helped finance the large volume of homes and durable goods produced in the last 5 years.

(5) The strong surge of demand for plant and equipment in 1955–57. Many industries were actually operating too close to capacity in the peak year 1953, indicating a real need for expansion. Business confidence was high, the economy having successfully withstood the test of two downturns without serious results, and prospects for further growth were bright. The liberalization of depreciation computation for tax purposes was a contributing factor.

(6) Consumer confidence and buying power in the 1949 and 1954 recessions was sustained by social security, unemployment compensation, bank deposit insurance, and the agricultural price stabilization program.

(7) The monetary policies of the Federal Reserve Board. Economic growth has been facilitated by—

(1) The growth in population—the birth rate has remained relatively high and the death rate has slowly declined.

(2) Technological progress—we have been spending an increasing proportion of our national income for research to learn how to produce goods and services more cheaply and to develop new products.

(3) Investment—the new machinery and plant needed to translate the results of research into practical use have required the investment of large amounts of savings which are nourished by profits.

(4) Sharing of gains due to increased productivity—unless labor receives a fair share of these gains, consumer purchasing power will not support continued growth of productive capacity.

7 and 8. One out of every seven persons, or 15 percent, who were either on military duty or at work in 1957, drew his pay from Government—Federal, State or local. But in addition there were many more, an uncounted number, employed on private payrolls whose jobs were dependent on Government contracts connected with the defense program or otherwise. Another measure of the relative impact of Government spending is through an analysis of the gross national product figures. Government purchases of goods and services accounted for 20 percent of total demand in 1957. Since, in addition, close to $20 billion of consumer income in 1957 was in the form of Government transfer payments, virtually all of which is currently spent, it would appear that about 24.5 percent of the total demand for goods and services was supported by Government-disbursed funds. The national security program was responsible for less than half of this figure or 10 percent of the total gross national product. The nonmilitary portion of Government spending contributes to economic stability in the sense that it is relatively unaffected by business declines; it may even rise during such periods due to increased unemployment compensation payments or acceleration of public works construction.

Government spending for goods and services is justified to the extent that these are essential to the welfare of the community as a whole and it is inappropriate for private industry to do the job. A good or service furnished by private industry can only remain profitable so long as prices are competitive and enough people want it at that price. These tests are inapplicable to goods and services supplied by Government. Hence, to the extent that Government increases its activities, paying for them by corresponding subtractions from business and consumer income, it is also substituting the judgment of a few for the judgment of the market place in deciding the direction of economic development. The same departure from freedom of choice by consumers is reflected in a tax structure which discriminates against certain types of goods (excise taxes), certain types of services (transportation, communication, and entertainment), or even against goods in general as compared with services (sales taxes).

9. Monetary and credit policy has the advantage of being comparatively flexible in that it can be changed as soon after the occurrence of a shift in business activity as can be definitely determined from expert analysis of current data. It is also capable of variation to achieve differing degrees of effect. Since there is a lag in the receipt of economic information, another lag before a turn in economic activity is definitely confirmed, and imprecise knowledge of the timing and extent of the possible impact upon business activity which could be associated with particular changes in monetary policy, it cannot be said that monetary policy is a sensitive tool in a strict sense. We have already described how a rise in the rate of money turnover at least partially nullified the tighter credit policy during the 1955–57 period of inflation. The role of monetary and credit policy is commonly judged to be of less importance in promoting a revival of spending than in dampening excessive spending. Other incentives must be present than cheaper costs of borrowing money to encourage spending.

Spending and taxing programs are procedurally even more sluggish in relation to economic trends. Changes in fiscal policy are most apt to be decided upon when the business cycle is close to its trough or peak, with a further lag before the full effect is reached. It is possible, for example, that spending programs appropriate for a time of recession may be in full swing after recovery has taken place intensifying the upswing to the point of stimulating another wave of price inflation. The housing bill of 1954 resulted in a housing boom in 1955, a year when other types of construction were also at a peak. The relative inflexibility of fiscal policy may easily result in lack of coordination with monetary and credit policy, the two falling out of phase with each other, and intensifying the problems confronting the monetary authorities.

Tax revision measures may have more immediate effects on spending, but there are grave differences of opinion as to the type of tax revision which would be most effective in a particular situation. There is, besides, the danger that a revision in tax rates deemed desirable for immediate purposes may not be appropriately wise for the longer range. The long-standing problem of comprehensive reform of the tax structure may be made even more difficult to solve because of the patchwork measures adopted under emergency conditions. Actually, the progressive income tax system we now have automatically reduce the tax burden on individuals somewhat more rapidly than incomes are reduced.

The budget deficit arising from increased Government spending, or reduction in taxes, or a combination of both, must be financed by an increase in public debt. This tends to weaken the restraining power of monetary policy as a force against price inflation.

10. (*a*) In the case of individual commodities and services produced under our free competitive system, the supply is automatically adjusted to the market demand by changes in prices, which by altering the gap between costs and prices, result in reducing or increasing production as needed. But the supply of money, the most important commodity of all, because it serves as the universal standard of exchange in trade for all other commodities and services, cannot similarly be left to adjustment by market forces without greatly intensifying the amplitude of business fluctuations. The fact that our monetary system must be continuously kept under surveillance and manipulated is its greatest weakness. One of the most important problems facing the monetary authorities is to preserve the purchasing power of the dollar. This involves control of the money flow so that it is kept in proper relation to the flow of goods and services.

The tools used for this task are designed to control the quantity of money and only that portion of it representing bank loans. However, the size of the money flow is determined not only by the quantity of money but by its rapidity of circulation, i. e., how often it changes hands. If the demand for goods and services rises faster than they can be produced, total purchasing power will expand as more and more checks are written against existing deposits. An increase in total spending proportionally greater than the increase in supply of goods means higher average prices, i. e., lower average purchasing power of the dollar. It is possible theoretically to counteract the effect of a higher rate of money turnover by actually decreasing the amount of bank credit, rather than merely putting a lid on further expansion, but this is difficult in practice. No one really knows until after the event that the trend in total spending has enough momentum to bring about inflation if continued. In recent months, price indexes have continued to rise despite some decline in spending which reflects the fact that production (and employment) is being harder hit by the recession than purchasing power (wages plus transfer payments). If a recession merely means greater unemployment with no correction change in, or possibly even higher prices, we no longer can hope for price stability through monetary management, and the sooner we recognize this situation the better. We must have more exact information as to the reasons for the growing unresponsiveness of prices of goods, etc., to declining demand in the economy as a whole.

(*b*) The fiscal system of the United States is inadequate to the extent that specific spending and taxing programs may be (1) designed with narrow political ends in view rather than the needs of the people as a whole; and (2) adopted without adequate safeguards to assure minimum conflict during the life of the program with its proper economic objectives, and maximum coordination with monetary policies.

11. (*a*) If wage rates continue to rise during a period of declining demand, costs and therefore prices will continue to climb. There is less chance for an increase in the unit volume of sales to take place when prices remain high (or go higher) so that production is not stimulated. As production goes, so goes employment. Inflation through

higher wage costs, is therefore conducive to increased unemployment.

(*b*) Although full employment is desirable, inflation is potentially too dangerous to be acceptable as a means toward that end. We must attack the root causes of inflation: (1) faulty fiscal policy and (2) abuse of economic power by mass labor organizations. There is no proof that full employment and price stability are incompatible.

12. Debt plays a valuable and beneficial role in the economy but because its rate of growth inevitably tends to parallel that of business activity, it acts to widen the swing between boom and recession. When business is improving, namely, when sales, employment and incomes are advancing, new loans are contracted at an even more rapid pace, reinforcing the general upward momentum. When a downturn commences, and sales, production, and employment begin to decline, both lenders and borrowers exhibit greater caution toward incurrence of new debt, so there is less stimulus to spending from this source. Meanwhile repayments which have been growing with debt subtract a growing share of declining income so that the impact on sales is even more unfavorable than the actual decline in income would suggest.

13. Due to the necessarily imperfect workings of a large-scale economy such as ours, economic growth does not, and cannot be expected to, proceed at an even rate of advance, but occurs rather in a series of spurts to successively higher levels. Each peak period generates distortions, excessive inventory and debt burdens, higher labor costs and prices, and so forth, which ultimately require correction before further growth may be resumed. The process of correcting these imbalances involves curtailment of production, and therefore reduction of employment. We cannot reduce the need for economic adjustments of this type unless we act more vigorously to restrain the momentum of the upswing. Of course, we cannot afford to see our economy weakened for a prolonged period by widespread unemployment. However, Senator Douglas has estimated (in 1952) that a normal unemployment figure would be 6 percent of the work force. If this figure were to be used, Federal intervention would not be justified if unemployment should show no signs of exceeding it, or even if it should rise slightly higher for a period of a few months. Unfortunately there is less tendency to recognize an equally important obligation toward the same goal and purpose—the need for concerted action by the agencies of the Federal Government against the threat to stability posed by excessive spending, rising prices, and overemployment. This unbalanced conception of the role to be pursued by Government in rectifying the excesses of the business cycle will result in further cheapening of the dollar and will require increasingly larger doses of the remedies now being proposed.

14. During the 4 calender years 1952–55 the Federal Government pumped out nearly $10 billion more in cash payments than the amount of cash it took in from the public. More than half of this contribution to private purchasing power, $6.1 billion, was made during the single year 1953. In that year, the average percentage of unemployed in the labor force sank to the lowest point it has reached in the 12 years which have elapsed since 1945, while the average hourly pay rate for factory workers spurted ahead a little faster than in the year before or after. The high level of Federal spending for goods and services has in itself contributed to inflation since the type of goods

and services needed most were in competition with the booming sectors of private demand for raw materials, skilled manpower, and productive capacity.

15. Over the long run we can keep a larger proportion of our labor force at work by holding the purchasing power of the dollar steady, than by permitting it to decline. When wage rates rise faster than output per man-hour in general, consumer spending and business are stimulated for a time. The wage increases themselves are only part of the additional purchasing power created; the higher incomes of workers provide the basis for a further expansion of consumer and mortgage debt which helps to augment consumer spending still further.

The excessive wage increases, however, boost unit labor costs, and therefore prices. Debt expansion begins to slow down, and unit sales at higher price levels begin first to level off, then to decline, and reduced employment is the inevitable outcome.

16. Escalator provisions in wage or other contracts are dangerous and undesirable in that (*a*) the incomes of those not protected by such devices are hit even harder by loss of purchasing power due to higher prices; (*b*) those most guilty of causing inflation are shielded from its punitive effects (although this is at least partly a deception); and to that extent (*c*) public support of measures to fight inflation is weakened.

17. The present recession is primarily the result of a turn-around in inventory policy. When sales are ascending, production expands even more rapidly as individual producers compete for a larger share of the market. The resulting inventory buildup eventually reaches a point at which it is considered excessive in relation to the current flow of sales, particularly when sales begin to level off or to decline. Production is cut below the rate of shipments in the attempt to reduce costs of carrying inventories. The process may go too far in the other direction because business psychology may run to greater extremes than is warranted by the actual extent of sales decline. The drop in production and increased unemployment resulting therefrom tend, at least partially, to bring about the very condition which is feared—namely, less buying by consumers.

The inventory cycle was bound to reach a crest sooner or later. It was brought to a head by the sharp drop in orders for defense durable goods in the third quarter of 1957, capping earlier evidences of leveling off or decline in consumer and business demand for various types of durable goods.

The reduced demand for consumer durable goods was particularly evident in the case of automobiles. Consumer resistance to higher prices, lack of enthusiasm for the new models, and probable unwillingness to add to a record-high burden of installment debt, are all involved.

The curtailment of business spending for plant and equipment is even more important since the decline promises to continue into 1959 and will have a greater effect on total spending. This change was the result of an excess of productive capacity built up during the capital investment boom starting in 1955. Sales failed to match the growth in capacity, and profit margins began to take an unfavorable turn.

Modernization, replacement, and new product development are hopefully expected to cushion the decline.

Consumer purchasing power has held up quite well despite the increase in unemployment and reduction in working hours. Disposable personal income dropped only 1½ percent from the August 1957 peak to February 1958.

Payrolls in nonmanufacturing industries and Government have held quite steady and increase unemployment compensation payments have helped to offset the decline in factory worker's pay. Some sectors of the economy are expected to expand in 1958, including some of the service industries, State and local government spending, private construction other than industrial, and the defense goods industries. Inventory accumulation (even though modest) rather than liquidation may be seen by the second half, and there is a good chance that the inventory situation will constitute less of a drag on production in the second quarter of 1958 as compared to the first. In short, prospects point to business recovery in the second half of 1958 without emergency measures.

If this view of the business outlook is accepted, it should follow that, if Government action is at all necessary, it should be of such a nature as to produce its maximum psychological and financial effect as early as possible, tapering off after midyear. If it continues to exert an appreciable impact on economic activity very much later, it may accelerate the rate of economic recovery enough to initiate a new round of inflation. Of the various actions proposed, the President's plan for extension of unemployment compensation payments, the idea of a tax cut on a temporary basis, and the easing of home financing requirements and of credit generally, seem the most suitable.

GENERAL DYNAMICS CORP.,
New York, N. Y., May 7, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: In connection with the Senate Finance Committee's inquiry entitled "Investigation of the Financial Condition of the United States," you have asked that I submit my thoughts and opinions about vital matters affecting our economy.

Since your committee's study is "the first full-dress examination of our fiscal and monetary policies since the one conducted by the Aldrich Monetary Commission in 1908," its fruits will no doubt provide fresh insights into the delicate mechanisms of fiscal and monetary control and their effective application to the flexible and variable forces of private enterprise.

Events since your committee opened its hearings have underscored with disturbing impact the vital need to find solutions to the crucial problems which your committee is examining.

Some of the elements of our current recession are sufficiently unorthodox in their manifestations and tendencies as to have frustrated the efforts of most of us to predict with confidence its precise course or duration. Ending the recession without inducing a resumption of inflationary pressures involves possible contradictions which complicate immeasurably the process of applying vigorous remedial actions.

Analysis differ in the weight they ascribe to the various precipitating causes of the recession. It is encouraging, however, to note that increased emphasis is being given to the impact of governmental and industrial actions on the psychology of the consumer.

How serious was the psychological impact? The effect can be measured to some extent by the recently published survey of the National Bureau of Economic Research. The poll, taken in early April and covering 25,000 families representing all parts of the United States, reveals that the plans of this cross section of the public to buy new cars fell by 20 percent and to purchase major items of household goods by 10 percent, from October 1957 to April 1958. This result can be explained, perhaps, partly by overextension of personal debt, lack of product appeal, or unemployment, but I personally believe that a very substantial part of the answer lies in the disturbance of the consumers' confidence in his personal financial security or in the stability of the economy. If this appraisal is correct, the meaning cannot be ignored.

Perhaps the combination of circumstances which triggered off the recession were unavoidable—given the economic antecedents and the then existing framework—but to the extent that opportunity for choice existed, one lesson of the last 8 months would seem to be that both industry and the Government must learn to plan and schedule their large-scale expenditure programs in such a way as to avoid, to the extent possible, the cutting off of both public and private spending abruptly and simultaneously. In the fall of 1957, business expenditures for plant and equipment were leveling off and planned programs indicated reduction of private investment expenditures for 1958. At the same time, the Government took rather drastic steps to curtail the rate and scale of defense expenditures. Since consumer purchases of automobiles and household equipment had already declined earlier in the year, and United States sales abroad had also declined, the impact was probably greater than most of us had anticipated.

One probable reason for failure to judge consumer psychology and economic trends with a higher degree of accuracy is that the methods of gathering and interpreting data on our economic forces are inadequate. The recently issued Rockefeller report on the United States economy suggests that an additional $5 million to $10 million a year devoted to the assembling of statistics indicating the state of the Nation's economic health would yield very high returns. Refinement and improvement of the techniques of handling economic intelligence should not be delayed.

The basic fiscal and monetary policies of the Nation contribute importantly to the mechanisms which determine the consumer's buying habits, wants, and satisfactions. Nevertheless, fiscal and monetary policies alone cannot serve as total regulators of our economy, particularly if, as now appears to be the case, their application does not necessarily reach wage-price relationships. It is to be hoped that this regulator can be supplied by self-restraint and mature judgment on the part of management and labor in our free society. For the prospect of a continued rise in costs and prices in the face of declining business activity and consumer resistance could prove serious. Although corporate profits are expected to decline in 1958 from approximately $41 billion to an estimated $36 billion or less, hourly wage rates are almost certain to advance because of wage increases written into existing contracts, to say nothing of the outcome of current labor negotiations in large industries.

But the Government is not powerless in this area, short of legislating a national policy. Congressional committees can be powerful instruments of enlightenment. What is needed is the development of a body of fact and opinion of such formidable import that false economic wage-price demands and practices will fall before the weight of enlightened public opinion. If, for example, support of the prewar purchasing-power theory of wages is demonstrably the major cause of the upward push of wages and prices, the case should be fully documented and disseminated. The same holds for the theory of expanding corporate profits as the cause of inflation.

The many experts upon whom you have called will unquestionably provide significant opinions on the technical aspects of fiscal and monetary policy. I would like, therefore, to offer a few comments on a facet of the problem which perhaps may not receive adequate discussion: the relation of fiscal and monetary policy to security expenditures.

In the fateful struggle between Russian militant imperialism and United States defensive resistance, there are several ways by which we can forfeit the victory. The most obvious and certain way is to let the balance of military power and prestige swing in Russia's favor. A less obvious, but interrelated way, is to fail to meet and counterbalance the cultural and economic offensive of Russia in all parts of the Free World. A third way is to tolerate a weakening of our economic strength to the point where we cannot effectively cope with the first two dangers.

As the cold war intensifies, and the cost of waging it multiplies, the balancing of the risk of endangering our economic system by reason of astronomical expenditures against the risk of imposing arbitrary ceilings on our defense effort for fiscal reasons becomes a formidable dilemma. The extent to which military programs should be cut back, stretched out, or eliminated for fiscal or economic reasons is fundamental. The extent to which security expenditures should be used as economic regulators should be more clearly examined and understood. And the true impact of security expenditures on our economy—favorable as well as unfavorable—must be put in proper perspective.

With respect to use of security spending as an economic regulator, Prof. John Kenneth Galbraith has recently expressed the following view:

"* * * military outlays should be established wholly by need and not at all by fiscal considerations. This is an ironclad rule.

"To adjust military spending to the fiscal needs of the economy is both reckless and immoral. It is reckless because it means that such expenditures will then be cut, regardless of urgency, whenever inflation threatens. And it is immoral because it means that outlays for these instruments of death would be increased regardless of need when there was unemployment and idle capacity.

"There has already in these last few weeks been far too much ill-considered talk about defense expenditures as the new form of pump-priming.

"I don't suppose there is any aspect of Communist propaganda that has made so much headway as the conviction in some way that the American economy is dependent on arms expenditures. It is a charge that we should most scrupulously and honestly avoid * * *."

A somewhat modified view of this principle is contained in the statement of the Committee for Economic Development, Antirecession Policy for 1958, issued in March 1958, at page 18:

"The size and character of the defense program should be determined solely by considerations of national security. It would not violate this principle, however, for procurement scheduled for a year or two ahead to be rescheduled to support incomes and employment when such support is needed. The danger of obsolescence and the long lead times required for many items limit the extent to which this can be done, but some significant support to the economy should be possible. Continued procurement of items that are no longer needed, merely because this is the easiest way to place contracts and obtain production quickly, must be guarded against."

I recognize, of course, that there are limits to the amount of expenditures which can be made, even for security, within the framework of a free society and a free-enterprise system. But, as a principle, the defense program, in my view, should be formulated and effectuated on the basis of need and not as a part of those Federal spending processes which can be adjusted flexibly to meet or further fiscal requirements. It should not be looked upon as a contracyclical device, for the volume of security expenditures is too sensitive to international pressures and tensions. Dependence upon them as basic tools to promote economic stability would appear to make neither good economic sense nor sound military sense.

Another consideration which should be weighed in determining the relation of fiscal policies to defense expenditures is the nature and extent of the impact of such expenditures on the economy. While security spending can be justified only on the basis of security needs, the effects of such expenditures on our economy must nevertheless be appraised realistically. The matter deserves our closest attention, for the rate and scale of our security effort should not be artificially limited by false or questionable economic assumptions. The risk of a mistake here is too great. Considering the lead time required to develop and manufacture tomorrow's weapons, there may be no recoupment of the advantage we yield today. Therefore, it is important to know whether defense spending is destructive to the economy, or if, in fact—as many economists believe—it has raised the realized rate of growth since 1939 and played a decisive role in revolutionizing research, development, and technology since 1940. Similarly, it is essential that we study the longer range implications of defense spending, as respects the possible diversion of resources from the civilian economy, the positive or negative effect of such spending on other segments of the economy, and the increasingly serious competition for sources of revenue. In this connection, the studies reported under chapter VIII, page 507, of the volume issued on November 5, 1957, by the Joint Economic Committee, entitled "Federal Expenditure Policy for Economic Growth and Stability," provide some stimulating and illuminating observations.

Interrelated with the question of defense expenditures is the matter of furthering the economic health and development of our friends and allies. Here is an area where aggressive action by the Government in establishing favorable conditions for investment and equally positive action by industry to expand foreign investment, could, at one stroke, help stimulate the economy and achieve incalculable benefits in international relations. While the encouragement of expansion of international trade does not at first blush appear to be a significant means of stimulating the economy, there is evidence that a relatively small advance in this area could go a long way. Increased effort must in any event be exerted sooner or later, forced, perhaps, again, by Russian example. With long-term loans at low interest rates, the Soviet bloc has doubled its trade with the less developed nations in 3 years from $840 million in 1954 to about $1.7 billion in 1957; and the number of trade agreements in this 3-year period has leaped from 49 to 147. We would be well advised, in my opinion, to address ourselves to an accelerated offensive on the international trade front. The mechanisms of credit and risk insurance, supported by policies which would encourage foreign trade, could open stimulating new frontiers for American industrial development abroad.

In general, monetary and fiscal policies appear to have the flexibility intended for them, but they cannot, in and of themselves, maintain a perfect equilibrium in our economy or provide complete stability. As Federal Reserve Board Chairman William McChesney Martin told your committee on April 22:

"By fostering conditions conducive to prosperity, the Government can help a lot. But it can't do it all. That is why the Employment Act of 1946 pledges the Government's efforts to create and maintain 'conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing and seeking to work.' And it is why the same act says the Government's efforts to that end shall be applied 'in a manner calculated to foster free competitive enterprise and the general welfare.'"

"Monetary policy is undertaking, within its inherent limitations, to provide such a climate for recovery. It is not omnipotent, but I can assure you that the System is approaching the problem of combating recession with just as much vigor as it exhibited in battling inflation."

The key to economic stability must necessarily lie in the power of industry to create new and permanent jobs in an expanding but secure economy. It seems to me that many areas of public and private policy should be reexamined with this fundamental objective in mind, such as: the area of taxation and its impact on incentive and initiative; the area of depreciation policies as they affect industry's ability to provide new resources for expansion and increased employment; the crucial relationship between the relative rigidity in the wage-price trend and the more flexible economic factors which are more responsive to changes in Federal monetary and fiscal policy.

There is an everincreasing awareness of these problems and the understanding of them will grow with the improvement of our techniques of economic intelligence. One formidable problem, as I see it, is to develop organizational techniques for the interpretation of economic indicators in a manner which will permit both the Government and industry to synchronize their planning in a more orderly and coordinated way than they now do.

Government and industry must develop more mature relations between each other, and each must reorganize itself in a manner so as to insure that the ultimate national policies which are important to the survival of the nation can be effectively applied by the Government cooperatively with industry. It must always be borne in mind that while Russia can make the national will felt almost by reflex action through its monolithic structure, the only possible exertion of Federal will in this country is through the coordinated effort of both the Federal Government and private industry. Not only our domestic economic life, but the whole defense effort and the prosecution of our foreign policy, necessarily involve industry as a partner of the Government, or at least as an essential instrument through which the Government's policy must be expressed.

The importance which I have attached to the relation of fiscal and monetary policy to security expenditures may suggest that this document is a self-serving one for the industry of which I am a part. You will appreciate, however, that my service in this industry has focused my attention sharply on this problem. The views which I have expressed in this letter represent my convictions.

I trust that the few observations I have made will serve the important deliberations of your committee.

Sincerely,

FRANK PACE, Jr., *President.*

PHILADELPHIA ELECTRIC CO.,
Philadelphia Pa., March 31, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D.C.

DEAR SENATOR: Your committee's investigation of the financial condition of the United States is a timely and desirable project. The following comments have been prepared with reference to the list of questions supplied by your letter of February 17, 1958. It has been a pleasure to take part in this project and it is hoped that these comments will be of value.

Price stability is an important segment of our free-enterprise system. Fluctuations of the economy resulting in periods of rising and falling prices, undermine the basic concepts of our economic system. While limited price variations within the various segments of industry do occur, they do not necessarily constitute inflation or deflation.

Economic growth in production, demand, and employment can continue as long as the supply of money, the demand for goods, and the ability to produce goods maintain a proportionate relationship. As soon as one of these factors is changed without a corresponding change in the others, the effects on price become apparent.

Since 1947 we have seen an erosion of the dollar which is continuing today. The monetary policy of the government and the economics of our free-enterprise system have each made their contribution to the inflationary potentials in our economy.

By pegging the interest rates on Government securities at a low rate during the period 1942–50, the Federal Reserve permitted the expansion of bank credit and money supply more rapidly than necessary for the rising physical volume of goods and services.

Following the accord with the Treasury in 1951, interest rates on Government securities were allowed to follow the free market. The reserve requirements of member banks were increased and the expansion of consumer credit was temporarily slowed. The fast action by the Reserve in 1953, when the reserve requirement was reduced, and in early 1954, when the discount rate was lowered, did much to make credit available for a fast recovery following the 1954 recession. Similarly, the tight money policy of the Reserve from 1955 until the end of last year has done much to contain the expansion of credit and the money supply.

These lessons have shown that restrictive credit policies are effective in stemming inflation, but their effectiveness as a stimulant to ward off deflation is questionable, because the mere price of credit is not the only determinant of its demand. The Federal Reserve should ease credit on the downswing as the market demands, but should remain alert to any resurgence of inflationary trends. It is its ability to act as a brake on the upswing of credit expansion which is the Reserve Board's major contribution to stability of growth in our economy.

There seems to be little question as to the adequacy of our banking system to meet the normal increase in credit expansion for the years ahead. Unfortunately, however, there is no definite measure of ascertaining the amount of credit expansion appropriate to a particular level of business activity. The sheer size of the consumer debt is often misleading. It seems that the relationship of extension of credit, repayment, and personal income might be the best indicators of the inflationary or deflationary pressures of this form of credit. As long as these grow at a relatively constant rate, there is no reason to believe the consumer debt is too large.

Prior to 1951, the Treasury's financing problems were eased by the ready market for its securities made by the Federal Reserve. It is now evident that this added to the inflationary trend. In retrospect, it seems that there should have been an attempt to lengthen the maturity of Federal debt in light of repeated warnings of the inflationary potentials. The higher interest rates which would have been incurred, seem small today.

Often sight is lost of the real effect of interest costs to the Federal Government. Much of the interest paid by the Treasury becomes income to other Government agencies, so that their requirements for other funds are reduced. Even now, lengthening the maturity of the debt seems to be the only way of relieving the strain of refunding during unfavorable periods. Most businessmen would consider it ill-advised to attempt to finance their capital needs through short-term loans, why then should the Government?

The rapid expansion of Federal, State and local spending, has contributed significantly to the inflationary pressures. High taxes have diverted funds into Government spending, which might otherwise have been removed from the money stream, and have reduced the effectiveness of credit restraints in varying degrees, depending upon the borrowers' tax bracket. During inflation the Government's tax bite increases as we move up the brackets of the tax ladder, thereby reducing purchasing power and the funds available for investment in increasing productivity. These funds are then used to purchase military hardware which does not add to productive capacity of the economy or become available for private consumption.

A stable dollar can best be achieved by a reduction in Federal expenditures and taxes. In this way a balanced budget would be maintained, thereby minimizing the effect of the Government's injections and leakages in the money stream. Spending of private enterprise is necessarily predicated upon a corresponding increase in productivity, so that the money supply and productivity relationship is affected only by a change in saving habit or an incomplete allowance for capital consumed, as has been the case in recent years. The increased funds required for replacement have not been allowed to accumulate, so that it has been necessary to use up savings and expand borrowing, thereby putting more money into the stream than might have otherwise been necessary. This factor will continue to exert inflationary pressure as long as a realistic approach to capital consumption is hindered by tax measures.

The economic controls inherent in our fiscal and monetary systems seem sufficient to maintain the continued growth of our economy without governmental control over the individual segments and enterprises. The banking system has the power to maintain credit structures, and the Government can influence the economy by spending policies and tax moves. There seems to be no need for further controls over prices, wages, and other costs.

Some accusations of administered prices have been aimed at big industry, but experienced businessmen realize that in the end prices must conform to what the buyer will pay.

The effect of administered wages may be even more prevalent with the continuing increase of the power of unions, which is now far beyond that of any corporation. This may be the major reason why wages continue upward despite a downturn in business. Escalator clauses tend to perpetuate inflation, but the fact that they are not universal will in itself diminish their effect in time. Regardless, the economics of supply and demand will in time control these features without Government intervention, and without the necessary imbalances to free competition.

The seeming paradox of inflation and unemployment may reflect pricing policies, but as has already been seen in many industries, these practices should right themselves in a free market. Control over such basic factors of our economy would endanger the free-enterprise system.

The use of large increases in public works may be effective as a pump primer in times of a serious depression, but would be of little effect during the present period. There has been no recession in which construction activity has ben the major force of resurgence, in fact, in the past business has been turned up prior to capital spending.

This poses the problem as to when pump priming and tax cuts are effective. Tax cuts have been the more effective means of putting money into the stream quickly and efficiently. In 1954 it took less than 2 years for tax revenues to exceed those prior to the cuts. Tax cuts also can be remanded if inflation again threatens. Public works are long term in nature and usually affect the economy long past the time required for pump priming, thereby adding to the resultant inflationary forces. Also it may be harder to raise the extra funds required to balance the budget because of the delay from the time these funds are put into the economy until they are received as taxes.

Certainly in a recession of the magnitude we are now experiencing, a large public works program would kindle the fires of inflation and might be more difficult to control once underway than the effects of a tax cut of similar proportion.

The effectiveness of public works should not be ruled out, but this is a weapon which should be retained for extreme cases such as the depression in the thirties.

Our present economic recession stems from an oversupply of goods created by overinvestment in facilities without a corresponding increase in the demand for goods. The high inventory situations of many of our basic industries have been accumulated as a result of overspeculative production. The policies of tight money and economy in Government, which were so prevalent about a year ago, have caused many people to reevaluate their expansion plans. Those that were founded on speculation have been canceled and many people looked for other means of financing their working positions. Large inventories, especially in the durable goods industries, became an easy source of working capital. The same psychological factor had its effect on consumers also. They took a wait-and-see attitude based on the fact that their essential needs were well satisfied. Then the added effect of the resurgence of Soviet science added to this loss of confidence. All this led to inventory liquidation, a slowdown in production and employment, and finally increased unemployment and pressure on prices.

During all this, the loosening of credit by the Federal Reserve will probably have little effect because people who needed new facilities continued to build regardless of interest rates. It was only marginal expansion that was stopped.

The greatest weapon available to stabilize the economy today is psychological. If the confidence of the consumer can be regained, the necessary cash and credit are available to restore economic growth. The utility industry has the greatest confidence that this will happen in time as is evidenced by the continued expansion of facilities in order to meet the needs of the years ahead.

It would seem that economic stability can be achieved now in much the same way as in 1954—namely through the reduction of Federal expenditures, taxes and an easing of credit restrictions. Recognition should be given to the deterrent effects of taxes on business as well as the consumer. The reduction of corporate taxes could bring some relief to the need for funds in the money market. Business would better be able to absorb cost increases, thereby passing much of the benefit on to the consumers. The stabilizing effect of prices would stop the rise in the cost of living, and the inflationary effects of escalator cost increases. Individual income-tax reduction would immediately put more funds in the hands of the consumer, some of which in turn might be used to make purchases now delayed.

Certainly, one of our greatest fears still is inflation and any fiscal tampering must be careful not to upset the delicate balance of money supply and productivity. We must be alert to any indication of continued inflation in order to break the vicious circle of creeping inflation.

Stability of the dollar can be realized only through the exertion of economic and political wisdom and courage.

Very truly yours,

R. G. RINCLIFFE.

THE FIRST NATIONAL CITY
BANK OF NEW YORK,
New York, N. Y., March 7, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate,
Washington, D. C.

DEAR SENATOR BYRD: This is in reply to your letter of February 17, enclosing 17 questions and requesting my opinions on the matters covered. The questions are extremely broad. To deal with them in a fully comprehensive way, it would be necessary to write a book. Therefore, I should like to take advantage of the suggestion in your covering letter and, rather than attempt to answer each question in detail, use them as a guide for general observations on the issues raised.

Several of the questions deal with inflation, deflation, full employment, etc. A national economic policy must have twin objectives. On the one hand, it should be aimed at promoting growth in the economy to provide for national security and rising standards of living and welfare. At the same time, it should also have price stability as a goal. Price stability insures that the gains of growth are enjoyed by all, not merely by those who bargaining power is greatest. There is also real question whether the sound and sustained growth we need is possible in an inflationary environment. Inflation is not merely inequitable; it also, as economists have long recognized, leads to inefficiencies and misallocations of resources which reduce the economy's real rate of growth. It creates an atmosphere in which speculators thrive better than producers. We need to recognize, as we have not fully done, that inflation is as objectionable as deflation. I therefore suggest that the declaration of policy in the Employment Act of 1946, which is the stated guide to national economic policy, should be reworded and price stability specifically named as a goal of policy, coordinate with maximum employment, production, and purchasing power. I would answer question 11 (b) in the negative.

It follows from the above that I believe monetary policy, like other Government economic policies, should seek to attain both economic growth and price stability. I believe monetary policy has pursued these objectives in a generally commendable manner, at least since the Treasury-Federal Reserve Accord in 1951 freed the Federal Reserve of necessity to support prices of United States Treasury obligations. I believe the Federal Reserve System should continue to enjoy the same degree of independence in action that it has had since 1951.

Monetary policy should be flexible. It is most effective when restraint is called for, in checking boom excesses which historically have brought painful deflation as an aftermath. The effects of an easing policy, in the converse circumstances, are less certain and less pronounced; however, monetary ease in recession obviously has an impact on the ability of lenders to make credit available and on credit supply.

It doubtless has some stimulative effect on borrowers' credit demands. Flexible monetary policy promotes stability, within the framework of growth.

Monetary policy cannot do everything, of course, as the recent rising course of consumer prices in a period of credit restrain suggests. While some of the price rise reflects belated adjustments of the prices of services to earlier inflationary pressures, the major responsibility seems to lie in the area of wage and labor policy and Federal budget policy. However, the inflationary experience would have been worse if monetary policy had not been one of restraint.

Monetary policy has been hampered not only by wage policy but by the renewed upward trend in Federal spending. A lower level of spending and larger Federal budget surpluses would have permitted more debt retirement, releasing existing funds for private use. It would also have reduced the frequency with which the Treasury has come to the money market for new money or to refinance maturities, each time influencing if not requiring the Federal Reserve temporarily to moderate its restrictive credit policy. Recent Treasury funding operations to improve the maturity structure of the public debt are helping to relieve the weight of early maturities which have proved an impediment to the enforcement of a restrictive Federal Reserve credit policy.

Federal, State, and local government spending is just as inflationary as any other spending. In fact, many authorities, including Arthur F. Burns, former Chairman of the President's Council of Economic Advisers, say Government expenditures are more inflationary than private expenditures. Dr. Burns observes that Federal Government officials, by and large, are probably less efficient shoppers than private citizens, buy a good deal on a cost-plus basis, and are required to include special provisions regarding wages and other labor standards in the contracts they negotiate. He points out that their outlays, which nowadays are of necessity heavily concentrated on national defense, seem unlikely to contribute to the improvement of industrial capacity and productivity as would private expenditures of the same magnitude. In addition, Dr. Burns has warned that balancing expenditures by increased taxation does not necessarily cancel out the inflationary impact, for private spending need not be reduced by the amount of the tax increase. People may instead cut their savings in order to maintain their consumption, at least in part.

At the same time big Government spending leads to excessive taxation which, as more and more people are recognizing, has inflationary and other harmful effects of its own. It is siphoning away badly needed savings which could finance industrial growth, most particularly from small business which needs it most. Meanwhile our severe personal income tax rates are making it less attractive to gifted individuals to put out the extra effort needed to go ahead and succeed. We need to remember that in our type of society, depending on individual effort and initiative, we stifle the rewards and compensations at the risk of reducing performance. This is something we cannot afford in the face of the Soviet Union's challenge for world military and economic leadership.

The United States monetary system is currently financing gross national production well beyond $400 billion. Nevertheless, questions of adequacy and possible weakness have been raised with increasing frequency in recent years as the economy has developed novel and ingenious methods of economizing on and supplementing the available bank deposit supply. The growth of unregulated lending outside the banks and the creation of near equivalents to money by nonbank financial intermediaries are cases in point. We feel that these and numerous other changes since the Federal Reserve Act of 1913, and even since the financial reform legislation of 1933–35, call for a detailed, technical study of the United States monetary system. Accordingly, we endorse the Committee for Economic Development's projected National Commission on Money and Credit to make a "broad 3-year inquiry into the public and private monetary and credit policy of the United States."

Full employment and price stability are theoretically compatible. But in practice it is very hard to hold prices stable if full employment is misinterpreted to mean that we should never have more than an insignificant number of people temporarily between jobs or on seasonal layoffs. Trying to live up to this definition leads to overemployment, and the experience abroad as well as here is that overemployment brings shrinkage in the buying power of the currency.

The current recession is a natural reaction to an overexuberant boom. While it is wise policy to carry out necessary Government works in a time of reduced private demands (and conversely to defer public works during a boom), I believe that made-work projects are no cure for recession and should be avoided. They are likely to contribute to subsequent resumption of inflation. Larger public spending to counter recession would raise the specter of even higher taxes later. The fact is that the most promising way to stimulate business is to relieve the tax rates which are most constrictive of enterprise.

For the longer run it would be desirable to pass the Sadlak-Herlong bill which would reform the income tax structure over a 5-year period and culminate with a rate schedule running from 15 to 42 percent for individuals and a 42 percent rate for corporations. Both in terms of combating recession and furthering our long-range growth, it is doubtful if there is any other action Congress could take that would so brighten the economic outlook and revitalize efforts to produce and sell and go ahead with the creation of higher standards of living. Along with this, of course, should go strict economy to prevent deficits in prosperous times, when stability is best served by Treasury surpluses, debt reduction, and lengthening of the debt.

Very sincerely,

JAMES S. ROCKEFELLER.

AMERICAN AIRLINES,
New York, N. Y., March 31, 1958.

Senator HARRY F. BYRD,
Senate Office Building,
Washington, D. C.

DEAR SENATOR BYRD: In response to your letter of February 17 I am glad to enclose herewith a statement concerning our views on the national economy.

Sincerely yours,

C. R. SMITH, *President.*

1. Definition of "inflation" and "deflation." There are just about as many definitions of inflation and deflation as there are economists to define these terms—monetary inflation, wage inflation, cost-push, demand-pull, and so on. The plethora of definitions arises largely from the temptation to define inflation and deflation in terms of causes rather than effects. No matter what the causes, all forms of inflation are reflected in a broad upward movement in prices, and all forms of deflation are reflected in a corresponding broad decline. We therefore define inflation as a general rise in the price level and deflation as a general fall.

There still remain the problems of selecting the stage or level of the economy at which prices are to be measured (spot markets, wholesale markets, retail markets, etc.), and the technique or yardstick to be used in this measurement. In our own company, we customarily use the consumer price index of the Bureau of Labor Statistics to measure inflationary price changes, since this index reflects the aggregate behavior of a broad range of consumer goods and services and has broad geographic coverage. In the final analysis, all of us, as consumers, are vitally affected by the prices of goods and services in retail markets. The BLS index is the most comprehensive measure available of the prices paid for consumer goods at retail.

2. Measures for avoiding inflation and deflation and suggested legislation: Inflation (a broad upward movement of consumer prices) normally occurs when the aggregate effective demand for goods and services (demand backed by money) exceeds the capacity of the economy to produce these goods and services. Conversely, deflation normally occurs when the capacity to produce exceeds the effective demand.

History teaches us us that most of the great postwar inflations have occurred after the money supply has been swollen by wartime deficit financing, and when the demand for consumer goods and services, pent up by wartime shortages, exceeds the capacity of the economy to produce at full employment levels. Under such circumstances, prices of both producer and consumer goods are bid upward, thus touching off the familiar cost-price spiral.

It is always tempting to legislate against inflation, as, for example, by amending the Employment Act of 1946, to make it the stated policy of Government to maintain stable prices at full employment levels. Something useful might be accomplished in this way, particularly in situations where there might otherwise be some confusion as to what the objectives of Government economic policy should be.

Fundamentally, however, the problem of controlling inflation and deflation is administrative rather than legislative—that is, of finding out exactly what to do and the most effective way to do it. To put the matter differently, the basic problem is to determine some workable arrangement for maintaining the delicate balances between aggregate effective demand on the one hand, and on the other hand, the capacity of the Nation to meet this aggregate demand at full employment levels.

Both from the practical and theoretical points of view, the achievement of full employment and stable prices is clearly not easy, and no general rules can be laid down that would be effective under all circumstances. At what level, for example, does full employment verge upon over-full employment, so that there is an upward pressure through wages and the prices of producers goods on costs and thence consumer prices? And is it possible, except by inflationary deficit financing or successive doses of easy money, to maintain aggregate demand at full employment levels? The experts do not agree on these matters, partly, perhaps, because we have had no concrete experience with a system in which the dual objectives of national economic policy are to avoid the ravages of inflation and the social and economic wastes of unemployment. Such a system, in my opinion, is certainly worth a fair trial, with or without additional Federal legislation.

Government expenditures now represent so large a share of gross national product, and such expenditures have varied so erratically and unpredictably in the postwar period, that the problem of maintaining full employment with stable prices should be attacked first at the Federal level. Such a program might perhaps be implemented through a steering committee at the Cabinet or near Cabinet level, comprised of representatives of all departments and agencies whose activities have a major impact on Government expenditures and their financing. In the absence of any coordinated control of these activities, Government programs to achieve this or that objective, no matter how desirable they may be in their own right, may be largely self-defeating as they relate to the dual objectives of full employment and stable prices. For example, one of the principal factors underlying the steady rise of the Consumer Price Index in recent years has been the sharp recovery in agricultural prices, and the upward spiral of prices of construction materials and costs. Such an inflation clearly cannot be brought under control by the Federal Reserve authorities acting alone, when the avowed purpose of major Government spending programs (such as agricultural price maintenance, slum clearance and public housing, the highway program, etc.) is to overcome the effects of monetary stringency in many areas. Or again, when the economy has shifted into the downward phase of the business cycle, easy money induced by the monetary authorities can be largely offset in the capital markets, by a funding of short-dated bills and notes into long-term Treasury bonds. A coordinated program is essential if we are to achieve full employment and stable prices. Therefore we propose (1) that the objectives of national economic policy be clarified to emphasize price stability along with full employment, and (2) that a committee be established to determine appropriate instruments to achieve these goals and to coordinate Government activities bearing upon them.

3. Monetary policy, 1942–57: Federal Reserve policy in the period 1942–57 can be divided conveniently into three sub-periods: 1942–46, the period of wartime emergency; 1947–51, the postwar aftermath in which Federal Reserve policy was inoperative owing to the pegging of the yield-maturity curve on Treasury obligations; and March, 1951–57, the period following the Treasury-Federal Reserve monetary accord, when monetary policy was restored to its proper role as a contracyclical force.

During the war emergency, prices of Government securities of all maturities were pegged to maintain orderly market conditions at a time when the Treasury was coming to market almost daily to finance the war effort. Generally, that policy appears to have been appropriate, although it would have been desirable if a larger portion of war expenditures had been financed through taxation rather than through deficit financing. That, however, was an error in fiscal policy, rather than in the policy pursued by the monetary authorities.

The crucial mistake was made in continuing the wartime pegging of interest rates until the monetary accord of 1951. Commodity prices rose rapidly in the immediate postwar period for reasons outlined in our answer to question 2, and monetary restraint was clearly called for to combat price inflation. Instead, the entire Federal debt was monetized (i. e., became the equivalent of bank reserves) by the policy of pegging the prices of Government securities of all maturities.

In the third of the periods mentioned above Federal Reserve policy was restored to normalcy. Monetary controls gradually became more restrictive up to the turning point of business in May 1953, were relaxed during the business recession of 1953–54, reverted gradually to a policy of monetary restraint until November 1957, and then gradually turned toward the side of ease during the current recessionary phase of the business cycle.

On the whole, monetary policy since March 1951 has been excellent, although with the advantage of hindsight it is possible to criticize minor details. Thus monetary policy may have veered too much to the side of active ease in 1953–54 than now appears to have been desirable in view of the subsequent rise in commodity prices. Conversely, the transition to the side of ease during the business downturn beginning in 1957 seems to have been rather hesitant, in the light of the depth of the current business recession. But these are comparatively minor matters of judgment and timing, on which even the experts disagree. On the whole, Federal Reserve monetary policy since March 1951 has been forthright and courageous, and the general results have been good.

4. Causes of the rise in consumer prices, August 1956–September 1957: The principal causes of the rise in the Consumer Price Index after August 1956 were (1) a "catching up" in the prices of services, rents, and transportation, which had been held down during the early postwar period by long-term contracts, Government regulation, and, to some extent, by custom (e. g., doctors' fees, etc.); (2) the resumption of agricultural price inflation under price-support programs of the Federal Government; (3) the wage-cost-price push (see the answer to question 2 above), resulting from over-full employment

(partly caused by Federal efforts to stimulate housing, road building, etc. at a time when private demand was more than sufficient to maintain full employment). Additional contributing factors were the strong consumer demand for goods and services, the efforts on the part of business to meet this demand by stepping up plant and equipment spending, and the concomitant rise in business inventories, which came on top of an economy already fully employed in the production of final goods and services.

5. Effects of debt management on the United States economy: In theory, debt management (defined here as adjustments in the maturity structure of the Federal debt rather than in its level) can play an important role in amplifying the effects of monetary policy. For example, in a period of monetary ease, when it is desired to encourage business investment and to expand the money supply, the indicated policy is for the Treasury to confine its financing to the short-term market by sale of short-dated bills and notes to commercial banks, the reserves to be provided for this purpose by the Federal Reserve authorities. The money supply is thus inflated (or a contraction prevented), and all of the funds flowing through the long-term market are thus made available to finance permanent capital expenditures such as housing, plant and equipment outlays, and so forth. Conversely, when business is booming, debt management can amplify restrictive monetary policy by a funding of short-dated Treasury obligations into long-term bonds, the bank reserves released by this process being mopped up by appropriate Reserve bank action. Under such circumstances, long-term funds which otherwise would be used to swell capital expenditures are, in effect, employed to reduce bank credit and to contract the money supply.

Thus, properly oriented monetary and debt-management policies are highly desirable. In practice, however, proper orientation is difficult to achieve since other objectives are allowed to intrude, thus mitigating or offsetting the effects of monetary policy. The recent issues of 3½- and 3-percent long-term bonds are cases in point. Since November 1957, the Federal Reserve has sought to ease conditions in the short-term market, while the issuance of long-term bonds by the Treasury in effect has tightened up the capital market. Earlier, when a restrictive monetary policy was called for to combat inflation, the level of bond yields appeared to the Treasury to be too high to permit long-term bond financing. The absence of long-term Treasury financing from mid-1955 to September 1957 illustrates the difficulty of effectively integrating monetary and debt-management policies in a period when bond yields are high.

6. Relative importance of price stability and economic growth: Of the three objectives of monetary policy mentioned in question 6—(1) price stability; (2) stability of production, demand, and employment; and (3) economic growth—the second is clearly inadmissible and can be rejected at once. Normal growth in our population and labor force implies growth in production, demand, and employment, unless we are to have rising unemployment, and a declining standard of living, which in the end would be incompatible with our free enterprise system. Growth in production, demand, and employment must therefore be the paramount goal of economic policy. A second goal—only slightly less important than the first—is to achieve growth with price stability. Price inflation in the postwar period has robbed many

of the more efficient and hard wording of our people of the fruits of their labor. As suggested in our answer to question 4, price inflation has also distorted normal price relationships throughout the economy, favoring sectors where prices are free to move upward at the expense of others where prices are fixed by long-term contract, custom, or Government authority.

In the last 2 or 3 years, the economy may best be characterized as one in which all sectors—the consumer, business, and Government—were trying to accomplish too much at once. Aggregate effective demand exceeded the capacity of the Nation to produce, and prices moved upward under the pressure of rising labor costs and expanding final demand. It is unfortunate that major Government projects such as the Federal roadbuilding program that were initiated to combat the mild business recession of 1953–54 contributed importantly to the price inflation of the boom years 1956–57.

7 and 8. Effects on the economy of Government spending and taxation: Government spending and taxing are two sides of the same coin; both involve a transfer of control over the limited resources of the economy from the individual to Government. Although many forms of Government spending may be highly desirable to achieve various social goals, the basic functions of Government are very simple and should be narrowly circumscribed. It is too often lost sight of that the basic Government functions are only two in number: (1) to govern and (2) to protect the individual. All other functions should be examined carefully to see that they do not infringe upon the individual's right of free choice in spending his income, and do not stifle initiative and efficiency through burdensome taxation.

All of this assumes, of course, that the individual is wiser than Government in deciding how he should best spend his income. On occasion there are overriding circumstances that might warrant Government interventon to prevent the free choice of individuals in the market place from directing the allocation of the Nation's resources to the most efficient uses. In the absence of such overriding considerations, Government spending (and taxing) should be kept to a minimum.

9. Role of fiscal and monetary policy in combating inflation and deflation: Fiscal policies relate to the activities of the Treasury (on the side of Government receipts, expenditures, and debt management) to maintain full employment and stable prices, whereas monetary and credit policies pertain to the activities of the central bank (the Federal Reserve System) to achieve the same ends.

According to textbook theory, appropriate fiscal policy under inflationary condition calls for a decrease in Government expenditures and an increase in Government receipts (tax and other revenues), with a resulting rise in the Treasury cash balance and a correlated decline in Federal debt. A decrease in Government expenditures results in a direct curtailment of aggregate effective demand for goods and services (the basic cause of inflation; see question 1 above); an increase in Government receipts through higher taxes, and so forth, results in an indirect decrease in aggregate effective demand through drains on disposable personal income and the net cash flow to business corporations. The related rise in the Treasury cash balance, and decline in Federal debt, are also deflationary, to the extent that liquid balances in the private sector of the economy are thereby reduced (here we include Government securities with cash as part of the liquid balances of the community). The converse policies are appropriate during deflation.

Restrictive monetary policy during inflation acts to reduce the availability of bank credit (and hence restricts the growth in money supply), thereby also reducing aggregate effective demand for goods and services. Restrictive monetary policy is, of course, most effective when supplemented and supported by fiscal policy. And conversely, the two policies—monetary and fiscal—can play an important role under deflationary conditions by checking the decline in aggregate effective demand.

From a practical point of view, the two policies are seldom geared to work together efficiently. For example, an increase in Government expenditures designed to check a deflationary trend usually lags well behind that trend. Thus, Government expenditures frequently rise when the business curve is rising and fall when it is falling, in exactly the opposite fashion to that indicated by the textbook theory of appropriate fiscal policy to combat booms and depressions. This means, in effect, that the only operational policy that we can rely upon to check booms and depressions is that exercised by the monetary authorities. The reasons are largely political, and result partly from the quasi-independent status of central banking in this country.

(10) Adequacies and inadequacies of monetary and fiscal systems in the United States: The adequacies and inadequacies of our monetary and fiscal systems have been touched upon in the answer to question 9. Theoretically, both are sufficiently adaptable and flexible to play an important role in combating inflation or deflation; practically, only one of these systems—the monetary system—can be relied upon to act in the appropriate way.

On the whole, our monetary system—particularly the quasi-independent political status of the central bank—seems to me to be efficiently designed to provide industry with needed bank credit, and to provide it in such amounts and at such times as to reduce inflationary and deflationary pressures. Recent experience suggests, however, that monetary policy alone is unequal to the task of maintaining full employment and stable prices. At times, excesses develop in the monetary and credit field, such, for example, as the expansion in mortgage loans and consumer credit in the 1955–56 boom. When excesses of this type appear in the credit structure it would appear desirable if selective credit controls could be instituted and coordinated with general monetary policy.

More important, however, the fiscal activities of the Government are now so large, and occupy such an important place in the economic framework of our country, that concerted effort should be made to see that activities in this broad area do not subvert monetary policy. We should, however, not lose sight of the problems that may arise from a coordinated effort to control inflation. One of the principal dangers of coordinated fiscal and monetary policy is that the Federal Reserve System might lose its independent status and might, through political pressures, be prevented from taking appropriate action to stabilize the price level. Coordinated effort is essential if we are ever to achieve the dual goals of full employment and stable prices.

In the process, however, the independence of the Federal Reserve System must not be undermined. An independent monetary authority is our principal bulwark against galoping inflation.

11. The Paradox of Inflation Amidst Unemployment: (*a*) The so-called paradox of inflation with unemployment is more apparent than real. It arises partially from the fact that the Consumer Price Index of the Bureau of Labor Statistics is a lagging indicator of price inflation. As a general rule, spot commodity prices begin to fall well before business generally turns down. In the price complex, spot prices lead wholesale prices, which in turn lead prices in retail markets. Only after unemployment has risen for some time and personal income has turned down is there a final response of consumer prices to lagging consumer demand.

Other factors besides the level of employment also play an important role in the behavior of the consumer price index. Agricultural price supports, for example, prevent food prices from adjusting freely to changes in consumer demand. Monopolistic practices in trade unions and in business also prevent prices in some areas from adjusting promptly on the downside to declining demand. Even the weather plays an important role in determining the direction of consumer prices—for example, the recent Florida freeze which resulted in higher prices for fresh fruits and vegetables. And there are other factors too numerous to mention. Some prices can respond promptly to changes in demand, while other prices—held down artifically by law, custom, or long-term contract—may continue to creep upward toward proper alignment with general prices and costs well after the more flexible prices have begun to move downward. The lack of balance in the price structure produced by an inflationary spiral—and the resulting upward drift in some prices after others have turned down—is largely responsible for the current paradox of unemployment with price inflation.

(*b*) The desirability (or inevitability) of creeping inflation as a device for maintaining full employment is a matter about which much has been written, but on which there is little evidence that might serve as a useful guide. The question is much too complex to be settled on the basis of the simplifying assumptions in vogue among those who are convinced they know the answer to this question.

As has been suggested in our answer to question 2, the problem is very complicated and is based partly on economic, partly on political, and partly on administrative considerations. In the final analysis the matter boils down to finding some workable administrative arrangement that would give practical content to the dual goals of full employment and stable prices. Until a concerted effort has been made in this direction, and until we have an historical record of experience with an economy directed towards achieving these two goals, no one can answer the question of whether price inflation is desirable (or necessary) to maintain full employment. In the present state of our knowledge, there is no reason to believe that price stability and moderately full employment are incompatible goals. Although we lack experience, both objectives are highly desirable. The system should be given a fair trial.

12. The threat of private indebtedness to economic stability and vitality: No conclusive evidence exists that the growth in private

indebtedness in the postwar period, or its present level, has created a threat to our economic stability and vitality. Asset values, equities, and income have grown roughly in proportion to indebtedness in the private sector of the economy. Because of the contractual nature of debt repayment, private indebtedness may become burdensome in the future, but only if there were a sharp deflation of income and values. Indebtedness, per se, is not a threat to economic stability and vitality, although it can seriously complicate the problems of economic adjustment in the event of a deflationary spiral.

To reduce the likelihood of complications arising from the contractual nature of debt service in the future, consideration should be given to maladjustments in our tax structure that favor debt over equity financing. An obvious step in the right direction would be to eliminate the double taxation of corporate dividends under the present Federal corporate income tax—to treat dividends paid by business corporations as deductible for tax purposes, just as interest on debt is now treated as a deductible expense. Similarly, in the case of mortgages secured by residential properties, attention might be given to tax revisions that would permit a home owner to deduct a portion of his equity in real properties, just as he is now permitted to deduct interest as an expense. Such measures would stimulate equity financing as against debt, and would thus help in maintaining balance in the financial structure of the private sector of our economy. But the principal protection against dislocations arising from debt liquidation is to maintain a level of asset values and incomes commensurate with the existing level of debt. Provided we can achieve dynamic economic growth, with full employment and stable prices, the current level of indebtedness will not be a threat to economic stability and vitality.

13. Statistical guides for fiscal policy: It is difficult to lay down hard and fast rules as to when tax cuts and public works should be introduced to combat a downturn in the economy. So much depends upon the behavior of different sectors of the economy that it is impossible to set up precise standards as to when fiscal action is needed to offset adverse business trends.

As a rough guide (subject, unfortunately, to amendments too numerous to mention), unemployment is a key indicator of the existence of unutilized capacity, manpower, and resources in our economy. When the seasonally adjusted rate of unemployment (unemployment expressed as a percent of the civilian labor force) rises above, say, 6 percent, consideration should be given to tax reduction as a first step in alleviating economic distress. And conversely, when the seasonally adjusted rate of unemployment falls below, say, 4 percent, attention should be given to tax increases and to the curtailment of postponable public works, in an effort to prevent an inflationary wage-cost-price spiral that might otherwise arise under conditions of over-full employment.

Unfortunately, the rate of unemployment alone provides little information on the direction of change in business activity. Action might be called for if unemployment were rising above 6 percent, with reasonably firm expectations that the unemployment rate would continue to increase, but would certainly not be called for if unemployment were temporarily above the 6 percent level, and if business were improving so that it could be reasonably assumed that unemployment would soon decrease. Unemployment is a lagging indicator of the direction of change in business activity. Various leading indicators, such as hours worked per week and other series selected by the National Bureau of Economic Research, provide useful information on what the future holds in store.

14. Federal deficit spending as a cause of inflation since World War II: Since World War II (roughly the period spanned by the Federal fiscal years 1947–57) the aggregate deficit in the Federal budget was $9.7 billion, most of which was incurred during the Korean war. Over the same period, the increase in gross Federal public debt was only $0.7 billion. Although large in absolute terms, these figures are small in an economy with a gross national product running well in excess of $400 billion per annum. On the whole, therefore, Federal deficit spending has been a minor factor in contributing to inflation in the postwar period.

Much more important as a factor contributing to inflation were the huge Federal deficits of World War II. The debt incurred during that period was largely monetized as it became lodged in the banking system, and contributed importantly to the price inflation in the immediate postwar years (see the answer to question 3, above). A second factor contributing importantly to price inflation throughout the postwar period has not been related to the deficit, per se, but to the sheer size, or weight, of Federal expenditures for final goods and services relative to the aggregate value of such goods and services produced by the economy (gross national product). Total Government expenditures (Federal, State, and local) in the year 1957 alone amounted to over $86 billion, and accounted for roughly 20 percent of GNP.

It is a mistake to assume that a balanced Federal budget is neutral with respect to prices and that deficits and surpluses have, respectively, inflationary and deflationary effects. As has been indicated, inflation occurs when the aggregate effective demand for goods and services exceeds the Nation's capacity to produce. When the economy is already fully employed in producing goods and services for the private sector of the economy, a high level of Government expenditures is inflationary. This was the expedience of 1956–57. Excessive Government expenditures have contributed to inflation in too many of the postwar years.

15. The possibility of achieving full employment and stable prices: As indicated in the answer to question 11 (b) this question, in the final analysis, can be answered only by trial and error. We have had no experience with an economic system in which a concerted effort has been made to achieve full employment with stable prices. The experience of the 1920's, when consumer prices were relatively stable at full employment levels, does suggest that these two goals are not incompatible under appropriate economic conditions. At the very least, properly coordinated fiscal and monetary policy could go a long way to achieve these objectives. The objectives are important; a well thought out program to realize them should be given a fair trial.

16. Escalator clauses in wage contracts as a cause of inflation: Escalator clauses in wage contracts have not been, up to this time, an important cause of inflation, although in certain key industries they have undoubtedly intensified the wage-price spiral, once the consumer price index has begun to rise. Under escalator clauses, wages are

geared to prices in the first instance, not prices to wages. The basic causes of price inflation are overfull employment of resources and the labor force, complicated by monopolistic practices in trade unionism, and other factors mentioned in questions 4 or 11.

Although escalator clauses in wage contracts intensify the upward push of wages on costs and prices, after inflation has gotten underway, the practical importance of such causes as a factor contributing to inflation in the postwar period has probably been exaggerated. The National Industrial Conference Board estimates that at the end of 1957, 4 million workers were covered by escalator clauses in union contracts. In an economy with a civilian labor force of 68 million, this represents a coverage of less than 6 percent.

17. Causes of the present recession and techniques for combating it: Superficially, the current business recession was touched off by the sharp cutback in Federal defense spending after August 1957, and the efforts of manufacturers and others to reduce inventories to a lower level of new orders and sales. The basic factor, however, was the termination of the great postwar boom in capital spending, which had been stimulated by the pent-up demand of the postwar period, by technological wartime innovations and developments, and by the upward movement in plant and equipment costs. We now know that these capital expenditures were excessive, judged by what can reasonably be expected as to normal growth in consumer demand. Not only has excess capacity appeared in many industries as the capacity to produce has grown to exceed final demand, but the inducement to invest has also been lowered by declining profit margins as wages and other costs of operation rose faster than prices in many fields, particularly in industries where prices are fixed by law, custom or long-term contract. As unemployment rose with defense cutbacks and inventory liquidation, consumer expenditures stabilized and then turned downward, thus further complicating the problem of excess capacity which had already appeared in many fields.

If our diagnosis of the causes of the current business recession is correct, the recession is more deep seated than the earlier postwar adjustments of 1949 and 1953–54. The basic problem now, as in all recessions, is to raise the level of aggregate effective demand so that it approaches more nearly the Nation's capacity to produce, but at the same time, to avoid proceeding so rapidly that aggregate demand once again exceeds capacity, thus touching off another inflationary spiral.

There are a number of devices available to combat the recession, including the following as perhaps the most important:

(1) Active monetary ease on the part of the Federal Reserve System, supplemented by appropriate debt management by the Treasury to avoid funding short debt into long.

(2) Immediate acceleration of Federal disbursements under existing contracts to offset the decline in private demand.

(3) An across-the-board reduction of Federal income taxes (corporate and personal) and a reduction in burdensome excise taxes and other special levies such as the emergency wartime tax of 10 percent on transportation of passengers.

(4) As a last resort, a stepped up program of Federal, State, and local public works, provided items (1) to (3) are insufficient to restore aggregate effective demand to appropriate levels.

The first steps should be taken in the monetary sector and in speeding up disbursements under existing contracts and appropriations, since such steps can be taken promptly and with a minimum of disturbance to the Federal budget. In view of the character of the present recession, such steps may prove insufficient to restore business to full employment levels, if we are right in our judgment that we are now in a long-term downward trend in plant and equipment spending. But whether this proves to be the case or not, tax levels and the tax structure are very burdensome and seriously impair economic efficiency, and a reduction would do much to strengthen lagging consumer spending and capital demand. An across-the-board reduction of, say, 10 percent in personal income tax would stimulate spending for consumer durables, transportation, et cetera, which have been hard hit by the recession. Such a reduction would also exert the minimum of pressure on such basic items in the consumer budget as food and personal services, and would thus reduce the risks of further inflation. Corporate income and excise taxes are also excessive, and revisions are long overdue.

Public works should be resorted to, only if it becomes clear that all other devices have failed. As a general rule, it is better to permit the consumer to enjoy the fruits of his labor rather than to siphon off a large share of what he produces for Government projects of a marginal nature. The postwar experience indicates that public works usually operate only after a long delay, and begin to take hold well after the recession is past, thus contributing to price inflation. A reduction in taxes would stimulate demand at the time it was needed, and would reduce costs and selling prices, thus removing one cause of inflation.

AMERICAN GAS & ELECTRIC CO.,
New York, N. Y., March 25, 1958.

Senator HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: Thank you for affording me an opportunity to express to you and your committee my thoughts on some problems that have been troubling members of the committee as well as others, including myself, for some time. While I do not believe that I can usefully address myself to each of your individual questions, I do want to express to you a few thoughts on those matters in your letter which appear to me to be particularly significant.

At the time I write this letter the economy is faltering in a recession which shows signs of reaching a severity well beyond that reached in the previous two post-World War II recessions, in 1948–49 and in 1954. Despite the frequently repeated assurances emanating from various quarters that we are experiencing something minor and shortlived, the key economic indicators continue to point down and the latest report on unemployment gives grave cause for concern. Nevertheless, I believe that, with appropriate governmental policies, including, particularly, fiscal and monetary policies, this current recession can in fact be contained and made relatively short-lived, after which the economy would once again resume its growth. But, if this is to result, vigorous action must be taken promptly. I do not exclude an immediate tax cut from this action. Otherwise the economy may fall to much lower levels from which recovery will take much longer, and then only at far greater cost. From your letter it appears that you and your committee are more concerned with the long-term problem of how to assure the maintenance of a proper rate of growth to provide the American people with the ever-rising standards of living which their resources and ingenuity entitle them to expect. But even in dealing with this long-run problem the short-term recession and boom phenomena must be kept in mind.

I might first point out that there has devolved upon the Federal Reserve Board the major responsibility to provide the monetary means for the maintenance of an adequate rate of long-term growth while at the same time maintaining stability; i. e., full employment and a stable price level. While the experience in the immediate postwar period emphasized, if any emphasis were needed, the desirability of sustaining the independence of the Federal Reserve Board from partisan political considerations, at the same time it indicates that the problems of economic stability and long-term growth are much too important to be subject to the exclusive determination of a relatively small group representing, essentially, the banking community and their point of view and having no accountability to the public for decisions having the gravest implication in terms of the public interest.

For example, the decision as to what is the appropriate rate of growth is much too important in terms of the National welfare to remain the exclusive domain of a small group of insulated men, however able, patriotic, and well-intentioned. Hence, some way should be found to bring to bear, both formally and effectively, the judgment of a larger group more responsive to the overall needs of the country. Certainly in the last few years the Federal Reserve Board in its efforts to be conservative has, in fact, been overcautious in its monetary policies and its attitudes toward economic growth. There is considerable doubt that they have made credit available in adequate quantity to sustain the economic system at a consistently high level of activity and to provide the needed monetary mechanism for continuing expansion.

It has been argued by some that this country may have to choose between slow, creeping inflation and unemployment. While this is a question that needs much more study before the final answer can be given, it does not appear to me that in the case of a free people intelligently guiding its own destiny this necessarily must be so. And even more there is ample reason to question whether monetary policy can offer anything but a small portion of the solution to this difficult problem. But granting that credit control does have an effect on it, the question clearly is one of such great and fundamental importance that it goes far beyond the area in which the Federal Reserve Board should be free to roam at will. In effect, then, I am suggesting that consideration be given to some methods whereby broader points of view can be brought to bear in the decision-making process in this extremely important area of responsibility. Also, some procedure should be found to coordinate the fiscal and other general economic policies of the many governmental and semigovernmental bodies concerned with these problems so that, given a policy decision, the various agencies follow that policy rather than contradictory courses of action.

Of course, one of the questions about which we know all too little refers to the timing and effectiveness of monetary policy. Much too little is known about the length of time required for changes in monetary policy to have their full impact on the economy in various circumstances. But we do know that there is a lag, both in taking hold and, so to speak, in letting go. The lag between the imposition of monetary policy and the result it sets out to accomplish may be such that, unless the greatest skill and care is exercised, insensitive monetary policy can be carried to excess in any particular direction. For example, after the imposition of monetary restrictions the various key indicators may, and generally do, continue their upward movement for some period of time. This delay, or inertia factor, may well lead the monetary authorities to impose additional restrictions which push the economy too far in the opposite direction from that in which it had been moving.

Such a development was clearly illustrated last August when the Federal Reserve Board raised the rediscount rate at about the same time that, we now know, economic activity had begun significantly to taper off in response to earlier restrictions. Although the present recession undoubtedly cannot be attributed entirely to the Federal Reserve Board's tight money policy, the additional restrictions imposed late in 1957 now appear to have been contrary to what was called for. And this, I believe, could have been anticipated in 1957. Greater attention, therefore, should be given to the development of more objective criteria for policy determination.

There is also considerable doubt concerning the effectiveness of monetary policy alone in stemming strong movements in the economy, either up or down, once momentum develops. It does appear, however, that it is less effective in stimulating an upturn than it is in curbing a boom. Because easy credit may be only one, and perhaps not the most important, of a series of inflationary influences, it may well be that to be effective in restraining such excesses, monetary policy must become so stringent as to greatly damage wide and important sectors of the economy. The growth and strength of the economy and the mitigation of inflationary pressures must, in the final analysis, depend upon growth in output at a sufficient rate to supply the ever-increasing per capita needs of the civilian economy while, at the same time, providing the goods and services necessary for the defense of the country.

This growth in output necessary to restrain inflation can result only from an increase in productivity and this, in turn, can be brought about only by the increased use of machines and inanimate energy. Yet it is the investment in productive plant and equipment which is precisely the area most severely inhibited by stringent monetary policy. It therefore seems desirable to give consideration to avenues of approach which may make possible the moderation of the effect of monetary policy on these productive and inflation-restraining investment areas.

I would also like to raise a point about the influence on monetary policy by the commercial banking community which cannot escape a direct interest in maintaining high rates of interest. In raising this point I do not intend in any way to impugn the high character or sincere motives of the banking community. I simply indicate an area in which their job has been made more difficult by creating a possible conflict of interest between private and public good. While it is obviously an extremely difficult question with which to deal, consideration should perhaps be given to the possibility of reducing the influence of commercial bankers in the decisional processes involved in the formulation of monetary policy. Perhaps one method of doing this would be to provide larger and more effective nonbanking representation in this connection.

Complementary to monetary policy, so far as it relates to encouraging capital growth, is the problem to be found in the tax structure, and particularly our income tax structure. In recent years the nature of our tax system has tended increasingly to discourage capital formation, risk-taking investment, and the kind of enterprise which in a free economy has served to make this country the greatest industrial nation on earth. Certainly a restructuring of the tax system is called for to eliminate those aspects which at present tend to discourage both individual and corporate efforts in expansion and innovation. Machinery and equipment in ever-increasing amounts, as well as managerial and entrepreneurial skill and talent of the highest quality, are necessary to provide the increasing productivity from which we can get ever-rising standards of living. These must be encouraged rather than throttled.

If in the process of growth we are to avoid inflationary pressures, the rewards of labor must not increase faster than increased productivity makes possible. Otherwise we will not be increasing income but will merely be redistributing it. I do not mean by this that labor should be deprived of its fair share of the national income, but I do point out, however, that over a period of many years, and particularly over the last decade, labor unions have continued to strengthen their monopolistic position and to use their legislatively acquired and legally protected monopolistic powers to obtain for themselves an increasing share of the national income. This has been done at the expense of the vast majority of people on salaries, pensions, or other fixed incomes. The real incomes of these groups have been reduced and their accumulated assets drastically cut in real value. Monopoly power has in recent years made it possible for organized labor to insist upon wage increases far in excess of the increases in productivity. These increases have clearly contributed to inflationary price movements—in my judgment they have been the largest single contribution. I do not believe that labor should be denied its rights to organize and to bargain collectively, but I do believe that unions should not be permitted to exceed the limits of fair market behavior in the light of the general public interest. A great deal of thought and effort needs to be given to this entire question and, while I recognize that a satisfactory solution will not be easy to find, this should not deter our attempt to make some progress on the job.

I do hope that the foregoing will contribute to the finding of answers to the general problems indicated by your specific questions. If I can be of any further assistance, please do not hesitate to call on me.

Sincerely yours,

PHILIP SPORN, *President.*

THE PENNSYLVANIA RAILROAD CO.,
April 15, 1958.

Senator HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: Enclosed are answers to the questions which you sent to me in connection with the Senate Finance Committee's inquiry entitled "Investigation of the Financial Condition of the United States." One of the questions has been omitted as requiring a highly technical answer and several others have been grouped for ease of exposition.

In discussing the answers to these questions with my staff, we were naturally most interested in those questions which had a direct bearing on our own industry or which could be discussed in terms of railroad problems. Questions 6 (*b*), 7, 8, and 9 contain information relating directly to the railroad industry. Comments on taxes in question 17 also refer to matters of particular interest to railroading. The whole broad problem of inflation is of vital concern to us, however, and I am glad to submit answers on the more general questions.

I hope that the comments on the questions will be helpful to you and to the staff of the committee. I shall be most interested in following your deliberations and I would appreciate receiving copies of future publications.

Respectfully,

J. M. SYMES.

QUESTIONNAIRE ON THE FINANCIAL CONDITION OF THE UNITED STATES COMPLETED FOR THE COMMITTEE ON FINANCE, UNITED STATES SENATE, BY J. M. SYMES, APRIL 15, 1958

1. Give a definition in your own words of deflation and inflation.

Inflation is a persistent and substantial rise in the general level of prices, sufficiently severe and of such long duration that a dollar appears to lose some of its purchasing power for an indefinite period. Deflation is the opposite—a protracted decline in prices. Inflation is usually accompanied by expanding credit and rising money income, and deflation usually entails credit liquidation. However, a definition of inflation and deflation in terms of their causes begs the question to which the Senate Finance Committee has addressed itself. No fruitful line of inquiry into the reasons for price fluctuations should be ruled out in advance by pat explanations.

2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

The economy of the United States is influenced by many factors which are best described as social or political as well as by many which have their origin in the business of making a living. Thus, the traditional approach of control over money and credit, though vitally necessary, is not sufficient. There are probably many ways—not just one—in which inflation and deflation can be avoided or mitigated; and, conversely, it will probably require action on many fronts to build an effective program.

By its nature, the quest for economic stability requires that legislation give wide scope to administrative policy. Legislation cannot hope to deal with changing economic problems in detail. The objectives of economic policy and the criteria of its effectiveness can be made clear, however, and constant legislative review can encourage responsible action.

One proposal for a change in existing legislation which should be seriously considered is that of making price stability an objective equal in importance to "maximum employment," as defined in the Employment Act of 1946. This would change the tenor of that basic piece of legislation, making explicit the realization that no one standard, such as full employment, can be absolute, to be achieved at the expense of other critical aims. It would help to correct a depression-born bias in favor of inflationary policies and a tendency to bypass the tests of free markets—for labor as well as for goods.

Another area which demands attention is the budgeting and expenditure practices of the Federal Government. This probably involves many separate pieces of legislation, some of which were suggested by the Hoover Commission. In general, controls over the timing of expenditures should be more firm. Provision should be made wherever feasible for slowing down or accelerating particular spending programs in accordance with the needs and capabilities of the economy. Similarly, the programs of certain administrative agencies (for instance, the Federal Housing Administration) should be made responsive to changing levels of business activity and to the programs of the fiscal and monetary authorities.

Still another large group of laws which demand reexamination are those which govern business-labor relationships. Much of the present legislation was conceived and enacted in an era in which the balance of power was different than it is today. Without pausing to examine the reasons or to discuss the social implications of this changing balance of power, it is nevertheless appropriate to point out that existing legislation has resulted in the creation of an extremely powerful force for continued wage increases—increases often in excess of long-term productivity gains. This does not mean that the blame for wage inflation is all labor's. In fact, management must share the responsibility for existing wage structures. It does suggest, however, that the institutional machinery which brings about excessive and inflationary wage increases—and this may include, among other things, industry-wide bargaining, for instance, or monopoly power on the part of unions—bears correction. Here, too, the administrative agencies may need new general instructions more in tune with the times.

Perhaps more than new laws, the Nation needs a clear understanding of the problems of inflation and deflation and the will to act on the basis of what is already known and the tools already in hand. This inquiry of the Senate Finance Committee is one step in that direction, but more needs to be done. Both labor and management can find ways to help mitigate both evils by their own actions. Long-range investment planning by management is one fruitful procedure; labor might well adopt an analogous approach instead of the policy of bargaining for what the traffic will bear at the moment.

3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942 to 1957. (You may wish to divide the period into two parts, 1942–50 prior to the accord, and 1951–57.)

From 1942 until the time of the accord with the Treasury, Federal Reserve policy was dominated by considerations of Federal financing rather than by the requirements of economic stability. In fairness, it must be pointed out that the experience of World War I and of the depression years seem to indicate that protection of bond values made a major contribution to a healthy economy. However, subsequent events proved that under any but strict wartime controls, the support of Government bond prices did, indeed, make the Federal Reserve an engine of inflation. The period from 1942 to 1950, therefore, might well be divided again into at least two: That which extended until the end of World War II, during which successful war financing had to be insured at all costs; and another which began in 1946, when the Nation began to shake loose from price, wage, and production controls. Under the latter conditions the program of bond price support was inappropriate.

From 1951 to 1957 the Federal Reserve was free to act as it saw fit in influencing money and credit conditions. For a short time, during the Korean war perid, it had the right to establish specific selective controls over real estate and installment credit. Such controls, though more general and less restrictive than price, wage, and production controls, are probably appropriate only under war or near-war conditions. As soon as urgent defense requirements were met after the Korean truce, it became extremely difficult to define the objectives of selective controls, much less enforce them without using stringent and costly methods.

The record shows the years 1952 through 1955 to be a period of economic growth and relative price stability. The recession of 1954 was very serious for some segments of the economy, including the railroad industry, but, in general, the slump was well contained and undoubtedly Federal Reserve policy helped to keep it so. If the letup on credit restraint was too great in 1954–55 and gave rise to excessive demand in subsequent years, this was, by hindsight, an error of degree. By the same token, if the rather sharp restrictive action of 1957 was late, this was an error of judgment in which the Federal Reserve was joined by the majority.

One final observation may be made. The Federal Reserve alone cannot insure business stability. Yet the seriousness of the current recession and the strength of the boom which preceded it, points to the need for action other than that which sufficed earlier in the postwar period. The Federal Reserve should take advantage of the considerable flexibility which it has and should not be bound by the policies of earlier years. The financial community should not be subjected to frequent changes in the rules of the game; however, it is not the rules which must be stabilized, but the economy.

4. Beginning in August 1956 there was an increase in the Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

The rise in the Consumer Price Index in 1956 and 1957 is the result of many factors. Some of these may be lumped together under the heading of "Business Boom," for this is exactly what the economy had been experiencing since 1955, particularly in the capital goods fields. During much of this period labor was tight and production facilities in many lines were strained. Combined with this was the persistent tendency for wage increases to exceed increases in productivity (especially under the conditions which prevailed in 1956 and early 1957) and, therefore, for unit costs of production to rise. It is difficult, in these circumstances, to pick 1 or 2 factors more important than the rest. Failure to place more severe restraints on credit soon enough and failure to restrain Federal Government spending, though negative factors, are probably as important as any others.

If the rise in prices from 1956 to 1958 were likely to be compensated for by falling prices in subsequent years, the decline in the value of the dollar for the period would be a transitory thing and, though troublesome, not excessive. But if the postwar pattern repeats itself, as is likely, the decline in prices will not be allowed to take place, thus making the loss in the purchasing power of the dollar permanent and injuring many individuals and industries. This is far more serious than a price rise during any limited period. And the factors most responsible for this are the whole gamut of full employment and labor policies, applied without regard for the structural damage to the economy caused by creeping inflation. Maximum employment does not require creeping inflation to support it. But inflation comes easily unless specific steps are taken to avoid it.

5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

The details of debt-management policies and their impact are highly technical. Suffice it to say here that the size of the public debt is so great that the refunding of old issues and the raising of new money from time to time cannot fail to have a profound effect on the economy. The Government is, of course, in competition with private interests for investment funds. The Government can, therefore, do much harm by inappropriate timing of its financial operations and by the issuance of inappropriate types of securities. It is difficult to see how debt-management policies in themselves could do any positive good for the national credit structure; but appropriate policies can probably contribute to orderly money markets and to a desired increase or decrease in liquidity generally, as business conditions might require.

6. (*a*) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand, and employment.
3. Economic growth in production, demand, and employment.

(*b*) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

(*a*) All three of the objectives are important and all are interdependent. Attempts to achieve one without the others will fail. Stable prices establish continuity and confidence and preserve economic incentives. Without them, growth is distorted and may ultimately be frustrated. But stable prices cannot be achieved without regard to the need to maintain a high level of employment and production. Finally, serious recessions can be avoided only if conditions favorable to long-term economic growth are maintained.

None of these objectives, however, can be completely fulfilled at all times if we wish to have the best possible combination most of the time. This paradox is readily explained. An economic system characterized by individual initiative and free markets yields the biggest dividends in balanced growth and good living. But such a system is flexible and must proceed by testing new products and ideas in the market place. Such a system requires some leeway—there are profits and losses, obsolete products as well as new ones, and so on. While we should continue to try to minimize periods of both unemployment and excessive demand, we should recognize that there will always be shortcomings to overcome. We should not fall into the trap of trying to meet completely any one objective, rigidly interpreted.

(*b*) From the end of World War II until the present, making allowances for the special conditions brought about by the Korean war, the United States has enjoyed reasonable stability of production, demand, and employment at a high level of economic activity. The Nation has also enjoyed fairly steady growth in real income. The events of the last few months, however, raise important questions. Has this growth been well balanced? Have production and demand conditions been sound in the sense that high-level stability can now be maintained indefinitely?

The answers to these questions may hinge on the effects of another important trend that has been strong since the war—the trend toward almost continuous inflation. Immediately after World War II, the reasons for inflation were clear—too much war-deficit money, too little goods. The reasons for the resumption of inflationary trends within the last 2 years are less easy to describe and more disturbing because, under existing conditions, there is no end to the process in sight. These reasons were alluded to in questions 2 and 4 above.

The impact of inflation has been uneven, and this is precisely why it can distort economic growth and give rise to instability. The railroad industry furnishes an example of the destructive power of inflation and its ability to do permanent injury to the economy. Control over rates in that industry and ratemaking criteria which fail to take the rising cost of capital equipment and construction into account have placed the railroads in a financial squeeze. The inevitable lag between rising operating costs and rate adjustments and failure to provide an adequate rate of return for the industry have cut railroad earning power and have made it impossible for the industry to invest at a rate which will enable it to keep pace with the desired rate of economic growth. This, in turn, acts as a drag on the entire economy and allows investment funds to go into other channels which may, in the long run, be less productive. The effect of inflation is only one of a number of important problems facing the railroads, but it is one which is also significant for other industries. The proposal for an investment reserve made before the Smathers committee (Surface Transportation Subcommittee of the Senate Committee on Interstate and Foreign Commerce), if accepted, would help to alleviate the railroads' position, but the basic problems of inflation remain.

7, 8, 9. Give your opinion of the effect on our economy of current Federal, State, and local government spending. Give your opinion of the effect on our economy of current Federal, State, and local taxation. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy, and then relate them, one to the other. Please discuss these policies stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

At current levels, the effect of Government spending on the economy is very great indeed. When it spends, Government competes with the private sector of the economy for goods and services. This has several effects. First, it places resources where the Government directs, rather than where free markets direct. Second, when goods and labor are relatively scarce, it creates the danger of inflation. If there is unemployment, additional Government spending may stimulate the economy—provided the expenditures are of a type that do not injure private business or public confidence.

The high level of Government spending is often said to provide a cushion or prop under the economy. In a sense this is true—if we assume, as now seems likely, that we are committed to high defense outlays for an indefinitely long period. Yet, this is a cushion which we hope can be reduced. Government expenditures should not be looked on as a device to ensure maximum employment, but, rather, as a means of accomplishing those things which only Government can do. Of course, proper timing of necessary government outlays can and should contribute to economic stability.

To a large extent, the effects of Government spending depend on the means by which it is financed. Paying for Government service out of taxes is, undoubtedly, the best policy, though here, too, proper timing can contribute to stability by generating a surplus when business is booming and private debt is growing and by allowing a moderate deficit, if necessary, when private incomes are depressed. There is no prospect of doing more than chipping away at the Federal debt, but it can be kept from increasing. Meanwhile, as indicated in question No. 5, debt management can also play a constructive role. But in concentrating on the cyclical effects—the short-term effects—of taxation, the long-run impact of the tax structure in the economy is too often overlooked. Since taxes are so high, it makes a great difference to the health of the economy what is taxed and who is taxed. In general, the present tax structure is unfavorable to equity investment and to risk-taking generally, especially in new and small enterprises.

Present concepts of Government spending and taxation also have a tendency to distort economic development and to allow an inefficient use of resources. Nowhere is this more apparent than in transportation. Without an adequate system of user charges, large Government outlays on the waterways, airways, and highways appear to be costless to those who use them. The railroads, who provide their own right-of-way and facilities, are placed at a competitive disadvantage and suffer a loss of traffic and ability to attract capital to means of transportation, whose true cost is higher. The public pays the bill and gets a less efficient transportation system.

A lack of balance between Federal and State and local tax sources also creates difficulties. Heavy burdens on business in some areas make it impossible for the region to realize its economic potential. And here, again, the railroad industry, a large property owner, frequently bears a disproportionate load. Much needed local tax reform depends to an important extent on the resolution of national tax policy questions. This problem is becoming more urgent as State and local needs expand.

The long-term problems referred to above are chiefly in the area of fiscal policy. Monetary policy—the policy connected with the supply of money and credit—can assist in their solution, though it is chiefly concerned with short-range changes in business conditions. The independence of monetary policy from direct control by the administration often appears incongruous in view of their close relationship; but this type of check and balance is probably worth preserving in an area in which temptations for abuse are strong.

10. (*a*) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank credits.) Also please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

(*b*) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

Omitted.

11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy.

Within the last year, some prices—chiefly those comprising the consumers price index—have risen while production and employment have fallen off. The explanation is twofold. First, there has been a tendency for price adjustments to lag behind business events. The momentum of the price rise of 1956 and early 1957 has carried forward, especially in view of rising farm and food prices. Second, the policies and institutions discussed in questions No. 2, and No. 4, have given prices a strong underpinning. Rigid—in fact rising—wage rates have kept unit costs high. (Escalation agreements have contributed to this.) Competition is slow to take effect when the expectation is for Government action to continue the upward price movement.

11 (*b*) and 15. Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals? Can full employment goals be attained while maintaining a dollar that has relative stable purchasing power?

Certainly a gradual inflationary trend is not desirable. It robs those who depend on fixed incomes, destroys business continuity, distorts economic decisions, and is likely, ultimately, to turn into inflation of the galloping variety. High levels of employment can be maintained without continuous inflation. Moderate business fluctuations, however, should be expected. Insistence on completely full employment at all times would probably result in chronic inflation.

12. To what extent and in what way do you believe that the growth

of private debt in recent years may have become a threat to the stability and vitality of the American economy?

Private indebtedness has grown rapidly in recent years. In part this growth has seemed very sharp because of the liquid condition of business and consumers at the end of World War II. At this time corporate indebtedness is not a threat to stability, but its continued increase at recent rates would be questionable. The present tax structure encourages debt financing and should be reexamined on this score. Personal indebtedness has grown even more rapidly. While it does not appear that it is at the danger point, there is no doubt that consumer durables purchases may now be subject to more severe fluctuations by reason of the need to pay off indebtedness every once in a while, especially when incomes stop rising. There is a limit in sight, too, to the continued liberalization of mortgage credit terms.

14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

Deficit spending, in the sense of the Federal Government's spending more cash than it received, has been a minor factor. In most years, including the last 2, there have been cash surpluses. The huge increase in the money supply, which contributed to the postwar inflation, was created by deficit financing during the war. The Federal Government might have stemmed the tide of inflation to a greater extent by running bigger surpluses and smaller deficits.

16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

Escalator provisions, though they serve to solve problems in particular instances, tend to accelerate an inflation or deflation once it is underway. Under present conditions, events would probably not be much different in the absence of escalator provisions, but it might be possible to gain a little more flexibility which would help to create more stable conditions. At the present time, for instance, a continued rise in the consumers price index is forcing wages up at a time when unemployment is increasing. The absence of escalator agreements would not cut off wage-increase demands, but it would allow for more realistic bargaining. The main forces making for instability are to be found elsewhere, however.

13 and 17. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy. List and briefly discuss what you consider the causes of the present recession, and what should be done to terminate it.

There is probably no single measuring point at which large tax cuts or increases in public works are certainly indicated. When any particular point is reached, the trend of business is also a most important factor. Five million unemployed may be very serious or not, depending on surrounding circumstances.

There is no doubt now that the current recession is more serious than those of 1948–49 and 1953–54. This downturn comes at a time when the backlog of consumer needs for durable goods is completely dissipated. Furthermore, this downturn was initiated not only by inventory liquidation, but also by a decline in expenditures for capital goods which came after a period of very large investment. The heavy goods industries are seriously affected.

Under these conditions, Government action can be helpful in moderating the recession and in bringing an upturn in business closer. The form of this action, however, is very important. Indiscriminate tax cuts giving rise to large deficits, and large increases in public works commitments giving promise of deficits to come, might after a short time, overcorrect the slump and create the ingredience of a new inflationary push. Careful action on taxes, however, might be salutary at this time. The immediate problem is not inflation, and it might be possible, therefore, to afford some stimulation to the economy while at the same time making a start on tax reforms which are long overdue. The repeal of taxes on transportation has been recommended for some time and it should be carried out now. These taxes are obsolete and discriminatory. Other excise taxes might well be reduced or repealed as an aid in bringing prices down and in relieving certain industries of competitive disadvantages. Consideration should be given to a reduction in the corporate income tax and to liberalization of depreciation on regulations, to bring them into line with investment needs. Finally, if the situation warrants, a start might be made on the reduction of individual income taxes along the lines (but not necessarily to the same extent) recommended by the Sadlak-Herlong plan. The extent to which the plan can be followed at this time is limited by the immediate need to stimulate consumption quickly.

Such action must be taken with care and the full realization that entirely different policies may be called for before many months go by. If action is taken which will improve the tax structure rather than merely reducing the total tax take, we will have made an investment in the future which is not without risk but which has the maximum chance of success.

MICHIGAN CONSOLIDATED GAS CO.,
Detroit, April 10, 1958.

Senator HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: This is in reply to your letter of February 17, relating to the Senate Finance Committee's investigation of the financial condition of the United States. The questions you present for comment are indeed thought-provoking and most pertinent to the basic problems of assuring continued economic growth and preserving the purchasing power of the dollar—objectives with which I am thoroughly in accord.

During my many years of experience in the public utility business, I have had occasion to observe the impact of price increases, fluctuations in consumer incomes and expenditures, taxation, and the relative availability of credit on our company and the communities it serves. There are, on the other hand, certain matters covered in your questions of which I have no first-hand knowledge or experience; such matters I shall leave for discussion to those who are more intimately acquainted than I with their practical and theoretical aspects.

Before turning to the consideration of specific aspects of governmental and private finances as they relate to this area and my particular business, I would like to mention briefly those social and economic goals toward which, in my opinion, our political and economic efforts should be directed. Too often, I fear, these goals are lost sight of in the press of day-to-day events, or are subordinated to the interest of one or another group.

First among these goals I would place the balanced development of our country's natural and industrial resources, to the end that all may enjoy a continued rise in their standard of living. Secondly, I would urge that this development be sought within the framework of competitive free enterprise, involving the minimum amount of governmental regulation, supervision, and intervention necessary to its realization. Of course, in my field—the public utility business—governmental regulation is necessary and accepted. Third, I would emphasize the importance of maintaining a stable purchasing power of the dollar as essential to economic development. Fourth, I would stress the heavy burden of responsiblity that rests upon each segment of the economy and each economic group for relating its claims upon the national output of goods and services to its contribution to the production of these goods and the providing of these services. Fifth, and finally, I would underline the vital necessity for political and economic statesmanship in defining our economic goals and inspiring us toward their accomplishment.

The public utility business, as you well know, is not a free agent in our competitive, free enterprise economy. While subject to all the pressures exerted by rising labor and material costs and increases in taxation, the public utility must sell its products at prices which are prescribed by the various State and Federal regulating commissions and which in turn are determined on the basis of fairly rigid and inflexible formulas. Prior to World War II and its inflationary heritage, the price of public utility services to the consuming public was trending downward; since World War II utilities have been forced to raise their rates, but the increases granted them by the regulatory commissions have not for the most part kept pace with the rising costs of providing such services, particularly if consideration is given to the cost of replacing facilities. Michigan Consolidated Gas Co. has for years been replacing large amounts of old property at a cost many times in excess of the original cost, although only the small original cost is permitted to be recovered in our rates. Moreover, the relocation of facilities has of late become a serious burden. For example, the company has been spending large sum in recent years to replace facilities necessitated by the clearance of right-of-way for arterial highways and other municipal improvements. This replacement, which adds little or nothing to the overall capacity of our distribution system, imposes a heavy burden on the company's finances and earnings. We believe that some recognition should be given in our tax and rate regulation to this high cost of replacing facilities which represents an actual but in many ways hidden attrition of capital.

While we recognize that adequate national defense and the multitudinous service expected of Government in this day and age require the imposition of heavy taxes, we do feel that every effort should be made to achieve maximum economy in Government. As recently as 1948 our total taxpayments amounted to 8 percent of total revenues; in 1957, by way of contrast, taxpayments exceeded 14 percent of total revenues.

Citing the above illustration in answer to your question about the effect on our economy of current Federal, State, and local taxation, I would say that not only are taxes unduly burdensome but also—and much more important to our future economic development—they diminish the incentives to further expansion and reduce the volume of funds available for this purpose. My company's tax bill for 1957 exceeded $18 million, which was twice the amount distributed to stockholders in dividends, and roughly 78 percent of that year's capital expenditures. Net income after taxes amounted to 8 percent of 1957 gross revenues. Return on invested capital amounted to 5½ percent.

As regards labor costs and wage rates, there are some reflections I have which cast doubt on the compatibility of escalator provisions in wage contracts with the achievement of economic stability. One important aspect of the public utility business is the servicing of customers equipment and appliances; another, the reading of meters and the inspection and repair of distribution lines and equipment. So far as these activities are concerned, there has been little or no increase in productivity in recent years, despite the fact that our average wage costs have risen from $1.50 per hour in 1948 to $2.50 per hour in 1957. One man reads just about the same number of meters per day at the present time as he did 10 years ago; the servicing of more numerous and complex appliances requires considerably more man-hours now that it used to, and much of this servicing is provided without specific charge to the customer. Since many of the jobs for which we hire people cannot be mechanized, and since the productivity of such labor is subject to only nominal improvement, any increase in basic wage rates can only be recovered by raising the price of our product. At the same time we must compete for labor with companies that are able to recapture some part of increased labor cost through increased worker productivity. When the wage rates of labor in those industries are advanced automatically with increases in the consumer price (cost of living) index, it puts pressure on other industries and services to increase their wage rates, irrespective of their ability to pay or to recapture such increased costs. The program feeds on itself and the effect is depressed earnings or serious losses for many businesses, with resultant unemployment, and more inflation and even higher prices to the public.

Turning briefly to the subject of the present recession, I would say that what we are experiencing is a reaction to a period of long-sustained and abnormally large consumer and business investment. Studies show that inventories are still high, and that consumer indebtedness is at an alltime peak level—both absolute and relative to disposable income. Since the end of the war, moreover, industry has been engaged in a massive capital expenditure program involving upward of $290 billion which has resulted in a substantial addition to productive capacity. It was inevitable too that such expenditures would taper off at some point, since additions to plant and equipment are seldom correlated precisely with growth in demand for the products of industry.

Although restrictive credit policy has been blamed by some people for bringing about the current recession—and I do believe that we went from soft to very hard money too precipitously—it seems to me that temporary fulfillment of consumer purchasing capacity and the emergence of temporarily excess productive capacity are more likely causes. In the absence of a restrictive credit policy which forced the postponement of some marginal business capital expenditures and the deferral of some consumer purchases, the business boom might have reached higher levels and the resulting readjustment might well have been of more serious proportions.

This is not to minimize or treat casually the current recession which has already brought hardship, uncertainty, and suffering to many pleople. It only emphasizes the necessity for prompt and enlightened action to meet the problem. To my mind, the thing we now need is the restoration of confidence in our business and economic system. It cannot come through the revival of illusory schemes which, even within the memory of many of us, have proved themselves failures. Rather, confidence must come through the adoption of sound financial and fiscal policies so that inflation can be controlled and the average citizen protected.

May I add that your willingness as expressed in the press to continue in public life, despite the many personal sacrifices required, is most heartening to us all.

Hoping that the foregoing comments, which touch directly upon certain of the questions that you raised, may prove helpful to you and your committee, I remain

Very truly yours,

HENRY TUTTLE.

SUNRAY MID-CONTINENT OIL CO.,
Tulsa, Okla., March 31, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance of the Senate,
Washington, D. C.

DEAR SENATOR: I have your letter of February 17 and have given it much thought and study. I am very pleased in one way, but somewhat at a loss in another way, to try to offer suggestions about the questions on economic matters confronting the Senate.

However, I want to give you the information which has been assembled by our economics department, assisted by some other local people, banks, and so forth. It might be clearer and more understandable to give you a copy of their report to me, with letters written by others in the company also, and I am enclosing them. The report will, I am sure, contain information which you already have, but perhaps it may be prepared in a different manner, and with a different approach.

The problems before our leaders in Government are very great, and I am sure that you and others in public office are deeply concerned about them. The only comments that I feel capable of making are of a practical nature, coming from actual experience over a period of 40 to 50 years.

It seems to me that the greatest problem now facing the people of this country under our free-enterprise system is the high cost of high living, which has been brought about in the past 25 to 30 years. It is true, and we all realize, that our country has made great progress in that time, and our standard of living is much improved, and having become accustomed to such conditions, then it is very hard for people to console themselves during depressed times.

In our own business, we have found that one of the troubles we face is getting into a category of prosperity, and then there is a retrenching period. No one likes to give up the habit of good living.

At the moment, throughout the country we have a large number of people unemployed. I know there have been legislative efforts made to help carry this burden, but when many people are without work naturally the buying power recedes, and as a result general business is affected. It would be a fine thing if you in Washington could act more quickly to create jobs through public works, such as highways, and other substantial things that will be of a permanent nature, thus putting many people to work promptly.

For the younger generation, I think the greatest problem is the matter of taxes. It is quite discouraging for young folks today to try to accumulate anything when the tax burden is so great.

There is no need for me to say anything about the hows and whys, or the methods of doing these things. You know much more about that and have a lot more information, but I feel that immediate action is necessary and that time is of the essence of the present situation.

I have no comments about foreign conditions. You in Washington have all the facts. We laymen do not, and therefore we are not in position to offer any constructive ideas. We continually tell our own people in our country that in order for our business to prosper and have a profit we must be productive and create more than we consume. No business can be profitable on any other basis, and neither can our country.

I have been a great admirer of yours, and I am delighted that you have decided to stay in the Senate.

I hope that you may get something out of the various papers which I am enclosing that may be worth while.

Wishing the very best for you and for our country, I am

Sincerely,

C. H. WRIGHT.

SUNRAY MID-CONTINENT OIL CO.,
Tulsa, Okla., March 27, 1958.

To: C. H. Wright.
Subject: Letter of Senator Harry F. Byrd dated February 17, 1958.

You submitted to me a letter dated February 17, 1958, from Senator Harry F. Byrd, chairman of the Committee on Finance of the United States Senate, in which he requested your opinion concerning certain economic questions confronting the United States Senate. He has circulated these same questions to a substantial number of leading corporate executives and economic experts.

At your direction I wrote to Senator Byrd, telling him that we would submit answers to his questions before April 1 as he requested.

These questions have been submitted to Mr. Robert O. Law, head of our economics department. Mr. Law has made a study of these questions and has prepared a written discussion of them, which is attached with his letter of transmittal of March 21, 1958. You will observe that Mr. Law has prepared his discussion by classifying in each section the questions bearing upon the general subject of the section, as suggested by Senator Byrd.

In preparing this discussion, Mr. Law has conferred with Mr. Elmo Thompson, with Mr. Paul Henry, and with me. I have read the discussion carefully and I agree with Mr. Law's conclusions.

The discussion prepared by Mr. Law might be classified as textbook economics, but he has added some particular observations which bear upon the problems of the oil and gas industry and also has presented the discussion from an employer's viewpoint. He has summarized his conclusions in his letter of transmittal to you of March 21, in which he has said:

"The position taken in this report is that, while the immediate problem is one of an economic recession, the long-term problem remains one of inflation. The most effective way to combat the recession is to take steps to reverse the decline in the rate of business investment. The problem of long-term inflation should be met by reducing the Federal debt, by making sure that tax revenues do not increase in the future as rapidly as does the value of the goods and services produced in this country, and by preventing monopolistic labor practices which force wages to rise at a rate not justified by increases in labor productivity. The Government can make its most effective contribution toward ending the present recession by adopting sound long-term anti-inflation policies which will generate confidence in the stability of the dollar. Government economic policy should not be aimed at establishing a controlled economy but should seek to further the growth of the free-enterprise system."

M. D. KIRK.

D-X SUNRAY OIL Co.,
March 21, 1958.

To: C. H. Wright.
Subject: Senator Byrd's request for a statement concerning vital matters affecting our economy.

Senator Byrd's letter was accompanied by a list of 17 questions. Some of these questions duplicate each other. Thus question 11 and question 15 ask the same thing. Further, it is difficult to develop a coherent and well-supported statement of position on these vital matters by merely answering each question as it appears. I have, therefore, taken the liberty of adopting the suggestion made by Senator Byrd in the second paragraph of his letter wherein he states, "In preparing your reply it is suggested that you use the attached list of questions merely as a guide."

A study of Senator Byrd's list of questions shows that the ground they cover can be divided into four areas. I have, therefore, divided my report to you into four sections which cover, to the best of my understanding, all of the points raised by the Senator.

The four sections of this report, and the specific questions which are covered in whole or in part in each section, are:

Section 1: Discussion of definitions of inflation and deflation and the various types of inflation.

Covers questions 1, 4, 11, 12, 15, 16, and 17.

Section 2: The effect of Government fiscal and monetary policy upon economic stability.

Covers questions 3, 5, 7, 8, 9, 10, 14 and 17.

Section 3: Appropriate goals of Government economic policy.

Covers questions 6 and 15.

Section 4: Suggested policies for the achievement of these goals.

Covers questions 2, 10, 11, 13, 15, and 17.

The position taken in this report is that, while the immediate problem is one of an economic recession, the long-term problem remains one of inflation. The most effective way to combat the recession is to take steps to reverse the decline in the rate of business investment. The problem of long-term inflation should be met by reducing the Federal debt, by making sure that tax revenues do not increase in the future as rapidly as does the value of the goods and services produced in this country, and by preventing monopolistic labor practices which force wages to rise at a rate not justified by increases in labor productivity. The Government can make its most effective contribution toward ending the present recession by adopting sound long-term anti-inflation policies which will generate confidence in the stability of the dollar. Government economic policy should not be aimed at establishing a controlled economy but should seek to further the growth of the free-enterprise system.

You can appreciate, I am sure, the difficulty I faced in attempting to put together an adequate statement of your position, or that of the Sunray Mid-Continent Oil Co., relative to these important matters. I have consoled myself by recognizing that my report to you is merely a preliminary statement and that you will undoubtedly want to recast it to more completely reflect your views before sending it to Senator Byrd.

ECONOMICS DEPARTMENT.

SECTION 1. DISCUSSION OF DEFINITIONS OF INFLATION AND DEFLATION AND THE VARIOUS TYPES OF INFLATION

A. DEFINITIONS OF INFLATION AND DEFLATION

Defining inflation and deflation in terms accurate enough to reflect the important events which occur is extremely difficult. The task is made more difficult by the fact that deflation is not the exact opposite of inflation. However, it is not possible to suggest measures which the Federal Government should take in the areas of fiscal policy, management of the monetary system, and elsewhere to combat inflation or deflation without first arriving at an adequate definition of these two words. An example of the difficulty caused by using an imprecise definition of inflation is to be found among those who see a paradox in the fact that at times inflation and unemployment exist side by side in our economy.

Perhaps the most useful definition of inflation is to call it a decrease in the purchasing power of the dollar. This seems to be more useful than it is to call inflation an increase in the general level of prices, which is a more popular definition. It is possible to have a decrease in the purchasing power of the dollar even when prices do not change. This happens when a product is downgraded or diminished in some manner. The fact that a 5-cent candy bar contains less candy than it did some years ago is a case in point. Five cents buys less candy than formerly though the price of the candy bar has not changed.

It is also true that not all price increases are inflationary in nature. Price rises which reflect product improvements are not a form of inflation. The price of a gallon of gasoline has increased in the course of the last decade and this is true even if the gasoline tax is not included in the price. However, the quality of gasoline has been so improved that the useful power delivered in the cylinder has increased more rapidly than has the price. The gasoline dollar purchases more useful power today than it did 10 years ago.

The harm done by inflation lies in the manner in which it destroys the value of savings, insurance policies, fixed incomes, and so on. Such destruction cannot be truly measured by watching the movement of price levels. Defining inflation as a decrease in the purchasing power of the dollar places a finger on the heart of the matter.

It is not helpful to define deflation as an increase in the purchasing power of the dollar although this is what generally happens in the course of a deflation. The objectionable feature of a deflation is not an increase in the purchasing power of the dollar. Rather, it is the growing unemployment of labor and equipment and the consequent general economic stagnation which is to be feared.

There are a number of factors which lie at the root of a deflation. However, the mechanism which spreads the deflation virus throughout the economy is a relatively rapid decline in the general price level. Not all price decreases are deflationary in nature. Price drops which reflect the lower costs brought about by more efficient production techniques are actually a stimulant to economic activity. They result in an increased volume of sales and production and in a more complete utilization of men and machines.

When decreases in price become general and when they reflect a lowering of demand rather than of costs, the economy is in the grip of deflation. The most useful definition appears to be one which states that deflation is a decrease in the general level of prices which is greater than any possible decrease in cost levels.

B. THE VARIOUS TYPES OF INFLATION

The mechanism of inflation is as yet imperfectly understood. A more complete comprehension of the foundations of inflation is a prerequisite for effective Government action in this area. This represents a problem to which economists and others in business, Government, and academic circles could well devote more attention.

It used to be thought that the root of inflation was to be found in the money supply. Observers noted that when Government printing presses ran night and day creating additional currency, inflation generally resulted. The era of the greenback inflation in the United States in the 19th century was of this nature. The supply of money was increased more rapidly than was the supply of goods and services available for consumption. As a result, prices rose so rapidly that the greenbacks became virtually worthless. The answer to this problem, obviously, was to stop the Government printing presses and to withdraw most of this paper currency from circulation. Such a policy was adopted with the result that this particular inflation was halted.

The notion that all inflations are brought about by excess money supply is current in many quarters. The corollary is that all that is needed to stop an inflation is to manage the monetary system correctly. Unfortunately, inflation is a much more complex phenomenon than this position indicates and monetary management alone is not an adequate antiinflationary device.

There appear to be at least three basic types of inflations; purchasing-power inflations, cost inflations, and supply-failure inflations. During the course of any given inflationary period, it is probable that more than one of these types of inflation is present. Each of these types requires different corrective measures. Government antiinflationary policy in a specific inflationary period must be tailored to cope with the pattern of types of inflations present in the period in question.

Purchasing-power inflations are those brought about when purchasing power in the economy increases more rapidly than does the available supply of goods and services. The movement of excess purchasing power into the market bids up the prices of goods and services and the general price level rises.

There are two kinds of purchasing-power inflation, monetary inflation and credit inflation. In the case of monetary inflation, the supply of money (which includes demand deposits as well as currency) rises too rapidly. The remedy here is to contract the supply of money. Demand deposits can be contracted by having the Federal Reserve Board increase the reserves that member banks are required to maintain against demand deposits and by increasing taxes. Increased taxes, however, will reduce demand deposits only if the increased tax revenues are used to reduce the National debt held in the banking system. There will be no decrease in demand deposits if increased taxes are matched by increased Government spending or if increased taxes are used for redemption of Government bonds held by individuals, insurance companies, or pension funds.

The amount of currency in circulation can be contracted by having the Federal Reserve Board sell Government bonds in the open market and place the currency secured from the sale of these bonds into idle balances. Currency in circulation can also be contracted by requiring increased reserves against the issue of Federal Reserve notes.

Credit inflation occurs when an expansion of credit acts to cause purchasing power to increase more rapidly than does the available supply of goods and services. The type of credit involved can be credit granted to consumers to finance their purchases of consumption good, credit granted to producers to finance their purchases of raw materials and equipment, or both.

At the present time, the Government can only act indirectly to force a reduction in the creation of credit. For example, an increase in the rediscount rate charged by the Federal Reserve System will act to increase interest rates in the economy. Such an increase in interest rates causes a rise in the charges levied for the extension of credit. This will discourage some individuals and firms from making use of additional credit and will serve to relieve some of the inflationary pressure. If such measures prove insufficient to halt a credit inflation, it would be possible for the Government to adopt a program of the direct control of credit. Such control, however, is extremely difficult to administer adequately and probably should be undertaken only in the case of war or of extreme emergency.

Cost inflations are radically different from purchasing-power inflations. The problem here is that the money costs of the factors of production rise more rapidly than does the productivity of these factors. The most important type of cost inflation is wage inflation. In this situation, the wages paid to labor increase faster than does labor productivity. An increase in unit cost of production is almost inevitable.

A portion of this increase in the unit cost of production is usually absorbed by the manufacturer through reduced unit profits. There is, however, a definite limit to the degree to which profits can be shaved. A drop in unit profits ultimately affects the ability of management to pay dividends. If dividends continue to drop, investors become disinterested and management is unable to raise the money capital required to expand or even to maintain production. Thus, the time comes when management must raise the price of the company's products in order to protect the company's ability to produce. This increase in price does not reflect an improvement in the quality of the product but rather the fact that wage rates are rising more rapidly than is labor productivity.

The answer to this problem is to prevent wages from rising more rapidly than does labor productivity. Such unwarranted wage increases are made possible by a number of monopolistic practices sponsored by labor unions. The right to strike and thus to halt production within an area of our economy carries with it the responsibility to society as a whole to see that strikes, or the implied threat of strikes, do not result in wage increases unmatched by increases in labor productivity. Few unions appear to worry about this responsibility. The result is that some segments of the labor force are able to secure unwarranted wage increases and, thus, to benefit at the expense of the consuming public which must pay higher prices to foot the bill for such unearned wage increases.

Supply-failure inflations are not as common as are purchasing-power inflations or cost inflations. These inflations result when, for one reason or another, an insufficient supply of goods and services flow into the market to meet the demands of the consumers. Such inflations affect the entire economy only in those relatively rare instances when some catastrophe such as war has acted to reduce materially the entire productive capacity of an economy or, at least, to reduce that portion of the productive capacity which can be devoted to the creation of goods and services for civilian consumption.

More commonly, supply-failure inflations affect only one segment of the economy. A general crop failure will reduce the supply of food with a consequent sharp increase in food prices. A producers' monopoly deliberately contrived for the purpose of increasing prices would cause a form of supply-failure inflation.

The answer to this type of inflation is to increase the supply of the commodities affected. If supply cannot be increased rapidly from sources within the economy, it must be imported until local production units are capable of meeting the demand. Factories devastated by war or other catastrophe must be replaced as quickly as possible. Crop failures can be met by importing food until a new crop can be harvested. Producer monopolies must be, and are, prohibited by law.

Although much remains to be learned about inflation, it has become obvious that it is a complex matter and that, actually, there are a number of different kinds of inflation. It is probable that more than one type of inflation is at work during any given inflationary period. There is no one remedy that the Government can adopt in a fight against inflation. Adequate Government action in any inflationary period requires a comprehensive analysis of the specific pattern of factors which are in action. Only when this pattern is understood will it be possible for the Government to determine an effective course of action.

SECTION 2. THE EFFECT OF GOVERNMENT FISCAL AND MONETARY POLICY AND OF THE STRUCTURE OF CORPORATE AND PRIVATE DEBT UPON ECONOMIC STABILITY

There are a number of forces within an economy which have impact upon the stability of this economy. Examples include businessmen's expectations concerning the future (optimism or pessimism), the pattern of consumers' demands for goods and services, the available supply of money capital, interest rates, the rapidity of change in production technology, the debt structure, Government fiscal and monetary policies, and so on.

These forces are subject to varying degrees of manipulation by those who would like to influence or direct the course of the economy. The fact that these forces are interrelated and that they are linked together in ways which are complex and imperfectly understood calls for the exercise of considerable caution and good judgment by those who would influence the course of economic events.

A. GOVERNMENT FISCAL AND MONETARY POLICIES

Measures adopted at the various levels of government (Federal, State, and local) in the area of fiscal policy and those adopted by the Federal Government in the area of monetary policy have an important effect upon the general level of business activity. While fiscal policy and monetary policy exert their influence upon the economy through slightly different channels, each of them has an effect upon the other. It is important to remember this fact for the economic effect of a policy adopted in the area of monetary management may be nullified by a policy adopted in the area of fiscal management.

The roles of the Treasury Department and the Federal Reserve System

Fiscal policy relates to the level of Government expenditures and income and to management of public debts while monetary policy relates to management of the Nation's supply of money. In the administrative branch of the Federal Government, the implementation of fiscal policy is primarily the responsibility of the Treasury Department while the Federal Reserve Board is primarily responsible for monetary policy. Federal fiscal policy is laid down by the Congress although the Treasury Department plays some part in the establishment of such policy through its management of the current Federal debt and through its recommendations relating to tax and budget matters. Congress appears to play a much smaller role in the area of monetary management, with the Federal Reserve Board doing most of this work, although the fundamental authority of Congress in this area cannot be denied.

It is evident that fiscal and monetary policies have an impact upon each other. Thus, an increase in interest rates brought about by Federal Reserve Board action in increasing the rediscount rate will force the Treasury Department to increase the interest rates it offers on Government bond issues and will affect the number of tax dollars which must be used to pay interest on the Federal debt. A reduction in the Federal debt, an action taken by the Treasury Department, which involves redemption of Government bonds held by individuals (rather than by the banking system) will tend to increase the amount of currency in circulation and will affect the problems faced by the Federal Reserve Board in managing the Nation's money supply.

It is important, however, to recognize the fact that the basic goals of fiscal policy may differ from the basic goals of monetary policy. For example, fiscal policy should be aimed at efficient management of the Federal debt and at making it possible for the Government to provide essential services at a minimum expense to the taxpayers. On the other hand, monetary policy should be aimed at managing the money supply in such a manner as to contribute to the stability of the economy and to make possible a reasonable and orderly rate of growth in the economy. The Treasury Department and the Federal Reserve System should be sufficiently independent of each other as to enable each of these agencies to achieve its basic goal.

The problems that arise when such independence is not permitted can be illustrated by the history of the monetary control policies of the Federal Reserve Board from 1952 to 1957.

The fact that the necessity of financing heavy defense expenditures during World War II would require an enormous expansion of the Federal debt was a cause of concern to those charged with responsibility for fiscal policy. It was necessary to assure a market for huge issues of Government bonds without impairing the credit of the United States. In order that the prices of these bonds in the open market might not fall below par, the Federal Reserve System was required to engage in open market operations to support these prices. Such a requirement took precedent over policies which would represent the most efficient management of the monetary system which is the basic responsibility of the Federal Reserve System.

Support of the Government bond market by the Federal Reserve System during the war may well have been justified. The overriding importance of maintaining an active demand for Government bonds at par or above is apparent. The relatively low interest rates which prevailed in the economy as a result of this policy undoubtedly helped to provide for a more rapid expansion of our industrial capacity during wartime than otherwise would have been possible. These low interest rates also helped to keep to a minimum the burden of servicing the rapidly expanding Federal debt.

Justification for maintaining such a policy in the period extending from the end of World War II to 1950 is more difficult to find. The inflation which occurred during the latter half of the 1940's was a combination of a supply-failure inflation and a purchasing-power inflation. The supply of consumption goods flowing into the market when rationing was abandoned was not sufficient to meet pent-up civilian demand which had been postponed during the war. Money supply had been increased rapidly during the war and a considerable portion of this increased money supply rested in the hands of consumers as idle balances. The result was a sharp decrease in the purchasing power of the dollar.

It is improbable that the Federal Reserve Board would have continued to maintain a policy that resulted in low interest rates and a bountiful supply of money in the face of a 25-percent cut in the purchasing power of the dollar during the short space of 5 years had it not been required to support the price of Government bonds. Prudence called for a policy designed to reduce the money supply and to allow interest rates to seek a more realistic level. Higher interest rates would have increased the rate of saving. This would have reduced the quantity of purchasing power seeking goods and services and, thus, would have tended to put a brake on the erosion of the value of the dollar. It also would have made more money capital available for expansion of the productive capacity of the consumer goods industries.

Forcing the Federal Reserve Board to continue to subordinate its function of manager of the monetary system to the Treasury Department's role as manager of the Federal debt after the war was over was a costly move. Whatever advantage the American public gained from having Federal debt refundings accomplished at a low interest rate was far overshadowed by the incalculable harm done by the erosion of the purchasing power of the dollar.

With the accord of 1951 wherein it was freed from the requirement that it support the Government bond market, the Federal Reserve Board was permitted to return to its primary task of managing the monetary system. The responsiveness of the monetary system to the needs of the economy improved at once.

No one contends that our monetary system has been perfectly managed since the accord. It is possible, for example, that the rediscount rate was lowered too quickly in response to the 1953–54 recession. But the improvement over the situation which existed prior to 1951 is obvious. The Federal Reserve Board is to be commended for its courage in raising the rediscount rate despite considerable opposition when inflation again became a problem in 1957. However, the fact that the efforts of the Board have not been completely effective in halting the decline in the purchasing power of the dollar shows once again that manipulation of the rediscount rate and of reserve requirements are not in themselves sufficient to stem a strongly inflationary tide.

It has been pointed out that fiscal policy and monetary policy, despite the fact that each has an effect upon the other, seek different goals. It follows that the Federal agencies responsible for the execution of these policies, the Treasury Department and the Federal Reserve Board, should be allowed to operate independently of each other insofar as is possible. It remains to trace some of the channels by which fiscal policy and monetary policy affect economic stability.

2. The effects of fiscal policy upon economic stability

The three major aspects of fiscal policy which affect economic stability are Government spending, Government taxation, and management of Government debt. The general economic effect of the first two aspects is approximately the same whether the spending and taxing is being done by Federal, Stater, or local governments. In the case of the third aspect, there is a significant difference in the economic impact of management of the Federal debt and management of State and local government debts.

(*a*) *Government spending.*—In a free-enterprise economy, spending patterns have a profound effect upon the production sector of the economy. Changes in production patterns always follow changes in spending patterns. A decrease in the demand for a commodity or service is always reflected by a drop in the spending for that commodity or service. Producers must revive the demand for their products, must shift to the production of other products, or must face financial failure.

Federal, State, and local governments accounted for one-fifth of all the spending in the United States economy in 1957. Shifts in Government spending patterns will be mirrored by consequent changes in United States production patterns. Production pattern changes often cause dislocations which affect management, labor, and investors alike. Abrupt shifts in Government spending patterns offer a serious threat to economic stability.

Government spending affect economic stability in other ways. Government purchases of strategic raw materials for stockpiling in periods of inflation acts to push these raw material prices even higher. Government spending for public-works-type projects in periods of full employment can pull productive factors away from the creation of additional goods and services available for consumption and, thus, add to inflationary pressures. Spending by State or local governments on ill-conceived projects can be as harmful as is an equal volume of unwarranted spending by the Federal Government.

(*b*) *Government taxation.*—Taxation by Government units affects economic stability in several ways. It must be recognized that however necessary taxation may be to the existence of organized government, it does take from the individual the right to determine the manner in which a portion of the money he earns by his labor should be spent and places the right to determine the pattern of the spending of this money in the hands of Government agencies. Unless the Government agencies are as determined as are most individuals to see that this hard-earned money is well spent, economic stability is threatened.

Taxation is one of the tools that can be used to adjust the money supply to the needs of the economy during periods of inflation or deflation. Increased taxes will act to reduce the quantity of money in circulation (if the increased taxes are used to redeem Government bonds held by banks) and thus to reduce the pressure on prices in periods of inflation. A reduction in Taxes in periods of severe deflation will increase the supply of money and will help to bring about economic recovery.

An income-tax structure which is so highly progressive as to seriously diminish incentive is inflationary in nature. Talented managers are often loath to accept positions of increased responsibility when most of the added income paid to compensate the individual for the additional effort he must put forth is taxed away. Those with accumulated savings often conclude that the after-tax return is disproportionate to the risk. Even the skilled laborer may voluntarily limit his hours of work when he finds himself in the higher tax brackets. And yet the only manner in which additional goods and services can be provided in our society is by prevailing upon men of ability and those who supply capital to undertake the additional effort and risk which such increase in the supply of goods and services requires. The only way to offset the increased demand occasioned by our expanding population without inflation is to keep expanding the available supply of goods and services. Anything which interferes with this process generates inflation.

There is an even more fundamental manner in which a distorted income-tax structure affects the fabric of a free enterprise society. To seek security in the face of the uncertainties of life and the infirmities of old age is to respond to the basic human drive for self-preservation. In the past in this country, such a drive has led men to seek the greatest amount of income permitted by their own abilities and to save as much of this income as possible. They were attempting to provide their own security and that of their family.

However, when a distorted income-tax structure renders it almost impossible for the individual to secure a sufficiently high after-tax level of income to make provision for his own security, he will look elsewhere for this security. The only agency which appears ready, willing, and able to shoulder this burden is the very Government which is taxing away his self-dependence. From this point on, two roads are open. The individual can follow a dictator who promises protection and security or he can throw himself into the arms of the Socialists who promise that an all-controlling Government will provide his security. Both of these roads lead away from a free-enterprise society. A way of life which in the past has earned for us an unmatched standard of living coupled with a degree of individual freedom which is unique in history is in the process of being taxed to death.

Like results obtain when progressive estate tax rates approach confiscatory levels. If a man knows a substantial portion of what he accumulates for the security of himself and his family will be taken by the Government at his death, a forceful incentive to produce and save is removed.

(*c*) *Management of the public debt.*—The stability of an economy is affected by the structure of debt within that economy. However, that portion of the debt structure which is represented by Government debt differs considerably from corporate and private debt and its management presents a unique series of problems and opportunities.

Government debt is different from corporate and private debt in several important ways. Generally, money is lent to corporations or individuals on the basis of their ability to create through their own efforts sufficient income to permit repayment of the loan and of their possession of assets large enough to cover the value of the loan. The Government, however, creates little income of its own. Rather, it relies on its ability to tax the incomes created by corporations and individuals in order to secure funds with which to repay money lent to it. Further, Government assets do not stand behind most loans made to the Government. The security involved, in reality, is this same ability to tax.

The upshot of these matters is the fact that the incomes and assets of corporations and individuals in this country are subject not only to the liens established by their own borrowings but also to liens established by Government borrowing (anyone who fails to pay his taxes finds that both his income and his assets are subject to confiscation).

Prudent management of the public debt requires recognition of this fact. If the public debt is allowed to expand more rapidly than does the ability of corporations and individuals to create income, the liens thus established upon income and assets will finally become too great to be supported. Some individuals and corporations will face the intolerable situation of being taxed out of business and being forced into bankruptcy not as a result of their own mismanagement but as a result of unwise Government fiscal policy.

Government debt is an important segment of the total debt structure in this country. In December of 1956, it equaled $327 billion or 41 percent of our total debt structure of $793 billion. Federal Government debt was at the level of $277 billion (about 85 percent of total government debt) while State and local government debt amounted to $50 billion.

State and local government debt differs somewhat from Federal debt in its impact upon economic stability. A much greater proportion of State and local government debt is funded than is the case with the Federal debt. When a sinking fund is being accumulated, retirement of the debt at maturity is being provided for automatically without requiring further action on the part of State or local officials. Federal bonds do have a maturity date. However, the lack of a sinking fund means that some decision is required at the maturity date as to the manner in which the money required to pay the bond is to be raised. As a rule, it is decided to issue a new bond to pay for the maturing bond. Thus, there is a somewhat greater possibility of State and local government debt being decreased than is the case with the Federal debt.

A more important difference between the two types of government debt is the fact that Federal Government bonds can be used as a reserve against the issuing of Federal Reserve bank notes or as a part of the reserves which banks are required to maintain against deposits. This is not true, of course, of State and local government bonds. This ability to monetize the Federal debt affects the stability of our economy and creates some acute problems in the area of monetary management.

An increase in the Federal debt is likely to result in an increase of the quantity of Federal Reserve notes in circulation and in a growth in demand deposits. A decrease in the Federal debt may result in a decrease in these two portions of the money supply. Such more or less involuntary changes in the money supply may not meet the monetary needs of the economy at the moment. The problems of monetary management are thereby increased. The growth of the monetized Federal debt since 1940 unquestionably has contributed to the pressure of inflation.

3. The effect of monetary policy upon economic stability

While fiscal policy managers must take into consideration the effect of their decisions upon the level of economic activity, the primary goal of fiscal policy is to finance the operations of government. The primary goal of monetary policy, however, is to adjust the supply of money (including demand deposits) to the needs of the economy.

There are two schools of thought relative to the manner in which these needs should be met. There is a group which maintains that monetary policy should be essentially a passive factor in the economy; this is to say that the money supply should be manipulated in such a way as to adjust to the current demand for money in the economy. This group recognizes the fact that economic change is inevitable but feels that such change should be the result of factors other than monetary policy. This approach lays stress upon the development of policies which provide for an automatic adjustment between money supply and current demand for money.

A second group takes the position that monetary policy should make a firm contribution to economic growth, that it should be an active factor in the economy. The need for maintaining a degree of equilibrium while the economy grows, and the importance of monetary management policies to this equilibrium, is recognized. However, monetary management should stress those policies which will stimulate economic growth in the view of this second group.

An example of the difference in the basic policies advocated by these two groups is their approach to the question of interest rates. The first group contends that the interest rate should be determined by the relation between the demand for money and the supply of savings. They admit that the production sector of the economy may not grow as rapidly in this case as it would if interest rates were forced to a lower level. However, they feel that the growth in capital goods should be limited to the rate of growth in savings. Otherwise they contend that the economy will suffer a long-term inflationary trend.

The second group feels that the interest rate should be forced to a somewhat lower level than would be the case if it was determined solely by the relationship between the demand for money and the supply of savings. This can be done by, among other things, having the Federal Reserve Board maintain a relatively low rediscount rate and reserve requirement. Such a policy creates low interest rates both directly, because of the close relationship that exists between interest rates and the rediscount rate, and indirectly, because of the consequent increase in the supply of money. This low interest rate, says the second group, will stimulate business investment to rise to higher levels. They feel that the growth in the quantity of goods and services available for consumption brought about by this increased business investment will be great enough to eliminate the danger of long-term monetary inflation.

A discussion of which of these points of view represents the position that should be adopted by the Government belongs in sections 3 and 4 of this report. The point to be noted here is that one of the ways in which monetary management affects economic stability is in the impact of monetary policy upon interest rates.

Monetary policy can affect economic stability in one other way. Inept monetary management can result in an erosion of the purchasing power of the dollar which is so rapid that the people begin to fear for the fundamental stability of the currency. The result is a full-blown financial panic. The velocity of money increases tremendously, there is a flight of capital from the country, speculation becomes rife, and economic chaos ensues. The German inflation subsequent to World War I is a classic example of such a panic. It may seem incredible that such a situation could develop in this country but the possibility, remote as it may appear, is always present.

B. THE STRUCTURE OF CORPORATE AND PRIVATE DEBT

The effect of Government debt upon the economy has been discussed earlier in this section of this report. The other portion of the total debt structure, corporate and private debt, also has a series of effects upon economic stability. Some of these effects stem from the sheer size of corporate and private debt, that is, the relationship between the quantity of such debt in existence and the quantity of goods and services being produced at any given time. Other effects are the result of the various types of uses to which the borrowed money has been put. Finally, the relationship between the growth of debt capital and equity capital has important implications for economic stability.

When debt is incurred as a result of the transfer of money from one individual to another, as when a man pays cash to a corporation for one of its bonds, there has merely been a transfer of money. The total supply of money has not been increased. However, when this same corporation goes to a bank for a loan the situation is different.

The funds are made available by a demand deposit created by the bank to the order of the corporation. The bank must maintain against this demand deposit a reserve in cash (or in Government bonds) equal to only a portion (11 to 19 percent) of the amount of the demand deposit. Total money supply has been increased by the difference between the amount of the demand deposit and the amount of the reserve. The major share of corporate and private short-term debt, of course, has been created by the demand-deposit route rather than by the direct transfer of funds from creditor to debtor. Thus, much of the corporate and private debt existing in this country has resulted in an expansion of the money supply.

A rapid expansion of corporate and private debt can lead to economic instability. Increases in consumer debt that enables effective demand to exceed supply is inflationary. Increases in producer debt of such a magnitude that they lead to overbuilding of productive capacity is inflationary in its first effect as it bids up the prices of labor, raw materials, and equipment. At the same time, it lays the groundwork for subsequent deflation as productive capacity becomes increasingly greater than current demand.

The use to which borrowed money is put has much to do with the effect of debt upon economic stability. Money borrowed for the purpose of commodity speculation has an inflationary effect which is especially pronounced in periods of full employment. Money borrowed for the purpose of building producing facilities which will take several years to come into production is generally more inflationary than is money borrowed to create working capital. Money borrowed to finance inventory speculation has an immediate inflationary effect.

Corporations face two general possibilities when it comes to increasing their capital. They can resort to debt financing or equity financing. As a general rule, corporations prefer to engage in debt financing when they anticipate inflation and to engage in equity financing when they expect deflation.

The relationship between the quantity of debt capital and the quantity of equity capital in an economy has some interesting implications during periods of economic change. This is especially true when the ownership of corporate bonds and corporate stocks is widely dispersed among the consuming public. An economy which is characterized by a relatively large proportion of debt capital may resist the early stages of a deflation more successfully than will an economy in which there is heavy reliance upon equity capital. While dividends tend to drop early in a deflation, bond interest payments are made by corporations as long as it is possible to do so. Bondholders will find their purchasing power curtailed to a smaller degree than will stockholders. Thus, in economies wherein there is a large percentage of debt capital, consumers' purchases may not drop off as rapidly in the early stages of deflation. On the other hand, these economies may spend more time in the depths of a serious deflation than will economies wherein equity capital is more prevalent. The burden of meeting bond interest payments may throw a number of corporations into bankruptcy in such a situation. This creates a form of economic chaos which is most difficult to combat.

Section 3. Appropriate Goals of Government Economic Policy

A. THE FREE ENTERPRISE ECONOMY VERSUS THE CONTROLLED ECONOMY

Decision as to the goals which are appropriate for Government economic policy must be based upon a clear understanding of the nature of the free-enterprise system. The controlled economy system, which is the economic aspect of the philosophy of collectivism, relies upon Government planners to direct the course of virtually all of the production in an economy. This system is closely allied with the concept of the welfare state wherein differences in individual incomes are eliminated and everyone is provided with the same standard of living under the watchword security for all. The free-enterprise system, which is based upon the philosophy of individualism, in essence leaves the direction of the course of production to the entire group of producers in the economy who must submit to the discipline of the market. This market is the means whereby the consumers indicate their preference for the specific types of goods and services they wish to consume.

The fatal weakness in the controlled economy system is the inability of human planners to forecast the future or to measure the present. Yet both of these functions must be undertaken if a central agency is to plan and direct production. No system of surveying and no set of questionnaires is as effective in measuring consumer's desires as is the actual decision of the consumer to spend his money for specific goods and services in the market.

In the matter of forecasting, the free-enterprise system provides a measure of protection for the economy. The planners in a controlled economy must come to some agreement in their forecasts of demand, size of harvest, weather, and so on. The agreed-upon forecast becomes the basis of all production planning. Everything goes well if the forecast proves accurate, but if the forecast is inaccurate the results can be disastrous for the entire economy. Under a free-enterprise economy, each of a myriad of products bases his plans upon his own forecast and these forecasts vary widely. Some producers will have forecasted incorrectly and they will suffer individually. However, other producers will have forecasted correctly and they will prosper and will provide a source of strength in the economy.

The welfare-state type of planned economic system reflects a fear of the future and a consequent desire for security on the part of the individual. There is little appeal to individual initiative in a situation wherein all persons are provided with substantially the same standard of living. Most men will content themselves with the minimum of productive activity permitted by the planners. The free-enterprise system places a premium upon individual initiative. Generally, the highest standard of living is enjoyed by those who are contributing most to the production of goods and services. Each man is subjected to a strong economic incentive to produce to the limit of his ability. The result is a much larger flow of goods and services than is the case under a planned economy with a much higher average standard of living as the result.

The free-enterprise system continues to provide this country with the highest living standards and the greatest amount of personal freedom in the world today despite constant encroachment by those who favor control of the economy by the state. If Government economic policy is not to cripple the ability of the free-enterprise system to provide the foundation for our way of life, Government policymakers must work within the framework of an understanding of the economic requirements of this system.

B. APPROPRIATE GOALS OF GOVERNMENT ECONOMIC POLICY UNDER THE FREE ENTERPRISE SYSTEM

The fundamental requirement of the free-enterprise system is freedom of action. Consumers must be free to make their consumption choices without coercion, producers must be free to compete with maximum effectiveness, and labor and capital must be free to seek their highest possible rates of return. The problem is to preserve the maximum possible degree of freedom for all concerned. The freedom of producers to compete must not interfere with the freedom of consumers to make intelligent consumption choices nor with the freedom of labor and capital to flow to their highest rate of return. The freedom of labor to organize must not interfere with the freedom of producers to compete or of consumers to consume.

Admittedly this is a difficult problem. Monopoly, whether it be a producers' monopoly, a labor monopoly, a consumers' monopoly, or a monopoly of capital, tends to interfere with this fundamental freedom. One of the goals of Government economic policy should be the preservation of such freedom.

The importance of individual initiative to the free-enterprise system has already been pointed out. Government economic policy must act to provide an environment within which individual initiative can flourish.

Free-enterprise economies and controlled economies alike are subject to fluctuations in the level of economic activity. Some of these are caused by forces generated internally within the economy while others are the result of the impact of outside factors. Some degree of fluctuation is inevitable and desirable, for this represents the economy's attempt to regain its balance. Thus, when inventories grow too large production must be curtailed until the excess inventories are worked off. When productive capacity has expanded too rapidly, business investment in new facilities must decrease until demand has an opportunity to catch up. Preventing economic fluctuations of the corrective type results in an increasing unbalance in the economy until the whole structure collapses. The problem, then, is not to eliminate economic fluctuations but to keep them from getting out of hand.

Government economic policy in the matter of economic fluctuations must seek two goals. It must attempt to maintain sufficient flexibility in the economic structure to enable this structure to undergo corrective fluctuations. At the same time, it must attempt to keep fluctuations from degenerating into severe inflation or deflation.

There is a strong tendency for the free-enterprise economy to grow. This is not only the result of population increase but also of the determination of individuals to enjoy a higher standard of living. The stimulus of individual initiative coupled with the desire for an increase in real income leads to a rapidly developing technology and an expanding capacity to produce. Government economic policy should attempt to foster such growth.

In summary, the economic policy of the Government should be directed toward providing a climate conducive to the most effective operation of the free-enterprise system. Basic goals of the Government should include (1) the elimination of barriers to the freedom of action of, and yet prevent monopolistic practices by, consumers, producers, laborers, and capital; (2) the stimulating of individual initiative; (3) maintenance of the flexibility of the economic structure; (4) prevention of severe inflation or deflation; and (5) the fostering of a healthy rate of growth in the economy.

Section 4. Suggested Policies for the Achievement of These Goals

The previous sections of this report have attempted to provide a background for suggestions as to specific economic policies which should be established by the Federal Government. The various types of economic instability have been discussed with emphasis on inflation. The effects of Government fiscal and monetary policy upon economic stability have been explored. A statement has been made as to those goals which are appropriate for Government economic policy in our type of society. All that remains is to spell out the economic policies suggested by this background.

PREVENTION OF SEVERE INFLATION OR DEFLATION

As was pointed out in section 3, it is neither necessary or desirable for the Government to attempt to eliminate all fluctuations in the level of economic activity. However, there is always the possibility that one of these movements will gather a momentum which leads to severe economic dislocation and this must be prevented. One of the goals of Government economic policy must be to prevent severe inflation or deflation.

The structure of the economy of the United States is complex and the interrelationships which exist between its various segments are not completely understood. It is obvious, however, that no two periods of inflation or deflation involve exactly the same factors and that the course of economic events is never quite the same in any two periods. An understanding of the current situation and of the events which led up to it is a prerequisite to effective Government action.

It appears that the economic situation which confronts us today developed in the following manner. Recovery from the economic valley of August 1954 was sparked by a rapid increase in the rate of business investment. The resulting increase in employment in the capital goods area stimulated consumer purchasing. As sales increased, retailers began to expand their inventories. This inventory rise was probably caused not only by the need to meet increased sales levels but also by the fact that retailers anticipated an upward movement in price levels. They wanted to take advantage of the opportunity to make an inventory profit.

Most of the anticipated price increases did not materialize immediately. The average level of wholesale prices rose only four-tenths of 1 percent between 1954 and 1955. However, average hourly wage rates in manufacturing rose by 3.9 percent in 1955, by 5.3 percent in 1956, and by 4.5 percent in 1957. These increases in wage costs began to force up prices and wholesale prices climbed 3.3 percent in 1956 and 3.7 percent in 1957. One of the important causes of this price rise was the fact that hourly wages were increasing more rapidly than was labor productivity.

The increase in labor costs per unit of output which exceeded the increase in the price at which that unit of output could be sold acted to make management pessimistic about the probable course of future profits. Management's problem was compounded by the fact that the cost of money capital was also rising rapidly. Interest rates, as indicated by the rate of return on AAA corporate bonds, rose by 5.5 percent in 1955, by 9.8 percent in 1956, and by 15.8 percent in 1957. This increase in interest rates reflected the fact that the rate of demand for money capital was increasing much faster than was the rate of saving. Between 1954 and 1957, gross private domestic investment increased by 33.1 percent while personal savings rose only by 12.8 percent.

Toward the end of 1956, surplus producing capacity became evident in a growing number of industries. This, coupled with rapidly rising labor costs and interest rates, caused a number of businessmen to review their expansion programs and to begin some pruning. Gross private domestic investment dropped from $65.9 billion in 1956 to $64.4 billion in 1957. The effect was felt almost immediately in primary metals production, which began to slip after a peak in September of 1956, and in machinery manufacture which peaked in December of the same year.

Nonagricultural employment continued to rise until it reached a peak, on a seasonally adjusted basis, in August of 1957. By January of 1958, nonagricultural employment dropped by 2.1 percent from the August peak. However, average weekly hours worked in manufacturing began to decline in January of 1957 as did average weekly earnings in manufacturing. In February sales began to drop, with the rate of decline becoming exceedingly pronounced by October of 1957.

Despite the drops in the quantity of goods produced, in employment, in weekly hours worked, in weekly earnings, and in sales, both retail and wholesale prices continued to rise and are still rising. It is not necessary to look far to find the cause. Hourly wages in all manufacturing continued to rise until December of 1957 and are now continuing at just one cent below this peak. With manufacturing output declining and hourly wages rising, labor costs per unit of production have increased rapidly. Since the last quarter of 1956 corporate profits before taxes have successively decreased each quarter as corporations, caught in the squeeze between rising labor costs and declining sales, have fought to hold down the prices of their products.

Those who fail to understand how it is that inflation can continue in the face of unemployment and sales declines, are guilty of a naive view of inflation. The present situation is an excellent example of a cost inflation. The naive view of inflation, which is based upon the classical school of economics, holds that wage rates will decline as unemployment grows and that this decrease in labor cost will allow producers to lower their prices as sales decline. Actually, producers today are sacrificing profits in a desperate attempt to keep prices from rising and they are only partly successful in this effort.

Organized labor and labor wage contracts generally act to prevent any substantial lowering of wage rates in a recession, thus introducing an element of rigidity into the economy. The leader of one of the major unions recently informed management that the union preferred layoffs to a reduction in hours worked. He relied on unemployment benefits to support those workers who lost their jobs. In the meantime, wage escalation clauses which tie wage rates to the cost of living will continue to bring about wage increases which will themselves increase the cost of living and thus generate further wage increases.

It is sometimes argued that these wage increases place more money in the hands of consumers and that this is a good way in which to combat declines in sales volumes. Such an argument fails to consider the fact that such wage increases act to cause rises in unit costs, and thus in prices, unless they are offset by increased labor productivity. These price rises more than offset the increased purchasing power placed in the hands of consumers by the wage increases. This is evidenced by the fact that manufacturers' sales volumes have been dropping for a year despite the fact that wages have continued to rise during that year.

Manufacturing production dropped during the first half of 1957 as firms attempted to reduce their inventories in the face of a decline in the sale of capital goods. This attempt was unsuccessful, since sales of capital goods continued to drop more rapidly than did output, and manufacturers' inventories reached an all time high in August and September of 1957. In October, output was cut in earnest (manufacturing output dropped 2.7 percent in the month of October alone) and the inventories began a decline that has continued ever since.

Retail sales have held up surprisingly well (with some difficulties apparent in department store sales) despite a drop in total personal income which began in November of 1957. An expansion of outstanding consumer credit has acted to prevent a retail sales decline. There has been no significant decrease in retail inventories on a seasonally adjusted basis.

This discussion of the course of economic events during the past 15 months has not been exhaustive. However, enough has been said to indicate the fundamental causes of the present decline and, thus, to suggest the type of policies which should be adopted by the Federal Government in its efforts to prevent a severe recession.

The root of the present economic difficulties lies in the area of business investment. The drop in the rate of business investment was brought about by a rise in unit labor costs, in the cost of money capital, and by the development of overcapacity in some industries. This is not an inventory recession in the same sense as was true in 1949 although difficulties in liquidating manufacturing inventories has compounded the problems brought about by the decline in business investment. Consumer demand generally has held up surprisingly well despite rising prices and some decline in personal incomes. Retail inventories do not appear to be excessive. The continuing decline in the purchasing power of the dollar is the result of a cost inflation rather than a monetary inflation or a supply-failure inflation. The drop in employment is a result of rather than a cause of our economic difficulties.

There are three fields of action open to the Government in its effort to stem an economic decline although the three fields are to some extent interrelated. The Government can take action relative to the interest rate and the supply of money, relative to purchasing power and demand, and relative to employment. Government action in connection with the interest rate and the supply of money generally involves Federal Reserve Board manipulation of reserve requirements and the rediscount rate. Changes in Federal tax rates, in the length of time over which unemployment insurance payments will be made, in the rates of pay granted to Federal employees, and in the quantity of goods and services purchased by the Government all have a direct effect upon demand and purchasing power. The Government can directly increase employment by a program of public works.

The general pattern of action which the Government should adopt in combating a given economic decline depends upon the fundamental nature of the decline. In the present circumstances, Government policy should be aimed at reversing the trend of business investment. However, this policy must take into consideration the fact that we face a groundswell of inflation in this period of cold war. Government action should contribute as little as possible to the long-term inflationary pressures. When the economic decline has been halted, the Government must once again be prepared for an active anti-inflation campaign.

There are several opportunities available to the Government today which would increase the rate of business investment. There is little that the Government can do about the problem of excess productive capacity in some industries. However, lower interest rates can be accomplished by Fereral Reserve Board action by means of lowering the rediscount rate and reserve requirements and through purchasing Government bonds in the open market. Perhaps most important, the Federal Government should today attempt to influence organized labor to refrain from seeking wage increases or additional fringe benefits until such time as labor productivity catches up with labor compensation. Modification of the antitrust laws would be most timely since unjustified wage rates frequently are secured as a result of industrywide bargaining made possible by the exemption of labor unions from the Federal antitrust laws. A reduction in the corporate income tax should act to increase the current rate of business investment.

A reduction in total personal income tax collections should await concrete evidence of a decline in consumer purchasing. If such a reduction is granted, it should be for a specific limited period. Permanent tax reductions must await a decrease in Government spending. Government deficits are inflationary in their effect and a Government budget surplus is an important factor in the long-term fight against inflation.

An ambitious program of public works should not be undertaken by either the Federal Government or by State governments at this time. Such programs are appropriate only in the case of prolonged depressions, if then. Public works programs, for the most part, require so long a period of preparation that they will be of little real aid in combating the present cyclical decline. By the time these programs are in full swing, inflation will once again be the prime economic problem and such programs are inflationary in their effect. Public works programs are generally aimed at relieving unemployment. Unfortunately, the type of laborers required in such programs often are not the type of laborers who are unemployed.

In summary, Government economic policies designed to combat economic disturbances of a cyclical nature must be appropriate to the specific set of factors underlying any given disturbance. The Government must recognize that the goal of its economic policies in such a situation is not to completely eliminate economic fluctuations but to moderate them.

MAINTENANCE OF FLEXIBILITY IN THE ECONOMIC STRUCTURE

Moderating economic fluctuations is an important facet of Government economic policy. Perhaps an even more fundamental function of Government economic policy in a free-enterprise economy is to aid in maintaining the flexibility of the economic structure. Among the policy areas which might be studied in this connection are the following:

1. Reversal of the tendency to concentrate Government activities at the Federal Government level rather than at the State or local government level.
2. Make certain that the tax take does not increase in the future as rapidly as the increase in gross national product.
3. Wider dispersal of Federal Government bonds among the general public, insurance companies, and pension funds rather than in the banking system.
4. More effective separation of the policy activities of the Federal Reserve Board and the Treasury Department.
5. A more effective policy for reducing the Federal debt when economic activity is at a high level.
6. Moderation of the steeply progressive income tax structure, at both the Federal and State levels, in order to stimulate individual initiative.
7. Imposition of Federal general sales tax not only to generate additional revenue but also to impress the public with the additional tax burden which must result from increased Government expenditures for additional services demanded by the public.
8. Reconsideration of the Full Employment Act. In its present form, this act may place upon the Federal Government an obligation which forces types of Government action which are basically inflationary in nature.

GENERAL AMERICAN OIL COMPANY OF TEXAS,
Dallas, Tex., May 15, 1958.

Senator HARRY F. BYRD,
Senate Office Building,
Washington, D. C.

DEAR SENATOR BYRD: With further regard to your request for my opinion on matters affecting the national economy, I appreciate greatly the opportunity to offer a few comments.

Others to whom you have addressed a similar request are better qualified than I to be helpful in providing direct answers to the specific questions you have raised. I would like to offer a few brief and more general comments as invited by your letter.

I believe that the history and experience of our country demonstrates that an expanding development and use of our national resources is a vital factor in the Nation's economic progress. This applies to all natural resources but I feel more qualified to confine my remarks to petroleum.

Careful studies have shown that there is a direct relationship between standards of living and energy consumption, both in the United States and throughout the nations of the free world. As I am sure you appreciate, petroleum (oil and natural gas) has become the predominant source of the energy that has been so essential to our expanding economy. Petroleum now furnishes about twice the amount of energy supplied from all other sources. It becomes important, therefore, that national policies in all fields such as taxation, foreign trade and economic programs be consistent in their objective to assure adequate supplies of energy at reasonable prices in terms of real cost to the consuming public. This may, and in fact does, require and justify differential treatment to recognize unique characteristics in the economic process of providing energy supplies. The differential tax treatment for oil and gas production provides an outstanding example of wise national policy that has benefited the economy through the assurance of adequate energy supplies at reasonable prices.

In your important and constructive investigation, I would offer the suggestion that Federal fiscal policies, foreign trade policies and other basic policies affecting the national economy be examined to determine whether they are fully consistent and effective in accomplishing the necessary expansion of natural resources in general and our energy resources in particular.

Hoping that this may be of some assistance and with appreciation for your consideration, I am

Sincerely yours,

GORDON SIMPSON, *President.*

INTERNATIONAL HARVESTER CO.,
Chicago, Ill., May 8, 1958.

HON. HARRY F. BYRD,
Chairman, Committee on Finance,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: Your letter and questionnaire dated February 17 and addressed to our recently retired president, Mr. Peter V. Moulder, has been referred to me for reply. I give below my answers to the questions, numbered in accordance with your questionnaire:

1. Inflation is any considerable general upward movement in the level of prices; deflation is any considerable general downward movement in the level of prices.

2. Both inflation and deflation usually reflect economic excesses which took place before the movement began. I believe that prevention is much better than cure. I do not believe that this can be greatly helped by legislation but rather by sound policies on the part of all elements in the economy.

3. Federal Reserve policy was handicapped during the period 1942–50 by the requirements of fiscal policy. The policy of maintaining a low level of interest rates made impracticable an effective monetary policy.

During the period since the accord, namely, 1951–57, the greater independence of Federal Reserve policy has been advantageous. I believe that, had it not been for the conservative policy of the Federal Reserve System during most of 1955–57, the present recession would have been more severe than it is.

4. The rise in the Consumer Price Index between August 1956 and September 1957 was due primarily to increasing labor costs. This in turn was a reflection of the high bargaining power of labor.

5. The management of the current public debt has a great impact on the financial markets and, therefore, on the access by industry to the funds which it requires. A skillful management of the public debt will minimize this potential conflict of interests.

6. (*a*) The three objectives are so closely interrelated that it is doubtful whether they can be usefully separated. If employment is maintained by measures which inflate prices, the stage will be set for an ultimately more serious unemployment. Relative price stability is the best foundation for sound and enduring economic growth.

(*b*) The most important trend since World War II, and particularly during the last 3 years, has been the steady increase in costs and particularly labor costs. While this has been a result of the increasing bargaining power of labor, it brought about during 1957 an increasing cost of many goods and services to the point of consumer resistance. This in turn has resulted in the increase of unemployment with which we are now confronted.

7. Current Government spending is a supporting factor in maintaining national income but, since much of such spending does not add to consumable goods, it tends to inflate costs.

8. Current taxation is at such high levels as to impair the ability and the incentive of both individuals and corporations to maintain and increase investment.

9. Fiscal policy embraces all of the financial transactions of Government and particularly of the Federal Government. Since the Federal Government is in a position to incur debt in whatever way it desires, it can interfere seriously with monetary and credit policy. On the other hand, if the Federal Government formulates its fiscal policy with due regard for the requirements of monetary and credit policy, each can reinforce the other. For example, monetary and credit policy cannot restrain inflationary trends in the face of sharply increasing Government expenditures and increasing Government deficits. The lengthening of the average maturity of the Federal debt would lessen the interference with monetary policy which results from frequent refundings by the Federal Treasury.

10. (*a*) It has been frequently pointed out that the monetary system, which used to function primarily through the commercial banks, is now affected also by many new types of financial institutions. The difficult question of whether direct controls should be extended to these other institutions could only be answered by a complete study by a qualified Commission.

(*b*) In very general terms, I believe that the tax structure of the United States has been built up with inadequate attention to incentives for investment and enterprise.

11. (*a*) The explanation of this paradox is that when labor costs are forced upward, prices follow; when this process has proceeded to a certain point, buyer resistance develops and the reduced demand results in unemployment. Prices do not decline because the increased costs are rigid, particularly when there are automatic escalation provisions in labor contracts.

(*b*) The acceptance of a gradual inflationary trend as desirable or necessary would be disastrous. If such a development were generally expected, it would encourage speculative policies, as opposed to sound economic policies, throughout the economy.

12. The growth of private debt increases the vulnerability of the economy to recession and tends to prolong and deepen the periods of inventory readjustment which occur from time to time. An individual or corporation which is heavily indebted will be more likely to reduce expenditures and investment drastically at the first sign of downturn. Furthermore, they will be less able to increase expenditures at the most advantageous time, when such increase would help to brake the downturn and stimulate recovery.

13. This is a matter of judgment which it is impossible to deal with by a formula. In principle, it would seem that, if an orderly liquidation of inventories is taking place, special measures are not required. If, however, the necessary liquidation of inventories fails to proceed in an orderly way, it can best be assisted by a tax reduction. This should be designed to stimulate investment as well as consumption, and would be more rapid and more direct in its effect than increasing public expenditures.

14. The Federal deficit has been a factor, but in recent years it has not been a major factor, in contributing to inflation.

15. Yes, by steadily increasing efficiency and productivity. Under reasonably stable conditions, this will produce a large and steady volume of investment.

16. No. As indicated in 11 (*a*), escalation provisions tend to force a continuous rise of costs and prices.

17. The basic cause of the present recession is the progressive increase in costs, which has priced goods beyond the ability or willingness of the public to pay. What is necessary is to check the rise in costs and to pass along to the consumer in reduced prices, to the greatest extent practicable, the benefits of increasing efficiency and productivity.

In the short term, if inventory liquidation does not continue in an orderly manner, a tax reduction will probably be desirable.

Sincerely yours,

WILLIAM R. ODELL,
Vice President and Treasurer.

O

85th Congress 2d Session } COMMITTEE PRINT

INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES

COMMENTS OF OFFICIALS OF TRADE AND BUSINESS ASSOCIATIONS IN RESPONSE TO THE QUESTIONNAIRE

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE
EIGHTY-FIFTH CONGRESS
SECOND SESSION

CHAPTER 4

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CONTENTS

INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES

NATIONAL SMALL BUSINESS MEN'S ASSOCIATION,
Washington, D. C., April 25, 1958.

Senator HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: I enclose herewith 10 copies of our responses to your questions on the state of the economy enclosed with your letter of February 17, 1958.

As you know, the scope of these questions covers a tremendous area, and I do not know whether we have been able to make any noteworthy contribution. Nevertheless, we feel complimented that you have asked us to try, and we assure you of our heartiest cooperation and best wishes in your effort to maintain a sound economy.

Cordially yours,

HARRY E. BRINKMAN, *President.*

Enclosures.

REPLIES OF THE NATIONAL SMALL BUSINESS MEN'S ASSOCIATION TO QUESTIONS SUBMITTED BY SENATOR HARRY F. BYRD, CHAIRMAN OF THE SENATE COMMITTEE ON FINANCE

Question 1. Give a definition in your own words of deflation and inflation.

Deflation is ordinarily considered to be a sustained decline in the general price level. And inflation is ordinarily considered to be a sustained increase in the general price level. Price deflation and inflation are typically accompanied by monetary deflation and inflation. Monetary inflation is an increase in the money supply (cash and currency in circulation plus demand deposits times their velocities of turnover). Monetary deflation is a decrease in the money supply.

When the total money supply (including its velocity of turnover) changes disproportionately to changes in total physical output of goods and services, monetary inflation or deflation occurs with consequent changes in the purchasing power of the monetary unit.

Question 2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

Monetary inflation could have been avoided in the post World War II period if the money supply (including velocity) had expanded at the same rate as productivity. Here also, if monetary inflation had been controlled so would monetary deflation now be less likely to occur. Price inflation and deflation as they are related to monetary inflation and deflation would also be under better control.

For example, if taxes had been higher in the immediate post World War II period, or, if expenditures of the National Government had been controlled adequately, and the Federal Government had retired debt to reduce the money supply, both monetary and price inflation could have been checked and a sounder base for postwar growth developed.

Thus the current monetary laws are adequate if they are correctly administered so as to avoid severe inflation or deflation. To control inflation caused by excessive wage increases, it is necessary to equalize the bargaining power of employees to that of the employer; e. g., in the automotive industry there are four active producers which negotiate independently, but one monopoly supplier of labor, the CIO-UAW. If equalization of the economic power of the seller of labor with the buyer of labor occurred, there would be much less price inflation taking place and consequently less probabilty of price deflation.

One legislative change suggested then is the equalization of bargaining power between labor and the business unit. The strength of the typical labor bargaining unit is so much greater than the typical business bagaining unit that annual wage increases greater than annual productivity increases result, and these, by necessity, cause price increases. Small business firms are particularly at a disadvantage in dealing with the large labor monopolies. The small business firm typically sells its product in the competitive market whereas it purchases its labor from a power monopolist. The financial resources of small business are limited compared to those of the typical international union with which it negotiates. Bargaining in terms of financial strength is therefore completely out of balance.

Additional factors which militate toward an inflationary bias for the Nation and which are not within the control of the monetary system, are (1) a tax system which exerts pressure toward debt financing and against equity financing, (2) price support programs such as those in the agricultural and mining industries, (3) budgetary deficits of the National Government, and (4) credit programs of the National Government.

Question 3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942–57. (You may wish to divide the period into parts, 1942–50 prior to the accord, and 1951–57.)

The monetary control policies of the Federal Reserve System in the period 1942–50 were subservient to Treasury policies. The Treasury was concerned with selling Government bonds and maintaining bond prices; and, by continuing low interest charges to keep interest expense as low as possible, the Treasury forced its policies on the Federal Reserve to the detriment of the economic control of inflation.

In the period 1951–57 the Federal Reserve returned to its traditional pre-World War II role. Bond interest rates and prices were permitted to fluctuate to reflect the Board's interpretations of current and future business conditions.

The period 1942–47 was the period in which the traditional economic tools of the Federal Reserve should have been actively used to slow down the inflationary erosion in purchasing power of the monetary unit which was occurring. In that period consmer prices rose 51.8 percent.

The 1951-57 period appears to be a much more effective one in terms of controlling prices and maintaining the purchasing power of the monetary unit. In this period consumer prices increased 7.5 percent.

This appears to indicate that if the Federal Reserve Board of Governors has freedom to use it existing tools to regulate monetary and credit conditions the regulatory devices are adequate. It is realized, of course, that inflationary pressures were greater in the immediate post-World War II period than in the 1951-57 period.

Question 4. Beginning in August 1956 there was an increase in the Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar.

The factors which contributed most to the decline in the value of the dollar during this 1956-57 period were:

1. An appreciable increase in personal incomes, particularly labor incomes, which enabled consumers to increase their spending considerably, hence, there was a strong and rising demand for goods and services;
2. The increase in the rate of production of goods and services was so nominal as to be insignificant;
3. However, the disproportionate increase in labor incomes as compared to the norminal increase in productivity made for increased production costs and price increases;
4. Consumer purchases through increased credit buying added to the potency of demand for goods;
5. An appreciable increase in the velocity or turnover of money in circulation added somewhat to the money supply.

Question 5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

The management of the public debt involves, basically, the manner in which the Treasury decides to refund maturing issues such as bills, certificates, notes, or bonds—whether such refinancing will be short-term or long-term and whether it will be funded through the banks or nonbank investors.

Because the supply of funds available for investment in debt paper is limited, it behooves the Treasury to conduct its financing in a manner which will minimize competition with the private sector of the economy. Accordingly, it would seem desirable to finance a greater portion of the public debt by long-term rather than short-term maturities. This would help to reduce impact on the money market as well as to provide a sounder base for financing new short-term debt in an emergency.

Moreover, if the objective of the Treasury is to stretch out its existing debt and finance more of it through nonbank investors, then logically tax rates on individuals and corporations must be reduced. In fact, since World War II, bank financing of the public debt has been a primary cause of inflation. To avoid any greater use of the banks and to stimulate greater private nonbank investing and capacity, the tax burden must be kept to the minimum and the tax structure redevised to eliminate or to minimize its detrimental effects on incentive and risk taking.

Question 6. (*a*) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand, and employment.
3. Economic growth in production, demand, and employment.

(*b*) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

(*a*) In order of importance these three objectives should be rated (3), (2), and (1). Growth in production, demand, and employment have typified the growth of America with its rising level of living. The rapid increase in industrial production of the Soviet Union makes it even more imperative that sound long-term growth be continued in the United States.

Price stability for periods of time can be achieved with (3) or (2) by control of the money supply and by appropriate credit controls. The administration, the Congress, the Treasury, and the Federal Reserve Board of Governors could achieve price stability during (2) or (3) by working together with this goal in mind. However, although price stability as referred to here means general price stability of many individual prices of goods and services, it is not to be expected or desired necessarily, that minor fluctuations will not occur in response to individual consumer demands in the short run.

(*b*) The most important trends since World War II with respect to these three objectives appear to be relatively full employment up to the end of 1957; a monetary demand increased by liberal credit expansion and low interest rates on long-term funds, both of which overstimulated capital expansion primarily during the latter 2 or 3 years and particularly in 1957; a rising trend of monetary prices of commodities as a group. In the last few years, however, the general rise in commodity prices clouded the fact that the prices of farm products were declining.

The index of prices of all commodities remained remarkably stable in 1957 only dipping 1.5 percent while the index of farm-product prices declined over 3.5 percent. The apparent overall price stability also was misleading in terms of prices of such metals as lead and copper, both of which suffered severe declines.

Expansion of installment and consumer credit and private debt during 1955, 1956, 1957 occurred faster than population increases and growth in national income.

In addition, wages increased at a faster rate than industrial productivity and resulted in wage-push pressure on the general price level. Since agricultural workers, salaried workers, and many nonunion workers did not share proportionate wage increases, product price increases served to reduce sales volume. For example, automotive producers virtually were forced to grant substantial wage increases to employees. In turn, such increases were passed on to the consumer. The average consumer did not get the same increase as automotive workers and therefore credit expansion was used to make up the difference needed in purchasing power to buy the automobiles. However, when this credit was exhausted by auto buyers, it could not again be utilized without the passage of time. As a consequence, auto sales declined substantially.

The economic system is composed of many variables. Each can affect the price level, employment, and consumer demand. The logical economic policy, therefore, must be adapted to the existing circumstances. The goals of such policy should be relatively full employment combined with economic growth.

Question 7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

Comparison of official statistical data indicates that government spending, while influential at times on the level of economic activity, is by no means a primary force in economic prosperity or recession. For example, between 1953 and 1955, the gross national product increased by almost $29 billion whereas government spending decreased by $7 billion. There is little evidence to support the view held in some quarters that government spending has any substantial effect on the forces in the private sector on which real economic growth depends.

Government spending, whether at the national, State, or local level, must be financed through either taxation or debt. If it is financed through taxation, the assumption is that government can spend the money more efficiently and productively than the individual taxpayer—an assumption which has yet to be proven sound. If the spending is financed through debt by the National Government, the effect is almost certain to be inflationary with a subsequent further loss of purchasing power by all segments of our population.

Accordingly, the import of the question would seem to be whether government at the National, State, and local levels should increase its spending in an attempt, hopefully, to mitigate the current recession. If this is the intent of the question, then the answer must necessarily be in the negative. Alternatively, however, the enactment of legislation for reduction of income-tax rates over a period of future years would benefit all segments of our economy, both producers and consumers alike.

Question 8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

The present total burden of taxation at the National, State, and local levels is clearly too heavy. With over one-third of the national income channeled for the cost of Government, every effort possible should be made to reduce this percentage. Many economists and businessmen believe that total Government receipts—at all levels—should not exceed 25 percent of the national income, if economic growth within a free society is to be maximized.

Immediate steps should be taken by the Congress to establish a fiscal program which will:

1. Reduce tax rates on individual and corporate incomes appreciably over the next several years;
2. Develop a better balance in the tax system as between alternative types of taxation. For example, about 80 percent of net budget receipts of the National Government is from income taxation alone.

While numerous inadequacies could be cited regarding our present tax structure, particularly at the national level, the two suggestions noted above are singularly most important in terms of correction.

The rates of income taxation are a deterrent to economic growth and advancement because they reduce the incentives to produce, to save, and to invest; they cause a misutilization of time and resources of business; they foster taxpayer immorality.

Question 9. Will you distinguish between fiscal policy, embracing expenditures, taxes, and debt) and monetary and credit policy, and then relate them, one to the other. Please discuss these policies stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

Fiscal policy is public taxation policy and public expenditure policy as they relate to cyclical fluctuations and to employment and economic growth. If the Federal Government employs fiscal policy on a positive basis then taxation and public expenditure will be directed so as to reduce cyclical fluctuations and to stimulate employment and economic growth.

A positive monetary and credit policy is adjustment of the supply of money and credit (cash and currency in circulation plus demand deposits times their velocities of turnover) with a view to reducing cyclical fluctuations and to stimulate employment and economic growth.

The Federal monetary policy is administered by the Federal Reserve Board of Governors.

The fiscal policy is administered by the Congress, the Treasury, and the Bureau of the Budget.

The Federal Reserve in carrying out monetary policy can restrain inflation by raising the bank discount rate to member banks, raising stock market margin requirements, selling Treasury bonds in the open market, and increasing member bank reserve requirements.

In selling bonds the Treasury generally should lengthen bond maturities in prosperity and shorten them in recession. The antirecession and antiinflation policies of the Federal Reserve and of the Treasury must be coordinated in order for them to be effective. For example, the Treasury in selling a new money short-term bond issue in a recession would find extremely helpful a cut in bank reserve requirements by the Federal Reserve Board just prior to such sale. This would release funds for banks to purchase such an issue. In inflationary periods the Government should be balancing its budget as a minimum and preferably retiring already existing bond issues. If necessary, any sale of bonds in such periods should be to private investors, not banks. The Federal Reserve Board in such periods should keep member bank reserves tightened.

A sound fiscal policy should require adequate control over Government expenditures in order to avoid heavy taxation. The tax system should be so devised as to minimize its effect on incentive to produce, to save, and to invest. The inflationary effects of deficit financing can be avoided by keeping the budget within balance.

Question 10. (*a*) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank credits.) Also please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

(*b*) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

(*a*) The United States monetary system is basically sound and adequate.

(*b*) The fiscal system of the United States is inadequate for the following reasons:

1. There is no overall coordination within the Congress on budget, debt, and tax policies.
2. Within the Congress there is a complete absence of a set of goals or objectives which could be examined for future planning.
3. Specific objectives of fiscal policy in terms of evaluating expenditures with debt and tax reductions for a period of future years are nonexistent.
4. Income-tax rates are not conducive to economic growth.
5. The tax structure is too dependent on income taxation.

Question 11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

(*b*) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

(*a*) Inflation and unemployment do at times exist side by side. Wages in the period 1956–58 have advanced 4 percent even though unemployment has increased by 3.4 million. Raw material prices have increased 5 percent and consumer prices by 4 percent. The reasons are (1) continuation of wage increases in recession periods (some contracts made in 1956 and 1957 call for automatic increase in 1958); (2) wage rates are expanding faster than productivity rates as a result of the monopoly powers held by labor unions.

(*b*) Absolutely not. Fixed-income recipients such as retired people on pensions, and colleges and charitable institutions heavily dependent on fixed income securities, find the purchasing power of their income reduced; (2) Insurance beneficiaries find their dollar proceeds eroded; (3) Economic dislocations occur in imprudent business decisions; (4) The benefits of the inflationary policy go to monopolistic labor groups rather than to the consumer.

Question 12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy?

Between 1946 and 1956, total private debt increased from $171 billion to $456.5 billion. The latter figure is composed as follows (in billions):

Individual debt:	
Mortgage	$131.5
Consumer	41.9
Other	34.1
Total	207.5
Corporation debt	249.0
Total private debt	456.5

While it is true that total individual debt and corporation debt increased at a faster rate than national income, it does not follow necessarily that these debtors are incapable of carrying their obligations. Indeed, the preponderance of evidence is on the side of the American buyer in terms of paying his bills.

The rapid growth of corporation debt, on the other hand, is essentially the fault of the corporate income tax. This tax has a distinct bias in favor of debt financing over equity in that it allows interest as a deductible expense in determining net taxable income but prohibits a deduction for dividends. Moreover, if debt financing is encouraged through tax policy by penalizing business firms which would prefer to expand through equity capital, the economy is made increasingly vulnerable to a down-spiraling recession. Historical facts show clearly that no cumulative recession movement has ever developed because of a preponderance of equity capital over debt financing. Rather, only with debt financing can we associate the cumulative difficulties that the terms "insolvency" or "bankruptcy" bring to mind.

Accordingly, the income tax rates as a primary cause of debt do, indeed, become a threat to the stability and vitality of the American economy.

Question 13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy?

The question by implication presupposes that the "moves," or lack of necessary actions, which the Government has made, or not made, in former years has had a healthy effect on economic conditions, and that only if economic conditions were to worsen further would the Government take some direct action such as a tax cut or public works program.

Because unemployment has risen in recent months from a norm of 2.5 million to something over 5 million, pressures have mounted in several quarters, especially within Government itself, to focus primarily on the unemployment problem. From a political standpoint this is understandable, but in terms of economic consequences such ill-advised action is without logic and prudence.

Since the end of World War II, and particularly since the enactment of the Employment Act of 1946, virtually all segments of our society—business, labor, and Government—have discoursed at length on the need to do one thing—foster the economic growth of the Nation. Few people will quarrel with this objective. However, wide differences of opinion exist as to the actions needed to sustain economic growth.

One thing seems certain however. If the Nation's economy is to remain one based predominantly on competitive free enterprise, then the cardinal element of profit must be respected. No person or group of individuals will risk its savings to start a business enterprise or expand existing enterprise if they are not confident of realizing a profit.

If, then, we examine our economic environment in the light of this primary criterion, profit, we are faced with an almost certain conclusion—namely, that the economic policies of the National Government have not been conducive to a healthy business climate in terms of realizing profit. Whether by design or by blind allegiance to an unsound doctrine—progressive income taxation—the National Government has maintained policies which are in fact detrimental to consumers, labor, and business alike.

Moreover, the question suggests impliedly that a tax cut under current recessive conditions would counteract the downturn in economic activity by increasing the purchasing power of consumers and that, accordingly, increased consumer spending would result. This, presumably, would stimulate production and, accordingly, increase employment. Therefore, it is argued that the Nation's immediate economic problem is one of increasing employment per se, and that the heretofore sound objective of economic growth can be set aside. Such reasoning is, in effect, to "put the cart before the horse."

The Nation's primary economic problem today is the same one which has existed since the advent of progressive income taxation—namely, the all-important need to establish and maintain an economic climate which is conducive to growth and advancement. As day follows night, this, then, requires that income tax rates, both personal and corporate, need to be reduced over a period of several years—not for the purpose merely of stimulating consumer purchasing power per se, but rather for the purpose of providing incentives to save, invest, produce, as well as spend. No move by the Congress could be as singularly important in fostering a climate conducive to economic growth and employment as this one.

It is difficult to perceive any wisdom in increasing public work projects to counteract the current recession.

Question 14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

Since World War II, deficit spending by the National Government was as follows:

Fiscal years:	*In billions*
1949	$1.811
1950	3,122
1952	4,017
1953	9,449
1954	3,117
1955	4,180
Total	25,696

Accordingly, total deficit spending in the period (1947–57) amounted to nearly $26 billion. However, in the same period there were 5 years (1947, 1948, 1951, 1956, and 1957) when there were budget surpluses, which amounted, in toto, to $16 billion. Thus, on balance there was a net total deficit of $10 billion. While a net total deficit of this magnitude, over 11 years, by itself, would indeed be considered inflationary, because of the intervening budget surpluses the volatility of the deficits from the standpoint of inflation was reduced.

However, about 24 percent of the deficits occurring between 1949 and 1955 were financed through the banks. While this figure by itself may not seem too high, it is three percentage points higher than the amount of gross debt which the commercial banks held at the end of 1956—which was considered at that time to be unduly large—at which time, incidentally, national income was significantly higher than the average for the period (1949–55).

In summary then, it appears to be rather conclusive that deficit spending since World War II has been a factor in contributing to inflation by exerting pressure on a tight money supply, which was during a period of our economic history when consumers were competing for relatively scarce goods and services.

Question 15. Can full employment goals be attained while maintaining a dollar that has relative stable purchasing power?

Over certain periods relatively full employment has been attained while the purchasing power of the dollar remained relatively constant. An example is the period 1953 to 1955 when the purchasing power of the dollar (1947–49=100) averaged as follows:

1953	87.4
1954	87.1
1955	87.3

From 1952 to 1956, the purchasing power of the dollar declined 2 points from 88.1 to 86.1. During this same period, the Nation experienced relatively full employment although the recession of 1953–54 with unemployment of 3.2 million out of a total labor force of 68.9 million (including Armed Forces) did occur.

As previously indicated, overall price stability may camouflage selective economic dislocations such as in agricultural prices or in certain raw materials which reflect international supply-demand changes. But, if Government restrictions including oppressive tax rates placed on business firms are held to a minimum, it seems likely that under our economic system relatively full employment can be attained along with a relatively stable dollar, providing, of course, that wage increases do not outrun productivity gains.

Question 16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

Escalator provisions in wage or other contracts may be compatible with achieving economic price stability to the extent that they represent real productivity changes. However, if they are improperly determined, such provisions can actually feed inflation and help to foster instability in the economic structure. Certain groups of strongly unionized employees could obtain escalator provisions that would force price increases or prevent price reductions in the products of their industry. If other groups did not experience similar wage increases, the result could be exploitation of employees in other industries such as agriculture, retired people, white-collar workers, and business firms particularly small business.

Question 17. List and briefly discuss what you consider the causes of the present recession and what should be done to terminate it.

It is difficult to say the least, to pinpoint the specific factors which caused the current recession. The causes undoubtedly are numerous and varied. Indeed, it seems probable that virtually all forces operating in the economy contributed in one way or the other to the current downturn.

However, it seems clear that the drop in demand in the durable goods industries had a distinct effect on the investment plans of business firms, particularly in the second half of 1957, which has also carried over into 1958; also, the falling demand was influential in the decision to reduce inventories at a rather alarming annual rate of $6 billion. In fact, the book value of trade and manufacturers' inventories dropped more in the month of January of this year than in the entire fourth quarter of 1957—a drop which is the largest since the June–July drop during the recession of 1954.

If one attempts to examine the reasons for the decreasing demand in the durable goods industries, attention is focused on costs and prices. On the cost side, the primary element, labor, has been marketed at a rate faster than productivity. This has caused prices to increase at a time when constrainment was the guideline in monetary policy, which undoubtedly tended to reduce the availability of credit and increase its cost.

However, few people are prepared to say that the Federal Reserve Board's restraining monetary policy throughout most of 1957 was a primary cause of the current downturn, although, with the advantage of hindsight, an easing of credit in the summer of last year in all probability would have lessened the rate of inventory liquidation. To this extent, a more perfected statistical intelligence system would have enabled the Reserve Board to have acted with greater assurance and, hence, greater effectiveness. On the other hand, had the Federal Reserve Board not kept the check-rains on credit as long as it did, inflation would have been even more volatile; this would have cost the Nation in purchasing power probably many more times than the cost of the current decline. Moreover, it would undoubtedly have accentuated the ensuing economic dip even further.

Probably the most important factor toward sustaining economic growth and, accordingly, maximizing employment, is the necessity to reduce tax rates on individual and corporate incomes. The National Government's tax system is unquestionably a deterrent to the formation of capital, without which the economy cannot grow. If the population of the Nation's business entities, including individual investors, is dissuaded from producing, and saving for the purpose of investing in equities, it will be only a matter of time before even more serious economic dislocations occur.

Accordingly, the following suggestions are made in the interest of stimulating economic growth including the stimulation of its inherent component, employment:

1. Enact legislation which will reduce over the next several years, tax rates on individual and corporate incomes. This will stimulate the formation of capital, production, employment, consumption and, not the least of which will be the beginning of a rebirth of confidence and business initiative, the beneficial results of which are incalculable.

2. Enact legislation which will mitigate the monopoly powers of labor unions including their powers to increase costs.

3. Enact legislation which will provide for coordination, forward scheduling and planning of budget expenditures, receipts, and debt management. The establishment of such specific goals and objectives of fiscal policy would enable congressional committees and executive branch to evaluate current programs and operations in the light of these anticipated fiscal targets. This would provide guidance of a sort which is now virtually nonexistent.

ASSOCIATION OF AMERICAN RAILROADS,
Washington, D. C., March 10, 1958.

Hon. HARRY FLOOD BYRD,
Chairman, Senate Committee on Finance,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: As requested in your letter of February 17, which I acknowledged on February 18, I enclose my views on each of the 17 questions you have asked in connection with your inquiry entitled "Investigation of the Financial Condition of the United States."

Although the responsibility for these answers is my own, I have had a good deal of assistance from three members of our staff that I regard as outstanding in their field. They are Mr. J. Elmer Monroe, vice president and director of the bureau of railway economics; Mr. A. R. Seder, vice president, finance, accounting, taxation, and valuation department; and Dr. Burton N. Behling, economist, bureau of railway economics.

With kindest regards,

Sincerely,

WILLIAM T. FARICY.

1. Give a definition in your own words of "deflation" and "inflation."

To the layman, inflation and deflation are manifested, respectively, by upward and downward movements in the general level of prices and the cost of living. Especially if they are persistent over a considerable period of time, such movements of prices and costs bring about serious dislocations and imbalances in the economy because the price and cost changes do not occur evenly throughout the economy.

2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

Historically, the evidence is strong that inflationary factors and consequent maladjustments in the economy have within themselves the seeds of subsequent deflation. Inflation occurs when there is a disproportionate increase in the quantity of money and credit in relation to the goods and services available in exchange, and this excess exerts an upward pressure on prices and costs. Deflation is a corrective adjustment, to obviate which we must first prevent inflation. In recent years the emphasis in policy has been placed unduly upon full employment and economic growth, to the exclusion of due consideration for the importance of price stability. This makes for a bias toward inflation. The Employment Act of 1946 should be modified so as to recognize price stability along with full employment and economic growth as an important objective of national policy.

3. Comment generally on the monetary-control policies of the Federal Reserve System as exercised within the following years: 1942–

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57. (You may wish to divide the period into two parts, 1942–50 prior to the accord, and 1951–57.)

In the first part of this period (1942–50) too much attention was given in monetary-control policies to the pegging of Government bond prices and interest rates. Also, the costs of World War II were financed too much by borrowing, too little by taxation. These policies continued after the war and contributed substantially to the inflation which occurred in the immediate postwar period. The Treasury-Federal Reserve accord was an important corrective step in the direction of a more realistic Government fiscal policy, but it was too long deferred. Inflationary factors involving monetary policy in the more recent period are commented upon under subsequent headings in this statement.

4. Beginning in August 1956 there was an increase in the Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

Continuing inflationary pressures were working their way progressively through the economy, spearheaded by wage increases in key industries in excess of productivity increases. Pressures to transmit such patterns to other segments of the economy, including the service occupations, increased and exerted widespread upward pressures on prices. At the same time, business capital expenditures aimed at eventual cost reductions and efficiencies also were increasing, exerting further immediate pressures on available economic resources. Under these conditions, resistance in the prosperous pattern industries to demands for increased wages and fringe benefits were not as strong as they should have been, as the prevailing view seemed to be that cost increases could be passed along in prices.

5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

Deficit financing by the Government, particularly when it involves "monetization" of the debt through the money and credit supply of the banking system, is basically inflationary. If this occurs at a time when other inflationary forces are active, the spiral process is accelerated. Essentially, money and credit supply should be the servant of the productive economy, responsive to its needs but not its attempted master.

6. (*a*) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand and employment.
3. Economic growth in production, demand, and employment.

(*b*) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

As previously stated under item (2) above, there has been too little emphasis in recent years on the basic desirability of price stability, which has been slighted in favor of the other factors of stability mentioned. Apparent economic gains which merely reflect price (and cost) inflation are illusory and lead to maladjustments of the kind that have become so apparent in recent months. Shot-in-the-arm inflationary expedients can provide temporary stimulants but they are not themselves indicators of economic health. If we can maintain reasonably stable economic relationships, including price and cost relationships, economic growth will probably take care of itself through advancing technology and competitive enterprise.

7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

Currently, high levels of Government spending are helping somewhat to bolster a sagging economy. This should not be taken to mean, however, that Government spending in such circumstances is desirable for its own sake. One way or another the costs must be paid for and wasteful Government expenditures are no more to be desired in slack times than at any other. This word of caution seems particularly necessary now because of a rather general tendency to scrutinize less carefully than, say, a year ago proposed expenditures for Government undertakings in the civilian economy. Standards of sound economy in public works, for example, do not change with every shift in the economic breeze.

8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

Especially over the past 20 years it is well known that taxes have increased to ever higher levels, owing to war and defense costs, many extensions of Government functions, and inflated price levels. It is at least doubtful whether the health and vigor of our private economy, and its growth, can be maintained permanently under such heavy tax burdens as now exist. We may well be very skeptical, therefore, regarding assurances sometimes expressed that the Nation's productive economy will in time "grow up" to present or even higher levels of taxation.

Current high rates of corporate and personal income taxes, especially, are exerting a drag on business investment, venture capital and, hence, on economic growth. We can never afford to overlook the basic fact that profits and savings are vitally necessary to technological progress and growth in an enterprise economy. A corporate income-tax rate of 52 percent and individual income-tax rates reaching up to 91 percent cannot help but dry up private capital formation, dampen incentive and diminish economic efficiency.

Another consideration always to be kept in view is that in the final analysis taxation can never be judged apart from the Government expenditures for which the taxes are collected. Any tax, of whatever kind and at any level, is too high to the extent that its proceeds are used to pay for wasteful or unnecessary expenditures. In such circumstances, the taxpayers would make greater contributions to a sound economy if permitted to make their own expenditure decisions.

9. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy, and then relate them, one to the other. Please discuss these policies stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

To help restrain an inflationary situation the essential requisites of fiscal and monetary policy are, in general terms, rather clearly indicated. An inflationary period would be a time for reasonable credit restraint and for debt reduction by maintaining existing tax levels while holding back postponable expenditures. In slack times, of course, reverse policies may be indicated for maintaining a stable economy. But while these general criteria of fiscal and monetary policy are clear, their application presents exceedingly delicate problems of timing and degree. One of the greatest dangers is that pressures will rather continuously be exerted in an upward or inflationary direction, responsive to apprehensions that unless such policies are pursued conditions for sustained, or even accelerated, economic growth might be insufficiently nourished. Such views seem to have been largely responsible for inflationary predilections in recent years, this being associated also, with the widespread attitude that the Federal Government must in some way underwrite or guarantee uninterrupted economic growth and prosperity. In this connection, we need to be aware of two considerations: (1) As a practical matter, it is not easy to invoke the disciplines necessary to check inflationary tendencies and allures; and (2) the influence of governmental actions designed to promote economic growth and stability is, at most, rather limited.

10. (*a*) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank credits.) Also please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

(*b*) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

With respect to (*b*) it may be pointed out again that the Federal tax system is too heavily weighted in the direction of high rates of income taxation. With respect to the expenditure side of fiscal matters, there is great need to impose fully compensatory user charges to recover the costs of facilities such as waterways. highways, airways, and airports from those who gain special advantages from their use. There is no equity in imposing such burdens upon general taxpayers and, moreover. this method of financing only encourages those seeking special advantages for themselves to press for uneconomic spending of funds taken from general taxpayers. The selection of economically sound public projects would be made much more certain if those seeking expenditures on their behalf knew they would have to pay the costs.

11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

(*b*) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

With respect to the first question, the concurrence of inflation and considerable unemployment is both unusual and disturbing. The condition has developed from repeated increases of wage costs in excess of increased productivity, with the result that prices have been pushed upward where possible to meet the advancing costs and, where this has not been possible, measures have necessarily been taken to economize on the use of manpower. This represents an unhealthy situation from the standpoint of workers, of employers, and of the economy generally.

As to the second question, acceptance of a gradual inflationary trend as either desirable or inevitable is a dangerous escape from realities. While some elements of the economy may gain special advantage for themselves under such conditions, temporarily or even for considerable periods, many others are the unfortunate victims and especially those least able to protect themselves from the inflationary onslaughts. At bottom, persistent inflation is an insidious way of redistributing shares in the national income. Even an apparently modest inflationary push of 2 or 3 percent a year would amount to a very serious cumulative depreciation in the value of money over a period of 10 or 20 years.

12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy.

Our economic system has become progressively more reliant upon credit with respect to both production and consumption. To a very substantial extent the resulting debt structure reflects the creation of bank credit money rather than the accumulation of actual savings borrowed from others by the debtors. While debt formed through the bank credit process is a powerful expansionist factor in a growing economy, and hence contributes to its vitality in this respect, there also are very real dangers of excessive debt built up in this way. A threat to economic stability arises in that the accumulation of debt through the bank credit process may be too great during expansion or boom periods when optimism is high.

This appears to have been the case in recent years, for example, with respect to the rapid growth of consumer debt that has occurred. This process of financing growth through debt cannot go on without limit and the debt burden may become serious during an economic downturn such we are now experiencing.

It would be better for the economy, since excesses and inflationary tendencies would be less likely to occur, if debts were supported to a greater extent by actual savings rather than the creation of credit money through the banking system. There may also be a significant connection between our increasing reliance upon bank credit money and existing heavy burdens of income taxation which inhibit savings as the basic source of sound credit.

13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy.

This is a difficult question to answer in terms of "what point" because there are so many conditions that enter into a comprehensive judgment. Considering the unfavorable budget outlook and the large existing debt of the Federal Government, hasty measures for large tax cuts or enlarged expenditures for public works should be avoided, while watching over the next several months to see whether the economy gathers strength or grows weaker.

If the time does come when major counteracting or restorative measures by the Government seem clearly indicated, preference should be given to tax cuts rather than major increases in public works. The stimulative effects of tax cuts are likely to be more immediate, whereas public works programs are slow moving. Morover, emergency public works measures encourage waste and inefficiency in the selection of projects of dubious economic merit.

Meanwhile, since the revenue losses to the Treasury would be moderate and because their particular levies are a drag on the whole economy, immediate consideration should be given to repeal of the existing transportation excise taxes on freight and personal travel.

14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

Without attempting to state the matter in quantitative terms, which in any event would be impossible to do precisely, deficit spending by the Federal Government has been a significant, though not the only, factor contributing to inflation since the end of World War II. Lax fiscal policies, tied in with loose monetary and credit policies, were especially conducive to inflation in the immediate postwar years. Budget surpluses, reduction of the Government debt, and credit restraints were not sufficiently pursued. As previously noted, widespread and repeated rounds of wage increases in excess of growth in productivity, followed by price increases, have added to the inflationary spirals, with only occasional interruptions since World War II. In all of this there has been the persistent illusion that prosperity is measured by rising money wages and money incomes, whereas, basically, economic well-being depends upon what is created and produced in capital and consumption goods and services. In brief, as a Nation, even as we have talked about the evils and consequences of inflation, we have continued to indulge rather freely in it.

15. Can full employment goals be attained while maintaining a dollar that has relative stable purchasing power?

Yes, we can have full employment while maintaining a dollar that has relatively stable purchasing, although it must be recognized that some fluctuations will occur in both in a complex and dynamic economy. In the past there have been long periods of economic growth, prosperity, and reasonably full employment while the dollar has remained stable or when general price levels have even trended slightly downward.

Instability in the purchasing power of the dollar introduces an undesirable speculative element into all forward planning by business and industry, especially with respect to capital investments and their financing. Problems of individual and family finance also are subjected to the same uncertainties. Money then fails in one of its most basic functions—that of providing a standard of value over a period of time.

Rather than assuring continued economic growth and employment, persistent inflation inevitably generates dislocations in the economy that eventually lead to unemployment and associated economic distress. The notion that creeping inflation is a desirable stimulus to the economy is a devious way by which some obtain a greater share of total national income, at the expense of other segments and groups in the economy less fortunately situated. Eventually, when distortions and dislocations have become sufficiently aggravated, corrective forces set in which entail economic loss to the whole economy, and real suffering to many.

16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

Escalator provisions in wage or other contracts are not compatible with achieving economic stability. They are built-in factors which tend to sustain inflationary price movements, regardless of productivity. If we imagine conditions where all prices and costs contained automatic escalator provisions, the stage would be set for permanent and progressive inflation, with all such provisions chasing each other upward in an endless cycle of actions and reactions. Even when contractual escalator provisions exist in only certain sectors of the economy, as in the case of wage rates in certain major industries, they exert upward pressures on other prices and costs far beyond their immediate impact.

17. List and briefly discuss what you consider the causes of the present recession, and what should be done to terminate it.

The present recession is a culmination of certain excesses of an inflationary character in the postwar period for which the Government, organized labor and business interests are all in part responsible. There have been preachments against inflation while at the same time policies were pursued that were inflationary. The result has been a persistent though uneven uptrend of costs and prices, fed by liberal credit policies intended to foster continuous and accelerated economic growth by providing increased money incomes.

Now this bootstrap operation has faltered and we are passing through a period of corrective adjustments. There are not yet, at least, indications that we have entered into a cumulative series of declines and, therefore, precipitous actions by the Government of a counteracting nature would not seem to be called for. In most respects, the economy is still operating at high levels as compared with most periods in the recent past. Alarmist appeals for a resumption of inflationary tactics should be resisted, for in basic terms of resources and technology our economy remains strong and is not crumbling. Increased wages, costs and prices in the midst of declining economic activity certainly cannot be regarded as constructive or remedial. There is reason to believe that the regenerative powers of our economy will soon arrest the present declining phase if these constructive forces have reasonable opportunity to be asserted.

WILLIAM T. FARICY,
Chairman of the Board and Chief Executive Officer, Association of American Railroads, 915 Transportation Building, Washington, D.C.

MARCH 10, 1958.

New York Stock Exchange,
New York, N. Y., April 1, 1958.

Hon. Harry F. Byrd,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

Dear Senator Byrd: In supplementing my letter of February 24 in connection with the Finance Committee's inquiry entitled "Investigation of the Financial Condition of the United States," I have used, as you suggested, the list of questions submitted with your letter of February 17 merely as a guide. My remarks pertain particularly to questions 2, 6, 8, 9, 12, 13 and 15, and as they relate specifically to the investment process in which we have perhaps some special knowledge.

Events since the end of World War II have shown the crucial importance of capital investment to economic stability and growth. Business outlays for plant and equipment have been at record levels since 1946. Employment in the same period has been extremely high and has shown remarkable stability. This relationship is not accidental. Over this period, investment expenditures have not only meant the employment of labor to make capital goods, but have also generated higher incomes, which expanded demand and jobs in consumer goods industries. At the present time, the result of a sharp decline in capital spending is evident in the current recession.

Despite the fact that the large volume of investment since World War II boosted industrial capacity, it has not been sufficient to modernize and improve the efficiency of much of our industrial facilities. Because we have actually fallen short of our investment needs in the postwar period, inflation has dominated the economic scene. Wage increases have exceeded rises in productivity. Our fixed income population—the teachers, pensioners, Government workers—have suffered evaporation of their purchasing power.

Our competitive position in world markets has weakened, while other nations have pointed the way to wise economic progress. West Germany, for example, has adopted fiscal policies to stimulate investment—and has led the free world in its rate of economic growth—without inflation.

Thus if we are to grow soundly, the future calls for greater plant and equipment expenditures to dampen latent inflationary pressures with an increase in the flow of goods, manufactured at lower cost under conditions of rising productivity. Greater business investment in capital goods is the key to achieving what should be the prime economic objectives of our time: steady, continuous growth in production, demand, and employment—with price stability.

As President Eisenhower has pointed out, "* * * investment outlays contain the promise of greater national output and better living in the years ahead." Merely to continue our past rate of growth will require vast capital outlays. A growing population calls for an ever larger flow of capital goods just to maintain our present standard of living.

To satisfy the future demand of the American people for a constantly increasing supply and variety of consumer goods will require an enormously stepped-up rate of investment. An increased stock of productive capital goods, at the same time, will provide jobs for our expanding labor force—and at higher wages. Besides making maximum employment possibly, highly productive capital equipment, by increasing output per man-hour, will limit the recent tendency of wages to outstrip labor productivity.

It is my firm conviction that we have fallen short of our investment needs and, consequently, our economic objectives because we have penalized savings—the source of investment funds. We have reduced too much the incentive to invest. High personal income taxes, double taxation of dividends, and capital gains taxation have discouraged thrift and reduced the flow of savings available for business investment.

Tax discrimination against equity investment has caused business to rely heavily on debt financing—a situation of increasing concern. Corporate debt since the end of World War II has accounted for about 80 percent of external financing. An important reason for this emphasis on debt is favored tax treatment of interest charges, compared with dividend payments. As a result, corporate debt has more than doubled—up to $130 billion—since the end of 1945. If postwar financing trends continue, corporate debt will probably rise another 50 percent by 1965. In this respect, governmental policies should provide more incentive for common stock financing.

Although the buildup of debt may not yet have become excessive or dangerous, the heavy weight of corporate obligations has reduced business flexibility in periods of economic decline. Many small firms have jeopardized their future by heavy reliance on debt financing. The absence of an adequate equity base has hampered the expansion of many firms, particularly the smaller companies.

Encouraging business to expand investment—via a healthy financial structure—and providing individuals with incentives to save and invest will, I believe, eliminate a principal cause of irregularities in the business cycle.

The New York Stock Exchange has estimated that corporations alone will need $350 billion for new plant and equipment between now and the end of 1965. In my opinion, adoption of the following tax program would energize the flow of venture capital and move us toward the goal of meeting these capital needs:

(*a*) A substantial reduction in the high progressive rates of personal income tax.

(*b*) Further reduction of the unfair burden of double taxation of dividends.

(*c*) Cutting the capital gains tax in half by requiring only 25 percent of any long-term gain on a capital asset to be included as income.

(*d*) Reducing the capital gains holding period from 6 months to 3 months.

(*e*) Increasing the present maximum capital loss offset from $1,000 to $5,000.

(*f*) Allowing the individual taxpayer—at his option—to sell stock on which he has a long-term capital gain, without incurring an immediate tax if he fully reinvests the proceeds in a single stock investment within 30 days.

Although he is the one who ventures his funds in the first place, the risk taker—the investor—often has been forgotten. For example, in 1957, while labor income was 65 percent higher than in 1950, corporate profits were 7 percent lower. Individuals must have greater incentives to save. Increase the potential rewards of those risking equity funds and venture money in adequate volume will be forthcoming to finance business expansion.

In addition to this tax program, business must be permitted to earn enough, after taxes, to pay the investor a fair return on his money. Regulatory agencies must give a higher priority in their thinking to this need. Depreciation charges allowable for tax deduction should be increased and the corporate rate cut.

The adoption of a sound tax policy designed to encourage equity investment would, in my opinion, do much to smooth out the future pattern of economic growth. I believe a joint congressional-citizens committee, along the lines of the Hoover committee, should be appointed to review our entire Federal tax structure.

Speaking more generally, I believe that the Full Employment Act of 1946 should be amended to include stable prices as a goal. We should not accept a gradually inflationary trend as desirable or necessary to achieve and maintain full employment.

Certainly governmental deficits have contributed greatly to inflation. The Congress, therefore, should make greater effort to cut nonmilitary expenses—the Hoover Commission report makes many valuable suggestions in that connection.

I believe that in the period 1951–57 the Federal Reserve Board has acted with courage and foresight in their exercise of general credit controls. We have seen that the Board can—by applying general credit controls—effectively regulate the overall flow of credit or money in the economy, thus limiting inflationary pressures.

The Board also exercises selective control, taking the form of initial margin requirements to prevent "the excessive use of credit for the purchase or carrying of securities." In April 1955, these margin requirements were set at 70 percent and remained at that level until January 1958, when they were reduced to 50 percent. During this period, the exchange community believed that it was the Federal Reserve's general credit control policy and not the selective credit control of margins that restrained stock market credit so effectively. General credit controls acted as an effective brake on credit flowing into the stock market and tended to make high margins largely superfluous as a credit weapon. With margin requirements now at a more normal 50 percent, it is hoped that the Board will rely on general controls to restrict stock market credit in the future.

I have not discussed possible causes and cures of the present recession because that is a big subject by itself. Suffice it to say that we should not take hasty, ill-considered short-term steps which would weaken the Nation's bright future prospects.

Sincerely yours,

G. KEITH FUNSTON.

NATIONAL EDUCATION ASSOCIATION,
Washington, D. C., April 14, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: I am grateful for the opportunity to contribute to your inquiry entitled "Investigation of the Financial Condition of the United States." All too frequently otherwise sound investigations and treatises on the Nation's economy fail to account for the role that an educated people play as consumers, managers, skilled workers, and investors. Hence, I would prefer to address my remarks to a more limited phase of the inquiry; i. e., the financial condition of the United States as it is affected by and as it affects public education.

PUBLIC EDUCATION AND ITS CONTRIBUTION TO ECONOMIC GROWTH

The long-term economic growth of our Nation depends largely upon increasing the effective combination of labor, management, and wealth. Further gains in real national output as distinguished from inflationary increases will come from these three factors: (*a*) increasing the skill and educational level of workers; (*b*) improving productive plants and machinery; and (*c*) improving business organization, management, and labor relations. The quantity and quality of education available to pupils in the public schools is basic to the upgrading of all three factors.

There is considerable evidence that the educated person is better equipped to contribute to the Nation's economic and social growth. Recent studies have shown that the number of jobs available for unskilled workers is decreasing with the increasing technological development of the economy. A recent Bureau of the Census study entitled "Educational Attainment of Workers; March 1957" found that unemployment was more prevalent among workers with little education than among workers with high school and college educations. The unemployed had completed a median of 9½ years of schooling, while the employed in the labor force had completed a median of 11½ years.

Our plans for economic and technological growth are necessarily and inevitably tied in with—implemented or delineated by—the level of education and skills of the consumer-producer citizen. The pace at which the level of education attainment of workers is raised should be geared to much of our economic planning.

It is unwise long-range economic policy for the Nation as a whole or for the individual States not to invest adequate amounts in the public educational program—in adequate classroom facilities and in teachers' salaries which are high enough to compete with the salaries of college graduates in other fields.

We are currently suffering from complacency with our fine American system of education. Recent spectacular advances in education in other parts of the world have dramatically revealed two things: (*a*) the deficiency of our economic investment in education; and (*b*) how an adequate investment can over a period of years reduce an educational deficiency in the labor force. Unfortunately, economic gains from the money invested in the education of first-grade pupils will not be realized until they enter the labor force some 12 to 20 years hence. But losses because of failure to invest now are not recoverable.

COSTS AND SUPPORT OF PUBLIC EDUCATION

Progress toward a strong and sound economy to undergird our continued progress as a free nation is inevitably tied to the support of an adequate educational system. Our financial investment in education is a key to economic growth. The determination of the program and the level of support have been left largely to State and local governments. This is in spite of the fact that our States' educational resources are pooled into national efforts both in time of peace and in time of war.

The total cost of public and private education for kindergarten through higher education is estimated at $19,763 million for the school year ending 1958. Educational expenditures for current expense, interest, and capital outlay have increased largely through State and local efforts. The increase for public elementary and secondary schools has been from $2,870 million in 1946 to an estimated $12,884 million for 1958. Part of this increase is inflationary. School bond rates have increased approximately 120 percent since 1946. Building costs are up 79 percent since 1946. The calendar year average salary of the instructional staff member has increased from $2,080 in 1946 to $4,450 for 1957. By contrast, two-thirds of the men in the labor force who were college graduates had an income of $6,000 or more in 1956. Part of the increase in costs is not inflationary. From April 1940 to March 1957, 2½ years have been added to the median educational attainment of the labor force, 1.2 years since 1948. Since 1946 there are 10,209,000 more pupils in public schools and 462,303 more teachers.

For the Nation as a whole the responsibility for public elementary and secondary schools, however, is shared by the three levels of government with 55.8 percent of current revenues from local sources, primarily the property tax; 40.6 percent from State sources, primarily sales and income taxes; and 3.6 percent from Federal sources. Since education undergirds our real economic advancement, the losses because of failure to finance adequate public schools are shared by the Nation as a whole.

All public-school expenditures are ultimately paid from tax revenues, largely those of States and local governments. Annual current expenditures are met by current tax revenues of school districts or by appropriations from the State and (to a small extent) from the Federal Government. The payment of capital expenditures from tax revenues is largely deferred by school districts, by the issuance of bonds which are a first obligation on the local tax revenues. These bonds are then retired over a period of years from local tax revenues.

The workability of this system of capital financing is currently threatened by high interest rates and congestion in the tax-exempt bond market. This comes after a decade of increased construction and borrowing activity with no period of diminishing activity in sight.

School-bond yields, even with the attractive tax-exempt interest feature, have been forced to move closer to the yields of non-tax-exempt securities to attract investors. In 1946, high-grade tax-exempt bonds, including school-district bonds, were 0.89 percentage points below corporate bonds of the highest grade. By 1957 these tax-exempt yields were only 0.29 percentage points below the corporate bonds.

It is hoped that your committee will give attention to the precarious state of capital financing of public-school plants. Questions are raised here of how public education can compete in the money market with private borrowers in times when, partly by Government action, the supply of money is limited. Educational needs frequently cannot be deferred until the school districts can afford to borrow. Hence, many school districts borrow at high rates—the payment of the principal and interest of which may jeopardize the future of the educational program should economic conditions reverse.

IMPLICATIONS OF A RECESSION OF THE PUBLIC SCHOOLS

Public education approaches the current recession with a backlog of needed construction of approximately 142,300 classrooms in the fall of 1957, and an estimated need for 132,800 by the fall of 1958. Even in prosperous times, we have failed to achieve an adequate supply of classrooms and a balanced supply of trained teachers. The situation is further complicated because of the following factors: (*a*) The high percent of fixed expenditures for debt service; (*b*) the increased legal obligations of school districts for salaries, attendance, and school programs; and (*c*) enrollment increases extending as far in the future as the forecasters have ventured.

On the local level the property tax is relatively stable, slow to increase in times of economic prosperity and slow to decrease in recessions or depressions. The property tax is levied on the assessed valuation of real and personal property, but the bulk of the tax falls on real estate. We have yet to test the stability of the property tax in a recession with the present situation in home financing—many postwar communities are composed of heavily mortgaged homes.

We cannot assume that the property tax will be as stable in future recessions as it has been during past recessions. Should real-estate values fall during the recession, a decrease in assessed value of real estate at this time would put many school districts over both debt and tax limits and leave a large share of the decreased revenue committed to the payment of existing bonded debt.

Capital outlay and interest in 1957–58 were estimated at approximately 25.9 percent of current school revenues as compared with 6.5 percent in 1946. A decrease in revenues at this time would necessarily result in curtailing the educational program of some schools in order to meet fixed obligations for the payment of principal and interest on debt unless help will be forthcoming from other sources. The school debt outstanding at the end of the school year 1946 was 66 percent of annual current school district revenue as compared with 93 percent in 1956.

Sources of State school funds are largely sales and gross receipts taxes and corporate and personal income taxes. Sales-tax receipts immediately reflect increases or decreases in the volume of purchases.

In 1956, according to the Tax Foundation, general and selected sales and gross receipts taxes contributed over 70 percent of the total tax collections in 16 States and over 50 percent in 36 States. In 1957 the sales and gross receipts taxes contributed 57.8 percent of total State tax collections. The current recession has already resulted in decreased income- and sales-tax collections, notably in Michigan, Delaware, and the District of Columbia. According to Business Week of February 15, 1958, Delaware is having to resort to short-term borrowing, and Michigan has been forced to hold up payments to school districts. According to a report in the Washington Post and Times Herald of Thursday, April 10, 1958, the District of Columbia finance officer reported that the sales-tax collections for 1957 were off about 8 percent.

The resources of school districts, even with State funds, have been under strain for the past decade to meet costs of increased enrollments; to keep up with an adequate supply of teachers and classrooms; and to expand the program to meet the advanced educational needs of the economy. For continued economic growth we must increase our public educational effort. With the existing system of public-school finance, it will be impossible for us to maintain our present educational standards (let alone improve them), should the recession move deeply into our economy.

Cordially yours,

SAM M. LAMBERT,
Director, Research Division.

NATIONAL ASSOCIATION OF MANUFACTURERS,
New York, N. Y., April 17, 1958.

Hon. HARRY F. BYRD,
Senate Office Building,
Washington, D. C.

DEAR SENATOR BYRD: We appreciated the opportunity to give our answers to the questions you raised in connection with the investigation of the financial condition of the United States. I understand copies of our answers have been filed with your committee. I hope they will prove of assistance to you and to the members of your committee.

We have been greatly interested in the progress of your study. Once again you have provided constructive leadership, as you have done on so many previous occasions to the benefit of all of us. I can assure you that your efforts and activities are greatly appreciated and recognized as being in the public interest.

Sincerely yours,

MILTON C. LIGHTNER.

REPLIES OF THE NATIONAL ASSOCIATION OF MANUFACTURERS TO QUESTIONS SUBMITTED BY SENATOR HARRY F. BYRD, ON BEHALF OF THE SENATE COMMITTEE ON FINANCE

Question 1. Give a definition in your own words of inflation and deflation.

Answer. Inflation is an upward movement, which may be sudden or gradual, of the general price level, separate from the advance of individual prices produced by specific conditions of demand and supply. Basically, the cause is an increase of the money supply (times turnover) disproportionate to the volume of available goods and services. This increase of the money supply may occur before the price rise—as in the case of deficit financing; or it may occur after the rise and with a view to validating it—as in the case of wage and cost increases at rates faster than the growth of national productivity.

Deflation is a downward movement, which may be abrupt or gradual, of the general price level, separate from the decline of individual prices produced by specific conditions of demand and supply. Basically, the cause is a relative deficiency of money supply. This deficiency may result from a loss of money supply—as in the bank failures of 1930–33; or from a failure to keep the money supply increasing in step with the expanding output of goods and services.

As used here, the term "money supply" includes currency outside banks, and demand deposits of business and individuals. The total leverage of money on prices involves also the velocity of circulation of demand bank deposits.

Question 2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

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Answer. In the light of the definitions and explanations given as the answer to question 1, it would be self-evident that inflation and deflation could best be avoided by maintaining general price level stability. This involves regulation of the money supply so as to finance the transactions of the people and the Government as the economy grows, without letting the total money supply increase or decrease enough to cause either inflation or deflation, respectively, as indicated by general prices.

The authority to control the supply of money and credit is now exercised by the Federal Reserve System, which was established in 1913. The System's control is not applied directly to the money supply as such, but indirectly through its control over the capacity of the member banks to create deposit credits by making loans and investments. The key point of this control is the legal reserve which member banks are required to hold against their demand deposit liabilities. When an inflationary trend is evident, the Federal Reserve Board can restrain credit expansion by putting pressure on bank reserves, and when a deflationary trend is evident, credit expansion can be encouraged by easing off on the reserve restrictions. Federal Reserve policies of credit restraint are more likely to be effective in curbing inflation than those of credit ease in resisting deflation. The reason is that the demand for credit continues during an inflationary trend despite the restraint, but, if a deflationary trend prevails, the slackening demand for credit may not be effectively revived at once by easier credit terms. The shift from restraint to ease requires more sensitive perception and greater accuracy of timing than the shift from ease to restraint.

If there were complete flexibility within the economy, the monetary and credit control vested in the Federal Reserve System would be reasonably effective in resisting inflation. But strongly inflationary conditions have been allowed to develop which are beyond control through monetary measures. These conditions are built-in commitments to inflation in fields other than that of money and credit. Examples are: Policies and practices of labor unions which enable them to obtain wage increases at a rate faster than the growth of national productivity, farm and mining price supports, Federal credit programs, large Federal budgets with their risk of inflationary deficits, a tax system which gives the advantage to borrowing (as against equity financing) for meeting the financial needs of business, and so on.

The Federal Reserve Board is powerless to deal with these situations. Price rises brought about by these commitments to inflation cannot be reversed by any application of money or credit policy. If the Board were to attempt to restrain the upward push on prices resulting from these causes by reducing the money supply and restricting the availability of credit, the eventual result would be a decline in business volume and a reduction in employment.

This is precisely what happened last autumn. The Board shifted from credit restraint to ease in the fourth quarter of 1957, not because the danger of inflation was past (prices are still going up), but because the policy of restraint was operating to curtail activity rather than to lower prices.

With respect to legislation, the emphasis should be against any laws or amendments that would impair the Federal Reserve System's powers as the monetary control authority or interfere with the efficient discharge of its responsibility in this area. The steps that must be taken to restrain an inflationary impulse may often come under public attack and the System may possibly be blamed for a recession which, for the reasons noted above, was beyond its power to prevent.

The built-in commitments to inflation comprise an area in which statesmanlike action would render the System's task of inflation control easier and more effective. A legislative program for dealing with the more important of these commitments is suggested in the answer to question 17.

Question 3. Comment, generally, on the monetary-control policies of the Federal Reserve System as exercised within the following years: 1942 to 1957. (You may wish to divide the period into 2 parts, 1942–50, prior to the accord, and 1951–57.)

Answer. In this answer, the period is divided into two parts; namely, before and after the accord. For reasons that will appear later, the year 1947 marks a significant division point in the first part.

The keynote of Federal Reserve monetary-control policy for World War II financing is in the following statement in the Board's annual report for 1941:

"The System is prepared to use its powers to assure that an ample supply of funds is available at all times for financing the war effort and to exert its influence toward maintaining conditions in the United States Government securities market that are satisfactory from the standpoint of the Government's requirements.

"Continuing the policy which was announced following the outbreak of war in Europe, the Federal Reserve banks stand ready to advance funds on United States securities at par to all banks."

Early in the war, the Federal Reserve Board found itself wrestling with a series of conflicting and wholly contradictory policy objectives. These were:

(1) To make available at all times an ample supply of funds for war financing.

(2) To cooperate with the Treasury in maintaining prices and yields on Government securities close to the existing level for the duration of the war. The interest-rate pattern agreed on in 1942 was a range from three-eights percent on Treasury bills to 2½ percent on long-term bonds.

(3) To supply the banks with adequate reserves to enable them to purchase such amounts of Government securities as the banks were called upon to take.

In opposition to these objectives, which were definitely inflationary, the Federal Reserve authorities and the Treasury attempted a losing fight against inflation. The Board expressed this as follows:

"To resist inflation by joining with the Treasury in coordinated efforts toward the objective to derive the largest possible amount of funds from current income and savings and to depend on the banks as little as possible."

From the long-run standpoint as well as that of immediate war costs, inflation control was the most important objective, but this was the weakest part of the program. Despite the introduction of consumer-credit control under regulation W, resort to consumer-goods rationing, materials allocation, renegotiation, and excess-profits tax, the successive annual reports of the Federal Reserve Board noted that inflationary pressures continued to increase. The rigid, low-level pattern of interest rates, a policy dictated by the supposed political need to hold down interest cost on the debt, was less successful in drawing on private income and savings than a different interest policy might have been, and the banks continued to acquire ever larger amounts of war-debt paper. At a time when the Federal Reserve Board should have been absorbing excess credit and purchasing power by open-market sales, they were obliged, on the contrary, to increase bank reserves by open-market purchases so that the banks could buy more debt paper. In April 1943, on the Board's recommendation, Congress provided that no reserves be required against United States deposits arising out of war loans.

The act of June 12, 1945, reduced the minimum Federal Reserve bank gold reserve against notes and deposits to 25 percent, instead of the requirement of 40 percent for notes and 35 percent for deposits which had prevailed from the beginning. This act extended indefinitely the authority to use Government obligations as collateral security for Federal Reserve notes, and it terminated the authority to issue Federal Reserve banknotes. It also terminated the authority of the President and the Secretary of the Treasury, under the Thomas amendment of May 12, 1933, to inflate the currency by issuing United States notes.

The broad outlines of this part of the story are clear, without further details. In substance, the Treasury was the chief architect of war-finance policy, and the Federal Reserve System had the secondary role of assistant. There is no evidence in the Board's annual reports of serious disagreement with, or resistance to, Treasury aims and intentions. Even while clearly realizing the dangers of inflation, the Board was not able to employ its monetary and credit controls to curb the trend.

After the war, there appeared the first intimations of the Board's desire to regain its independence and a release from Treasury domination. In its report for 1946, it noted that postwar monetary policy would need to be closely related to public-debt management, and listed the following problems:

(1) An overly large money supply.
(2) A vast public debt.
(3) Extensive holdings of debt in the banking system.
(4) The existing structure of interest rates.

The 1946 report declared that the Federal Reserve System would need to regain control over the volume of credit and to exercise some measure of flexibility in credit policy. But its thinking did not yet go all the way, for the objective just stated was followed by the qualification—"while maintaining the low cost of debt service and continued stability in the Government securities market."

In 1947, the Board was still trying to find a way to control inflationary credit expansion without abandoning support of the Government securities market. Since these horses were galloping in different directions, riding both of them at the same time was, indeed, a difficult feat. Finally, in July 1947, the first important step was taken by discontinuing the buying rate on Treasury bills. Thereafter, the rates on bills and certificates of indebtedness rose. Through 1948, the

Board sought to cope with mounting inflationary pressures by accepting cash for maturing securities, increasing bank-reserve requirements, reimposing consumer-credit regulation, and raising the margin rate for loans made to buy or carry securities.

With the downward trend in business activity, employment, and prices that appeared early in 1949, the Board's emphasis in credit policy shifted from restraint to ease. Successive reductions in reserve requirements were made during the year. In June of that year, the Open Market Committee announced:

"It will be the policy of the Committee to direct sales, purchases, and exchanges of Government securities with primary regard to the general business and credit situation. * * * Under present conditions, the maintenance of a relatively fixed pattern of rates has the undesirable effect of absorbing reserves from the market at a time when the availability of credit should be increased.

After this statement, the Board stopped the practice of making Government bonds available on demand, to avoid absorbing funds from private borrowers.

Toward the end of 1949, the signs of economic improvement led to modification of the policy of credit ease. The restrictive policy carried through the first half of 1950. Then the Korean war broke out, and the inflation threat increased, but the Board and the Open Market Committee announced that they were prepared to use all means at their command to restrain further expansion of bank credit consistent with the policy of maintaining orderly conditions in the Government securities market. Accordingly, credit requirements were progressively tightened—rediscount rates were raised, and the Open Market Committee conducted its operations so as to make it less attractive for banks to sell short terms to make loans and investments. But the old dilemma persisted. The credit-restrictive measures were offset by purchases of securities, mainly to assure successful refunding of matured or called securities and, to some extent, to maintain a stable market for long-term bonds.

Here is an example of a dilemma which is likely to recur in the future. When large refundings must be made in a boom period, monetary ease is damaging for the economy but essential for successful refunding. This assumes, of course, that bank support will always be necessary in refunding operations. Such will be the case unless the refunding terms are sufficiently attractive to nonbank investors. But this raises a point dealt with in the answer to question 5 namely, Treasury diversion of funds from the private, long-term market. The politically inspired idea of saving on interest charges has cost the people many times more than the interest in inflation. This will continue, and the refusal to make income-tax rate adjustments whereby savings can be increased will aggravate the condition still further.

The showdown on Treasury and Federal Reserve policies came early in 1951. Commenting on the impasse in its report for 1951, the Board said that it had become increasingly clear that anti-inflationary credit and monetary measures could not be made effective—in fact, that credit and monetary developments would be inflationary—as long as Government securities were given a "money quality" by support of their price. Market support was not immediately withdrawn after the accord. Limited purchases of long terms were made on a scaledown of prices, and, pending refunding of short terms, it was agreed to stop open-market buying and let the rate gravitate around the market rate.

During 1952, the Federal Reserve objective was to encourage an increased volume of current saving to meet the credit demand and to restrict bank credit and monetary expansion to meet the growth needs of the economy. The pace of credit expansion was restrained by making it necessary for banks to borrow in order to get reserves. Thus, rediscount operations again became an effective instrument.

In the annual report for 1953, the Board defined its concept of a free, more self-reliant financial market as one in which the allocation of available funds among various uses is effected through competition in the market. In such a market, open market operations would be solely to influence the volume of bank reserves to promote economic stability and growth, and the Federal Reserve would seek to make its action as broad, general, and impersonal as possible. It would neither establish prices for particular classes of securities directly, nor set up or maintain particular relationships in rate levels such as might impair the efficiency of the market in its allocative function.

This is an excellent description of a free-money market and the central bank's relation to it. The principal obstacle to attainment of the standard set forth in the foregoing paraphrase of that description is likely to be the exigencies of Federal financing and debt management.

To minimize the impact of open-market operations, the following changes were made in 1953:

(1) Short-terms were emphasized

(2) Operations were limited to provision or absorption of reserves, except in correction of a disorderly market

(3) Operating techniques were changed during refundings, by discontinuance of buying "rights," "when issued" securities, and comparable outstanding securities.

The manner in which the Board's directives to the Open Market Committee were adjusted to the changing economic situation during 1953 is shown by the following:

> March 1953: Transactions to be with a view to "exercising restraint upon inflationary developments."
>
> June 1953: Transactions "to avoid deflationary tendencies without encouraging a renewal of inflationary developments."
>
> September 1953: Transactions to be with a view "to avoiding deflationary tendencies."
>
> December 1953: Transactions to "promote growth and stability in the economy by actively maintaining a condition of ease in the money market."

It would appear from this outline of the shift from inflation restraint to active ease the Board was correctly interpreting the signs which were pointing to the recession of 1954. There has been criticism that the Board was not sufficiently alert in moving from one course to the other, but these have been based on hindsight, and it is doubtful if the critics could have done better when the right policy was still uncharted.

The "condition of ease" policy was followed through most of 1954, by reducing the rediscount rate, lowering reserve requirements, and open-market operations to increase reserves. In the autumn of 1954 the credit policy was reversed and by December the banks were again borrowing to obtain reserves. The shift from ease to moderate restraint was continued into 1955. During that year the Federal Reserve policy was a combination of increasing credit restraint and open-market operations, including repurchase agreements, designed to moderate the impact of seasonal factors on the money market. The rediscount rate was advanced to 2¼ percent by mid-September.

A similar policy of alternation between increased credit restraint and action to increase bank reserves was followed in 1956. For example, in January the System reduced holdings of Government securities by more than $1.4 billion, to offset seasonal return flow of currency and reduction in reserve needs. In February and March small amounts of securities were bought at times to meet changing reserve needs and avoid an increasing degree of credit restraint in view of the growing tone of uncertainty as to economic prospects. In April and May discount rates were advanced and some $350 million of securities were sold because of indications of broad increase in spending and growing demands for credit. Member bank borrowings rose to more than $1 billion, a further indication of the rising demand for credit. From late May to early August, System holdings of securities rose to meet currency needs of the vacation season and to cover added demands for reserves around tax settlement and midyear settlement periods. From August to November discount rates were advanced to 3 percent, in conformity with the rise in market rates. At the same time System holdings of securities increased by nearly $1 billion. Even so, member bank borrowings averaged $900 million in August and between $700 and $800 million in other months. System holdings increased still more in December.

This short summary of Federal Reserve policy and action during 1956 is an application of orthodox theory to the condition of strong economic advance. According to this theory, the credit supply should continue to be adequate for necessary business needs but it should cost more. The Federal Reserve Board contends that the successive increases in the rediscount rate were made to keep that rate abreast of the market rate, which was rising because of the strong demand for credit accommodation. The motive was to impose restraint on the growing inflation while still keeping the money supply adequate to do the necessary money work. The Board is aware, of course, that the available lending capacity of the banks is determined by their reserve position and that the volume of bank reserves, in turn, can be determined by the open-market policy. In recent years the Board has designed the open market operations so as to involve a considerable amount of member bank borrowing, a condition which is necessary if the rediscount rate is to be an effective instrument of credit control.

A policy of restraint was followed through the first three quarters of 1957. The System sold $1.8 billion of securities between January and June, to offset the effect of seasonal factors and the sale of $600 million of gold to the Treasury by the International Monetary Fund. In consequence, member bank borrowings rose from $400 million in January to $1 billion in June. In August 1957 discount rates were raised to 3½ percent. In the fourth quarter the business trend had reversed and the System net purchases of securities were $680 million. Other steps to ease credit were the reduction of the discount rate to

3 percent in November, and to 2¾ percent in January 1958. Reserve requirements were reduced by one-half of 1 percent for all classes of banks in February 1958 and by another one-half of 1 percent in March.

In retrospect, a question might be raised as to the accuracy of the Federal Reserve Board's timing for the transition from restraint to ease. To be effectivve, credit ease must be introduced while there is still a substantial demand for credit to be stimulated. If this demand is already tapering off for other reasons, easier credit terms may be slow in reversing that trend. This question is easier asked than answered, for it would have been difficult in August 1957, in face of the evidences of continued inflation, to be absolutely certain that prolonged recession was about to begin.

Question 4. Beginning in August 1956 there was an increase in the Consumer Price Index each month through September 1957 thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

Answer. In terms of the 1947–49 base, the index of all consumer prices was 116.8 in August 1956 and 121.1 in September 1957. This was a decline in the purchasing power of the dollar from 85.6 cents in August 1956, to 82.5 cents in September 1957.

It should be noted that the shift of the index to the 1947–49 base instead of the old 1939 base conceals the earlier serious loss in dollar purchasing power which took place during and after World War II and deprived it of nearly half of the purchasing power it had in 1939. On the 1939 base, the purchasing power of the dollar in November 1957 was 48.5 cents.

The 13 months from August 1956 through September 1957 is a rather limited period, with a restricted price range, within which to pinpoint causal influences. However, we know that during this period the Federal budget was approximately balanced and the money and credit situation was restrained. The postwar gap between production and money supply had finally closed. Consequently the full force of continuous wage increases came to the forefront of the inflationary scene. Wage increases in excess of productivity gains during this period became the new force for inflation, and drove prices upward.

The index measures the effect of price changes on the cost of goods and services in the family market basket. The quantities and qualities of goods and services are assumed to remain the same, and the changes in cost are the result of price changes. Some 300 items are included in the index, more than half of which are food and apparel items. The relative importance of the different categories is determined by a weighting system based on the spending habits of the consumer groups for which the index is primarily designed, namely, city wage-earner and clerical-worker families. The largest weights are assigned to food (28.7 percent), shelter, other than rent (12.4 percent), transportation (11.2 percent), and apparel (9 percent). The prices of the individual items in the market basket are continually moving up or down in response to the changing balance of demand and cost influences. The overall index is a composite of these separate price movements. It would have been higher by September 1957 than it was except for the relatively small advance of the indexes for food (3.9 percentage points), apparel (1.8 percentage points), and rent (2.5 percentage points). On the other hand, transportation cost rose by 7.4 points, medical care by 5.7 points, reading and recreation by 5.4 points, and services other than rent by 6 points. Except for the low weighting assigned to all of these categories, other than transportation, the overall index would have been still higher in September 1957 than it actually was in that month.

Demand

An indication of the relative strength of demand for particular classes of goods or services during the period in question is provided by the changes of the indexes for the major components of the market basket as shown above. However, the prices of individual items are also affected by such matters as cost, shortage or excess of supply, shifting preference of consumers, and so on.

The vigor of demand is determined by the available means of payment plus a willingness to spend. There was a strong increase of consumer spending during the period under review.

In the third quarter of 1956, which includes the month of August, the total consumer spending was at an annual rate of $268.6 billion. In the third quarter of 1957, which includes the month of September, the annual rate was $283.6 billion.

Thus the annual rate increased by $15 billion over a year which included the terminal months of the period in question. Personal income rose from an annual rate of $328.1 billion in August 1956 to an annual rate of $347.2 billion in September 1957. Labor income, which is by far the largest component of personal income, advanced from an annual rate of $234.4 billion in August 1956 to an annual rate of $249.5 billion in September 1957.

The increase of labor income represents an increase of production costs as well as an increase in demand potential. The following changes occurred in average hourly earnings and average weekly earnings during the period in question.

Dates	All manufacturing	Manufacturing durable goods	Nondurable goods	Building construction	Retail trade
(a) Average hourly earnings:					
August 1956	$1.98	$2.10	$1.81	$2.81	$1.58
September 1957	2.07	2.21	1.88	2.97	1.67
(b) Average weekly earnings:					
August 1956	79.79	85.68	71.68	104.53	61.78
September 1957	82.90	90.24	75.24	111.14	64.01

Supply

The supply side can be indicated by the index of industrial production. The overall index moved only from 143 in August 1956, to 144 in September 1957. Total manufactures went up from 144 to 146; the durable goods index went from 158 to 159, and the nondurable index from 130 to 132. This included a relatively sharp increase of chemicals and petroleum products from 167 to 174. The index of output of consumer durables moved from 127 to 129. The index of foods, beverages, and tobacco was unchanged at 113.

These meager data suffice to reveal that in the overall, total production did not increase significantly during the period in question.

When the drift of a whole series of price indexes is in one direction, in this case upward, attention should be given to the money side of the price equation.

The money supply

As of August 1956, demand deposits excluding interbank and United States Government deposits, were $106.1 billion, and currency outside banks was $27.5 billion. In September 1957 the corresponding figures were bank deposits $106.2 billion and currency $27.7 billion. The net increase from beginning to end of the period in question was $300 million. There were minor variations in the monthly totals, the maximum being $108 billion of deposits and $28 billion of currency in July 1957. It will be recalled that the Federal Reserve Board raised the rediscount rate to 3½ percent in August 1957. Bank deposits fell by $1.8 billion from April to the end of September 1957. However, they rose again by $3.4 billion at the end of December.

Total purchasing power is made up of the money supply and the velocity of circulation or turnover. Velocity is measurable only for part of the bank deposits. The Federal Reserve Board compiles data on velocity for New York City, 6 large centers, and 337 other centers. The figures at the beginning and the end of the period in question were:

Date	Velocity or turnover of demand bank deposits		
	New York City	6 other centers	337 other centers
August 1956	51.8	29.9	22.7
September 1957	50.9	31.7	23.7

In all three of these series on velocity, there were monthly variations up and down from August 1956 level. The series for New York City includes a large volume of financial transactions and this is true, though in lesser degree, of the series of six other large centers. The general trend across the country is best indicated by the velocity rate in the 337 other centers. The net change of 1 point in this rate was an increase of some 4.4 percent in the rate at which the demand deposits included in the survey were turned over during the period.

Consumer credit outstanding rose from $39,898 million in August 1956 to $43,270 million in September 1957 a total increase of $3,392 million or a monthly average of $261 million. The actual monthly increase was quite irregular, however, ranging from $587 million in December 1956 to a decrease, or net repayment, of $80 million in February 1957. Nevertheless there was a net increase of some $3.4 billion which represented strong demand and contributed to the total of consumer spending.

Summary

The evidence briefly reviewed in the above discussion may be summarized thus:

First, there was no material increase in the rate of production of goods.

Second, there was a strong and rising demand, as indicated by the increase of consumer spending.

Third, there was a marked rise in personal incomes, and particularly in labor incomes. This rise made the total effective demand possible, but the reverse of the coin is that the increase of labor incomes also meant an increase in production costs.

Fourth, the net increase of spending by way of consumer credit purchases added to the pressure of total demand on the available supply of goods.

Fifth, an increase of 4.4 percent in the velocity of bank deposit circulation was equivalent to some increase in the money supply, but the bank debits in the 337 centers, where this increase occurred, were only about 40 percent of total debits to demand deposit accounts in 1957. An increase of velocity is a response by business and individuals to a rising cost level when there is restraint on increase of the money supply. But the steady rise of the Consumer Price Index was interpreted to mean that restraint was needed. Thus, the Federal Reserve Board's dilemma was either to validate the increased costs resulting from rising wages or run the risk of deflation becoming recession by restricting the money supply.

Question 5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

Answer. Management of the public debt involves the following:

1. Retirement of debt when and as a surplus of revenues permits;
2. Refunding of maturing issues insofar as they cannot be retired;
3. Selection of the particular issues to be retired when redemption is possible, and determination of the terms of refunding—types of new issues such as bills, certificates, notes or bonds; maturities; interest rates; and special features such as provision of a call date prior to maturity, eligibility for bank investment, and others.

Major problem of debt management

The principal problem of public debt management, in its relation to the national credit structure, is to handle the successive refundings in such a way as to minimize the competition between the Treasury and the private economy for the limited supply of funds available for investment in debt paper. The supply of such funds in the hands of nonbank investors is unduly and improperly restricted by the excessive rates of income tax which now absorb so much of the private income that would otherwise be saved and invested. The lack of private saving capacity and attitude has resulted in greater use of the banks in public debt financing and management, a policy which has been a factor in the credit inflation that has plagued the country since World War II.

The Treasury's dilemma may be stated thus: From the standpoint of sound debt policy, it is desirable to fund a substantial part of the debt into long-term maturities, first, in order to reduce the risks involved if a new emergency should compel sudden, extensive refinancing of short-term and demand debt in addition to raising new money; and second, to avoid the well-nigh continuous impact on the money market of successive refinancings of short-term maturities. But a sustained, vigorous Treasury campaign to refund maturing issues into long-term maturities would tend to deplete the supply of long-term investment funds to the detriment of business and mortgage financing. In the case of business, the income tax has been primarily responsible for the preponderance of debt in business financing since 1945. For example, the increase of corporation debt from 1945 through 1956 has averaged $11 billion a year, as against $2 billion a year in new capital stock issues.

With respect to the mortgage financing underwritten in any way by the Federal Government, there is evidence that the restrictive provisions which are a condition of Federal participation or support have often hindered a free flow of funds into such investments.

Short-term debt

It has often been urged by some that an ample supply of short-term Federal debt is necessary to provide the banking system with a liquid secondary reserve against their deposits. In this connection "liquidity" means sale for or convertibility into cash quickly and without loss. In this theory, the Treasury bill is the most liquid form of public debt paper. But this is true only for one holder or a small number of holders. If all of the banks were to present all of their holdings of Treasury bills for redemption at one time, the Federal Reserve banks would be obliged to provide the Treasury with a credit sufficient to redeem the bills.

As a matter of fact, the present volume of securities maturing within 1 year is far greater than would be needed for secondary bank reserves. As of February 1958, the total public debt paper maturing within 1 year was $82.7 billion, while the total of demand deposits, excluding interbank and United States Government deposits, was about $106 billion.

Legislative changes

The test of good debt management mentioned above, namely, to minimize the competition between the Treasury and the private economy for the available funds, will be more easily met by introducing changes in the tax laws whereby the supply of funds for long-term investment would be increased.

Another policy which would enhance the favorable attitude of investors toward long-term Federal securities would be firm assurance that the Federal spending would be controlled and reduced, to avoid, in future, the inflationary deficits that undermine the value of long-term investments.

Given these conditions, the Treasury could safely and successfully pursue a policy of gradual transfer of a larger proportion of the debt into long-term paper. The policies indicated above would materially contribute, also, to the stability of the national credit structure.

Question 6. (*a*) Discuss in their relationship to one another and acording to your judgment of their relative importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand and employment.
3. Economic growth in production demand and employment.

Answer. Rightly understood, the three objectives blend together and strengthen each other. They cannot be properly and adequately discussed as separate and mutually exclusive concepts. The ultimate national need is, of course, economic growth. This growth will be most beneficial for all segments of the economy if it can proceed at a steady pace, without the distortions produced by the extremes of boom and recession or depression. The most equitable distribution of the fruits of economic growth among all of the people is likely to be achieved if the general price level can be held on a fairly even keel, that is, without the excesses of either a marked rise or fall of prices.

Such an objective as to price stability, if it could be achieved and held, would promote stability of production, demand, and employment. That is, it would be as effective protection against boom and depression as would be possible through the operation of monetary controls. It has long been recognized that a good way to keep out of a recession is to avoid the preceding inflation.

The national objectives stated in the question, and any program for their realization are likely to remain a "counsel of perfection" as long as there are retained in the national policy the built-in commitments to inflation which now exist. Examples are the agricultural price supports, the general tolerance of wage increases at a rate faster than the increase in national productivity, Federal credit programs and unreasonable restrictions on general freedom of trade. The pressure on costs which these policies generate must in time be offset by injections of additional money into the economy in order to prevent unemployment, and thus the inflationary thrust is given new impetus.

Question 6. (*b*) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially in 1957.

Answer. The most important development relating to prices after World War II was the marked inflationary uptrend. As indicated by the Wholesale Price Index (1947–49 base) the general price level rose by nearly 46 percent from 1946 to 1951. It leveled off thereafter to 1956, with a range of only 4.7 percentage points between high and low in this latter period. In 1956, however, there was a definite impetus toward higher prices and this tendency carried over into 1957 but with diminished vigor. On the whole the wholesale price level was well stabilized in 1957, with a range of only 1.5 percentage points between monthly high and low.

Using the Consumer Price Index as the indicator (1947–49 base), the rise from 1946 to 1951 was 33 percent. In contrast to the behavior of the Wholesale Price Index after 1951, however, the Consumer Price Index rose continuously thereafter through to 1957 except for a setback of 0.3 percent points in 1955. The monthly index advanced steadily in 1957 from 118.2 in January to 121.1 in September and October, then to 121.6 in November and December.

Production.—The Index of Industrial Production moved upward after 1946 except for the 3 recession years, 1949, 1954, and 1957. The advance was irregular, being greater in some years than others. The decline through 1957 (10 percentage points) was more than in either 1949 (7 percentage points) or 1954 (9 percentage points).

Demand.—The effect of the 1949 and 1954 recession on demand, as measured by personal consumption expenditures, was to slow down the advance, but in no instance through 1957 was the spending trend reversed. The proportion of consumer spending devoted to services moved up from 31.5 percent in 1946 to 37.6 percent in 1957. The category of services includes the imputed rental value of owner-occupied houses, and the spread of home ownership has contributed to raising the housing component of the service category from 30.7 percent in 1946 to 32.7 percent in 1957.

Employment.—From 1946 through 1957, on an annual basis, employment kept even with the growth of the civilian labor force. Figures in thousands for the 2 years are:

[In thousands]

Year	Civilian labor force	Employment	Unemployment
1946	57,520	55,250	2,270
1957	67,964	65,272	2,692
Net increase	10,444	10,022	422

Within each year, however, there have been wide variations of both the labor force and the number employed. These monthly changes from high to low for the years 1956 and 1957 are worth noting. They are shown below in thousands:

Month	Civilian labor force	Employment	Unemployment	Net changes		
				Labor force	Employment	Unemployment
January 1956	65,775	62,684	3,092			
July 1956	69,489	66,354	3,134	+3,714	+3,770	+42
January 1957	65,821	62,578	3,244	−3,668	−3,776	+110
July 1957	70,228	67,221	3,007	+4,407	+4,643	−237
January 1958	66,732	62,238	4,494	−3,496	−4,983	+1,487

A peculiarity about these labor force totals for which no explanation appears, is the difference in the movement between high and low in 1956 and 1957. From January 1956 to July 1956, the labor force increased by 3,714,000, and from July 1956 to January 1957 it declined by 3,668,000, leaving the labor force in January 1957 only 46,000 higher than it had been in January 1956. The seasonal increase raised the labor force by 4,407,000 in July 1957, but the drop in the labor force to January 1958 was less than the preceding rise by some 911,000. It is to be expected that the labor force will grow as the population expands. The point here is that the annual increment picked up in the seasonal swings should be fairly uniform. A net gain of 46,000 in 1 year followed by a net gain of 911,000 leaves something unexplained.

Further light is thrown on the employment trend by the age and sex composition of the labor force. The figures for 1946 and 1957 are given herewith:

Year	Employed					Unemployed				
	14-19	20-44		45 and over		14-19	20-44		45 and over	
		Male	Female	Male	Female		Male	Female	Male	Female
1946	4,550	21,170	9,870	15,290	4,380	290	1,200	280	410	90
1957	4,720	23,453	11,247	17,246	7,804	574	935	566	606	255
Net change	+170	+2,283	+1,377	+1,956	+3,424	+284	−265	+286	+196	+165

As the years pass the members of the labor force move from one age group to another. The most striking disclosure of these figures is the relative increase of females aged 45 and older in the labor force. And except for the male age group 20 to 44, which had a net decline in unemployment from 1946, to 1957, fewer females aged 45 and older lost their jobs over this period than any other category.

Economic growth.—The gross national product has more than doubled since 1946, the figures being, in current dollars, $209.2 billion in 1946 and $433.9 billion in 1957. This growth represents an annual rate, compounded, of 6.9 percent. But the current dollar figures are materially distorted by inflation, and hence they suggest a greater addition to the national economic strength and well-being than is actually the case. In terms of constant 1947 dollars, gross national product has risen from $232.2 billion in 1946 to $334.7 billion in 1957, which is a growth rate, compounded, of 3.3 percent. When stripped of the influence of inflation the rate of growth since 1946 was not equal to the historic rate since 1869, which, down to 1928, was some 3.8 percent, compounded annually.

The year 1957 does not make a good showing in these comparisons. The increase of gross national product in that year over 1946 was almost 5 percent, but 4 percentage points were a result of inflation and only 1 percentage point constituted increase in physical terms.[1]

Question 7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

Answer. Government spending for goods and services—Federal, State, and local—is a component of gross national product as a matter of statistical compilation, but this means that Government absorbs certain dollar amounts in the annual total. The issue presented by the question is whether such spending, in one amount rather than another, is beneficial or harmful for the economy.

[1] Economic Report of the President, January 1958, p. 53.

The first point in this connection is that the Government spending does not correlate at all times with the movement of gross national product. The relationship for certain years is given herewith:

[In billions]

Year	GNP	Government spending	Year	GNP	Government spending
1929	$104.4	$8.5	1948	$257.3	$36.6
1931	76.3	9.2	1953	363.2	84.4
1940	100.6	14.1	1955	391.7	77.4
1944	211.4	96.5	1957	433.9	86.6

These figures show that the amount of Government spending is not always a positive factor in determining gross national product. When that product is rising, an increase of Government spending swells the dollar amount of the product; but in two instances, 1944–48, and 1953–55, gross national product continued to rise although Government spending was reduced. And from 1929 to 1931, gross national product fell although Government spending was increased.

The conclusion is that there are more powerful forces than Government spending which determine the changes in gross national product unless, as in World War II, the spending is on a scale so large as to dominate the economy. When these forces are unimpeded, a decline in Government spending will not hinder or prevent continued increase of gross national product. On the other hand, it is more likely that a reduction of Government spending, with a basic reform of the income-tax-rate structure, would contribute materially to the release of the growth forces on which the national economic advance depends.

A second point involves the assumption so frequently made that Government spending always contributes to the general welfare. This assumption is sharply contradicted by the record from 1944 to 1948, when gross national product increased by $46 billion notwithstanding a reduction by Government spending by $60 billion. Yet this assumption continues to be made, and it is currently (March 1958) being used to support legislative proposals for increased Government spending as a cure for the recession. The following passage from the Economic Report of the President, January 1958, should be considered by believers in this assumption (p. 56):

"Because the provision of services by Government requires that income be claimed that would otherwise be used privately, the first of these objectives (i. e., to make adequate provision for public services) means, in a broad sense, that the amount of income which is taken in taxes, the sources from which taxes are drawn, and the way tax receipts are spent, should be such as to maximize Government's contribution to national welfare. Constant vigilance is needed to get the work of Government done at the lowest cost consistent with the desired level of performance * * * but vigilance is needed also *to assure that the income which Government takes in taxes makes a greater contribution to well-being when spent publicly than it would if used privately.*" [Italic supplied.]

Government spending for essential public services, "at the lowest cost consistent with the desired level of performance," unquestionably contributes to the national welfare. The key point in the above passage is the warning against unlimited public spending which is conveyed in the declaration that there must always be assurance that Government can spend the people's money more wisely and more beneficially than they can.

This test cannot, of course, be made with objective exactness because of the great range of individual bias for or against more Government. It is submitted, however, that the best result will be achieved by insisting that the range of Government activities and the amount of Government spending of tax revenues be materially restricted, rather than by allowing Government a free hand in expanding its operations and unlimited access to the incomes of the people. The reason for this conclusion is that, since well-being depends on economic growth, the growth forces in the economy will operate most vigorously and most efficiently when they are impeded in the least degree possible by the burdensome exactness and controls of Government. Excessive and discriminatory taxation, which involve an arbitrary assumption that Government can spend private income to better advantage than private persons can, is a most serious impediment to growth.

Government spending in excess of revenues necessarily involves borrowing. State governments are prevented by their respective constitutions from incurring debt without popular approval. State legislation usually limits and controls local borrowing. The principal market for State and local debt paper is provided by individual and institutional investors and comparatively little of it is sold to commercial banks in the first instance. Hence there is a minimum of inflationary effect from State and local borrowing.

On the other hand, large-scale Federal borrowing tends to be inflationary because a substantial part of any large Federal debt issue in the past has ordinarily been taken by the banks, and the same procedure would no doubt be followed again. Thus there would be introduced once more a strong inflationary trend, with its resultant inequities and further loss of value of the dollar.

Deficit spending and credit inflation cannot restore lasting vigor to retarded growth forces. The most certain way of reinvigorating the economy is by adopting a sensible program of tax rate reform with forward scheduling of rate reductions. Under such a program, resumed economic growth would expand the tax base more than enough to offset the revenue effect of scheduled tax rate reductions. In the circumstances now existing (March 1958) the initial effect might be a deficit, although this is by no means certain unless the spending is allowed to get entirely out of hand. Even so, a deficit resulting as the first impact of tax reduction along the lines proposed above is self-correcting, because of the dynamic effect of the tax cut on economic growth. In contrast, deficits deliberately incurred in the hope of stimulating the economy tend to become self-perpetuating and hence, self-defeating.

Question 8. Give your opinion as to the effect on our economy of current Federal, State, and local taxation.

Answer. The latest available data for 1956, indicate that the total load of Federal, State, and local taxation was then $121.2 billion. This exceeded one-third of the national income, which was $343.6 billion in 1956 and $358.5 billion in 1957. While no precise ratio of tax burden to national income can be proved to be the breaking point, a load in excess of one-third should be viewed with deep concern, for it is possible that, without our realizing it, this point has already been reached. In fact, considering that the current recession is in large degree characterized by psychological reactions, the issue becomes even more germane. Pessimism takes over from optimism in the business world when the prospect of inadequate profit, or of no profit at all, looms too prominently on the business horizon. Excessive taxation means that the worker, the entrepreneur, and the investor, are not allowed to keep enough of the income earned to maintain the incentives to do more and get more.

State and local tax systems differ widely in detail among the States, but they have in common certain general characteristics. They consist mainly of property taxes, sales taxes, business and individual income taxes, inheritance and gift taxes, and selected excises on beverages, tobacco, gasoline, and motor vehicles. The relative proportion of total revenues derived from the several major sources of revenue varies greatly, but in each State the particular local arrangement appears to have the approval of the citizens. Improvements could no doubt be made here and there, and, as experience has shown, such action has been and will be taken when the local demand for it becomes strong enough. The Commission on Intergovernmental Relations suggested that the States could be more alert to discover and utilize more revenue sources within their own borders, but no specific examples were offered. Any necessary or desirable reforms of State and local taxation are matters of local concern, beyond the purview or authority of Federal agencies.

On the contrary, the Federal revenue system is very much a responsibility of the Congress and the executive branch. Being nationwide in scope, the bad features of the Federal tax system blanket the whole country and hence they are magnified accordingly.

The most damaging part of the Federal tax system is the excessive rates of the income taxes. In the budget for fiscal year 1959 these taxes are estimated to produce $58.9 billion, or 79.1 percent of net budget receipts. This extreme proportion is a result of the rate structure which has built up over the years and which has been retained virtually intact in peace as in war. It is appropriate to levy heavy taxes during war emergencies, which require intense effort from all through the periods of active hostilities. But the restrictions of wartime cannot and should not be retained beyond the war period. This has been recognized in the removal of rationing and other controls over the people, and also in the repeal of excess profits taxes. It has not been recognized in the case of the income tax rates, which still stand as a monument to the oppressive burdens of the war period.

If the economy is allowed to realize its possibilities of maximum growth, there would be no case for excessive tax rates in order to support the necessary public expenditures. The growth that would be promoted under a moderate tax rate structure would lighten the tax burden on individuals and businesses even if this could not be done by a substantial reduction of Government spending.

No justification can be found either for retention of excessive income tax rates on the ground that we are in a cold war. This kind of war can go on for a generation or more, and the fundamental requisite for victory in it is the development of a strong, growing economy. The major handicap to growth is the income tax rate structure.

It is no answer to reply that the country has grown under the present tax rates. When the effects of inflation are removed it is found that our growth since 1946, as indicated by gross national product, has been only about 3.3 percent compounded annually. In view of the rate at which the Soviet Union is growing, we may well lose the race for economic supremacy unless we can do much better than 3.3 percent. And when the economic race is lost there is little chance of victory in a military contest.

The principal counts in the indictment that can be brought against excessive rates of income taxation are:

1. They are a serious impediment to economic growth, because:
   (a) They lessen the incentives to produce;
   (b) They impair the capacity to save and the willingness to save and invest, thereby slowing up the rate of capital formation, which is the indispensable economic condition for growth;
   (c) They distort business decisions by compelling undue attention to the tax consequences of these decisions;
   (d) They divert the time and energy of business executives from management problems to tax problems;
   (e) They impair taxpayer morale.
2. Excessive rates of income tax negate the operation of the free market as the ultimate determinator of rewards for economic effort. The more industrious, energetic, and capable the individual, the greater the tax penalty.
3. They promote centralization of governmental functions at the Federal level by affording a monopoly of taxable resources, which leads to the vicious circle of Federal fiscal supremacy and State dependency.
4. The pessimism which excessive tax rates normally engenders is accentuated under recession conditions. In any close balancing of business and economic factors, the impact of excessive tax rates may well be a deciding factor in the direction of an economic downturn.

A dangerous consequence of the steep progressive rates of Federal estate tax should be noted. It is common knowledge that many large estates have been put into tax exempt trusts or foundations in order to avoid this tax. Insofar as trusteeship may, now or later, involve an influence on the management of the properties of businesses represented by the securities placed in trust, it will be in the direction of cautious, conservative polices. The danger is that dynamic, imaginative, courageous leadership of industry may be stifled by the caution and conservatism that are normal attributes of trusteeship. The law of mortmain has long since been abolished, but here is the possibility of a new kind of "dead hand" control that could be fatal to economic advance.

NAM has long advocated return of the estate and gift taxes to the States. Were this done, it is less likely that the trend toward lodging estates in foundations would be as strong as it now is, because the rates of transfer tax would be lower at the State level. The vitality of American enterprise requires that the control of enterprise be with the living, not with the dead.

Question 9. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy, and then relate, them, one to the other. Please discuss these policies stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

Answer. The distinction is already indicated by the parenthetical insert. Fiscal policy includes the measures taken to provide public revenues, to pay the expenses of the Government, and to supplement, where necessary, the current tax and other revenues by borrowing additional funds. Monetary and credit policy includes operation and management of the banking system in providing the necessary money supply through bank loans and investments, and the overall regulation of this supply by the Federal Reserve Board.

There are various links between the two policies and the agencies whereby they are implemented. The Federal Reserve banks act as fiscal agents of the Government. They cooperate closely with the Treasury in the management of the public debt. The banks serve as depositaries of funds obtained through taxation or borrowing until these are drawn upon for Government use. The Federal Reserve Bank of New York acts as the Treasury's representative in foreign transactions. An important link is the service rendered by the banks when deficits must be financed by the issue of new debt paper. At this point fiscal policy reaches over into monetary and credit policy in order to secure the additional funds needed to cover the public spending.

But the two policies serve different ends and should not be regarded as interchangeable, nor as substitutes one for the other. Under a sound fiscal policy Government spending would be sufficiently controlled and restricted to avoid imposition of a crushing tax burden; the tax system would be so organized as to provide the necessary public revenues without the levy of excessive or discriminatory taxes; and by keeping the budget balanced, resort to inflationary deficit financing would be unnecessary.

The management of monetary and credit policy would make its contribution to the overall goal by providing, through the banking system, enough money to do the necessary money work and by preventing the money supply from becoming so abundant as to impair its value.

The two policies may, on occasion, operate at cross purposes. For example, it is conceivable that at a time when sound monetary and credit policy indicated restraint on the creation of more new money through credit expansion, the budget would be unbalanced and thus render deficit financing necessary, thereby increasing the volume of credit. Or, in a period when credit restriction was necessary, Government loan programs could be setting easier interest and other terms for Government lending.

In order to "restrain inflationary trends and otherwise aid in preserving a stable economy," the best results will be obtained when the two policies keep to their respective grooves. It is often said that fiscal policies can curb a boom by maintaining high tax rates and accumulating a budget surplus. This, it is believed, will reduce the total money purchasing power in the economy and thereby prevent further rise of prices.

If the surplus is held in the Treasury as idle cash, there will be a reduction of the money supply to that extent. For various reasons, however, it is unlikely that the Treasury's cash balance would be allowed to accumulate and remain at a high level. It is far more likely that the surplus would be put to use, and if this is done there is a possibility that the money will be returned to the spending stream. Such, obviously, would be the case if Government spending were maintained at a high level. The most popular use of a surplus is to redeem some of the public debt.

If the debt paper selected for redemption is held by nonbank investors, the result is a transfer of funds from taxpayers to bondholders. Total spending power in the economy is not reduced, and the heavy taxation levied to curb the boom will have been in vain. If the debt to be redeemed is held by the commercial banks, the net effect would be to improve the overall reserve position of these banks. That is, there would be a net decline of privately owned demand deposits in the amount of the taxes paid, and the Treasury checks to the banks in exchange for securities would be cleared into the member bank reserve accounts, thereby increasing the ratio of reserves to deposits. But the member banks would then be in position to increase their loans and they would be inclined to do so where possible in order to replace the earning asset lost through the redemption. Since loan demand is likely to be active in a boom period, there would tend to be an increase of bank credit to offset the previous decline of taxpayer deposits and so, again, there would be no decrease of purchasing power in the economy as a result of the high tax rates. Fiscal policy alone would be ineffective. It could only be made effective if the Federal Reserve Board were to mop up the excess reserves created through debt redemption by selling in the open market, or by changing reserve requirements.

Finally, if the debt redeemed were that held by the Federal Reserve banks, there would be a reduction of the overall money supply but, as in the case of the commercial banks, the Reserve banks would have larger balances and they could transfer funds back into the economy by open market purchases. Such action would be unlikely for it would be counter to the kind of monetary and credit restraint policy that would be proper under boom conditions.

These details are spelled out to show that the reliance on fiscal policy to curb a boom by levying high taxes and redeeming debt will be ineffective unless great care and judgment are used in the application of the budget surplus. And even so, it would be necessary to rely, under some circumstances, on monetary and credit policy to make the effort at control through fiscal policy fully effective. The fact is that the restraint in a boom period that is sought by advocates of fiscal policy can be imposed more effectively through monetary policy.

The general viewpoint with regard to fiscal policy intended to be expressed in this reply is that it should not be thought of, or used, as a means of controlling the economy. The proper use and function of taxation is to provide revenues to pay the cost of the necessary public services. The manipulation of either taxing or spending for the purpose of regulating or controlling or directing the economy will certainly involve trouble for everyone sooner or later. Taxing in excess of the cost of necessary public services involves a presumption that Government can use the additional income to better advantage than the people can, but this presumption is far easier to assert than to prove. There are times when it would be proper to retire some of the debt, but this proper purpose should not be confused with the levy of excessive taxation at any time as a means of influencing the course of economic affairs. There are other times when it may be necessary to increase the debt because of a gap between the cost of necessary services and available revenues. In such cases the debt increase should be held to the minimum required by a prudent budget situation. A Pandora's box of financial woes is opened whenever deficits are deliberately enlarged by spending projects and new debt is irresponsibly created under recession conditions.

It should be noted that in the doctrine of compensatory budget balance the real purpose of debt reduction out of the surpluses of prosperous periods is not to eliminate debt principal and interest cost once for all, but to clear the way for another large increase of debt in the next depression.

Insofar as the variations from stability in the economy are caused by money and credit factors, or are susceptible of being influenced by these factors, the best means of restraint or stimulus are to be found in monetary and credit policy. The characteristics of an "inflationary trend" are expanding bank credit and money supply, and rising prices. The diffusion of cost increases throughout the economy, whether caused by higher labor costs, material shortages, or other influences, means an increase of prices which tends to reinforce the demand for a larger money supply. Applying the brakes on money supply through Federal Reserve policies is essentially a mechanism for limiting the amount of credit which the banks can extend to their customers, and increasing the cost of such accommodation. The built-in commitments to inflation referred to in the answer to part (*a*) of question 6 are not affected by this kind of credit restriction and the squeeze comes first on the producers who are unable to finance their higher costs under the credit restrictions.

This is not to say that credit restriction should not be utilized in a boom period. On the contrary it should, and the responsible authorities of the Federal Reserve System should be free to handle this problem according to the best information and judgment that can be marshaled for the task. The point to be made here is that while the Nation continues to tolerate other policies which are, in effect, an irresistible force for inflation, the result of credit restriction will be a serious impact on producers. Credit restriction means a refusal to underwrite the forces making for inflation. The blame for the recession which is likely to follow does not lie with this refusal, but with the policies which contributed to make it ineffective as to prices and damaging to the productive forces.

Question 10. (*a*) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank credits). Also please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

Answer. The term "adequacy" is interpreted here to mean the capacity of the monetary system to provide the economy with a money supply sufficient to do the necessary money work, with controls competent to prevent an excessive money supply from impairing its value.

From the standpoint of this definition, it is believed that the Nation's monetary system can be considered adequate. As the national economy grows, it is evident that a larger money supply will be needed to do the necessary money work at a stable price level. While some overall increase of money purchasing power would be provided by an increase in velocity, this is not the best way of adjustment. High velocity rates, and especially a sudden advance in these rates, tend to breed an atmosphere of uncertainty and distrust in the money and may lead to a flight from the currency which is characteristic to periods of serious inflation. The proper way to assure an increase of the money supply in step with the growing needs of the economy is for the banking system to expand in its capacity to make the loans and investments whereby the overall money supply, including of course bank deposits, would be increased. A larger economy will will naturally need more cash for pocket and till purposes, but this can readily be provided by the issue of more coins and Federal Reserve notes. The member banks would obtain additional notes or coins by drawing them as a charge against their reserves.

The crux of the problem of adequacy is, therefore, the question of the expansion of the resources of the banking system. The ramification of this question, if properly dealt with, would carry the discussion far beyond the tolerable limits of a presentation of this sort. Two major aspects of the problem will be briefly indicated. These are (*a*) the increase of bank capital, and (*b*) the function of bank reserves.

It is obvious that the capital invested in the banking business must increase as the demands on it expand. Capital investment of any sort involves saving, and here again, the evil effect of excessive income tax rates in reducing the capacity and the incentive to save and invest is to be noted. There is no ideal ratio of bank capital to note and deposit liabilities which can be set up as a target, and the actual ratio has declined greatly over the past century. For example, in 1840 the ratio of total capital accounts (including surplus, undivided profits and reserve accounts) to notes and deposits was 157.7 percent. In 1950 it was 8.3 percent.[3] While the soundness of the American banking system has not been impaired by this decline, nevertheless, it does not follow that the matter of capital as a factor in bank strength is unimportant.

Capital investment in banking can be increased either by organizing more banks or by new investment in existing banks. Both methods will no doubt be used. The great expansion of new urban communities and of suburbs around existing cities will require additional, convenient banking facilities. To some extent this need can be supplied by branch banks, although the State laws on this subject are quite diverse.

The original concept of a bank reserve was to serve as limitation on bank liability. No bank is expected or required to keep on hand cash equal to total deposits. Since vault cash or a reserve account with a Federal Reserve bank earns nothing, the inclination of bank management is naturally to keep such assets as low as possible. On the contrary, there is every reason to provide the necessary protection to depositors by investing in income-producing assets of high liquidity. As noted in the answer to question 5, an argument for the

[3] Cf. C. R. Whittlesey, Principles and Practice of Money and Banking, 1954, p. 189.

maintenance of a considerable supply of short-term public debt is that this paper is highly liquid and it is therefore ideal as a secondary bank reserve.

In banking circles today the function of bank reserves is recognized as being essentially part of the technique of credit control, and to provide depositor protection by the maintenance of liquid secondary reserves. If this view of the function of the cash reserve is accepted, the fraction of deposits at which the minimum reserve is set would appear to be relatively unimportant. Recognizing that there is a minimum below which reserve requirements should not be set, central bank control of credit expansion could be as effective at one level as at another, once the credit situation has become adjusted around a given level. For example, the range within which the Federal Reserve Board is authorized to fix reserve requirements is as follows:

Present statutory requirements	Net demand deposits			Time deposits
	Central reserve city banks	Reserve city banks	Country banks	
Minimum	13	10	7	3
Maximum	26	20	14	6

From June 1917 to August 1936 the reserve requirements were at the minimum shown in this tabulation. It is obvious that if the requirements were now at or near that level, the credit control vested in the Federal Reserve Board would be as effective as it would be with the maximum percentages in force. The problem of making available the necessary increase in money supply as the economy grows involves either more and more extensive open market purchases or a reduction in the reserve percentages.

Question 10. (*b*) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

Answer. The word "fiscal" is an adjective from fiscus, which meant the treasury. The connotation developed that this referred to the public revenues, and the term "fiscal system" is often used in this limited connection. In a broader sense, as indicated in the answer to question 9, the fiscal system means the whole array of Treasury functions, which include the gathering of revenue, its spending, and borrowing when necessary. The planning of financial operations, which is now done through the budget, is a fiscal activity that is divided between the executive and legislative branches. That is, the executive prepares the budget and the Congress legislates on its details. These various divisions of the fiscal system can best be discussed separately.

The budget.—The annual budget of the United States Government is, despite its size and detail, somewhat one-sided. That is, it sets forth with great minuteness the spending side of government operations, but it deals only in a sketchy way with the revenues. It is not suggested here that taxing and spending should occupy equal space in the budget, but rather that more complete and precise information be given with respect to the bases for estimates of tax yield and to the reasons for making or opposing specific tax proposals. The case for spending, whether it be for defense, subsidies, public works, or anything else, is carefully developed in the budget message and text, but there is never a comparable exposition and critique of the tax system. No good reason for this reticence exists, since the Congress has the same jurisdiction to initiate spending legislation—which is presented at length—as it does to initiate tax legislation—which is so meagerly considered. It would seem that the legislators would find a discussion of tax policy and practice in the budget as useful and enlightening as is that devoted to spending.

Spending.—Under the Constitution, no money shall be drawn from the Treasury but in consequence of appropriations made by law. The Chief Executive submits to the Congress, through the budget, his spending recommendations but the Congress has the final word on the amount to be spent. In theory, an appropriation is the vehicle for authorizing spending and the appropriation process is the technique of congressional control. But the term "appropriation" has come to have a limited, technical meaning which refers to the specific measures initiated by the Appropriations Committee of the House. In this view it does not refer to other ways of authorizing expenditure, and various devices for bypassing the appropriation process have been developed. Among these are:

(*a*) Authorization to spend from debt receipts;
(*b*) Contract authority created in substantive law:
(*c*) The revolving fund and/or the corporation form of organization; and
(*d*) The trust fund.

In using these alternative procedures there is no violation of the letter of the Constitution, for all of them will have been established and approved by legislative action. It is moot whether or not they violate the intent of the Constitution that all spending shall be in consequence of appropriations made by law. This much appears certain—that there has been serious loss of effective congressional control through their use.

The great size to which the Federal Government has grown, and the increasing complexity of its operations, have militated against the careful supervision of the spending programs which is fundamental to the performance of essential services at minimum cost. In consequence, there is duplication and overlap of agencies and the services they perform, with resulting wasteful expenditure. Bureaucratic empires develop within the Government which exert pressure for a continually expanding scale of operations and spending.

The basic objective, in taking private income and spending it for public purposes should be, in the words of the Council of Economic Advisers, "to get the work of government done at the lowest cost consistent with the desired level of performance" (see answer to question 7.) It is imperative that there be competent, vigorous expenditure control. The law has contained, for years, an effective procedure for this control in the Antideficiency Act (sec. 3679 of the Revised Statutes, as amended). The system of apportionment and allotment provided in this act is capable, under vigorous application, of achieving a prudent use of the funds supplied by Congress. But this procedure must be permitted to operate firmly and impartially. The source of such a policy attitude is the Chief Executive, who is the fountainhead of the will to economize. Where there is vigorous leadership at the top, the pattern will carry down to subordinates. And where there is a sufficient desire, the spirit of economy will extend to regard for taxpayers as well as for the services of Government.

Taxation.—From the standpoint of revenue yield, the Federal tax system must be regarded as adequate. But it is not adequate from the standpoint of being properly designed to serve the best long-range interest of the economy. That interest is the achievement of the maximum growth consistent with stability of prices, production, and employment. In this respect the Federal tax system has the following defects:

1. There is excessive reliance on the income taxes. No other nation depends in as great degree or these taxes as does the United States. The result is instability of receipts and a corresponding insecurity of budget planning.

2. There is an erroneous belief that substantial revenues from the income taxes depend on the maintenance of high rates. Contrary to this belief, the fact is that modern rates will produce a larger revenue over the long run because of the greater rate of economic growth that will result under such rates. Economic growth depends on capital formation and this, in turn, depends on saving and investment. The present high, punitive rates absorb much income that otherwise would be saved and invested, with the result that the Nation's growth rate is much below what it could and should be.

3. Even the income taxes are badly unbalanced as a result of changes in tax payment dates. For example, net budget receipts in the first 6 months of fiscal year 1956 were $25,240 million, and in the second 6 months, they were $42,925 million. This extreme variation was caused almost entirely by the differences in income-tax collection over the year. It involves serious financing problems for the Treasury, shown by the fact that net budget expenditures in the first half of fiscal year 1956 were $33,125 million and in the second half, $33,414 million. In other words, there was a deficit in the first half of $7,885 million, and a surplus in the second half of $9,511 million.

On any standard, this is very bad financial management. It is entirely unworthy of the richest nation in the world, with the highest reputation for managerial competence and "know-how." During the first half of the year the Treasury must go into the market for large sums of new money, thereby adding to the impact of its regular refinancing operations. The Federal Reserve System would have an obligation to ease up on the credit situation sufficiently to accommodate the Treasury, even if, by other tests, the credit situation would require restraint rather than ease.

Question 11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

Answer. The situation described in the question appears to fit one aspect of inflation described in the answer to question 1, namely, the case in which a price rise is produced by wage increases. This manifestation of inflation must be confirmed and validated by an increase of the money supply or unemployment will result. See the answer to question 17 for further explanation of this point.

The wage push on prices has been in operation for some time, and both the wholesale and the consumer price indexes have been inching upward. So far as these indicators show, there is still some inflationary pressure in the economy. But if so, it must be attributable to the wage push, for the money supply has been shrinking. The total of demand deposits and currency at the end of December 1956, was $139.7 billion. After some variations through 1957, this total was $137.7 billion in December, and at the end of January 1958, it was $134.8 billion. The velocity rate in 337 centers reached its high point of 24 in July 1957, and thereafter drifted downward to 22.3 in November. The drop in demand deposits may have resulted in part from the shift into time deposits, which increased from $82.2 billion in December 1956 to $89.7 billion in January 1958.

Something more must be said about the three-cornered relation of money, output and prices than was appropriate in the answer to question 2, and this involves the matter of employment. When forces other than money supply push prices up because these forces have increased costs, then the money supply must be increased or all of the high-priced output cannot be sold. And when such goods cannot be sold, their production is curtailed and fewer workers are needed. In one sense, these goods have been priced out of the market, but it would be equally true that the excessive wage increases have priced some workers out of the market. The expansion of time deposits suggests a growing consumer awareness that some commodities are not worth the prices asked for them in today's money; but the producers must try to get those prices as long as their costs compel them to ask that much if they expect to stay in business.

It would be futile to venture a prediction as to how long high and inflationary prices can continue with no infusion of additional money into the economy. Another way to put it is how much unemployment shall be tolerated at the existing wage level. If we hold fast on money supply and accept another round of wage increases in excess of national productivity, the result would be catastrophic in terms of unemployment. The connection is clear. Higher costs would compel higher prices, but sales would drop further and both output and employment would decline still more.

As noted in the answer to question 15, the alternatives to wage increases at a rate faster than national productivity are either inflation if the money supply is correspondingly increased or unemployment if it is not.

Question 11. (b) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

Answer. By no means. This would be the road to complete destruction of the value of the dollar, loss of the values represented by life insurance, pension funds, annuities, and all investments in fixed income securities such as Government and corporation bonds. It would reduce to destitution the large and growing group of citizens who are now dependent on the protection provided by insurance, pension funds, and other kinds of fixed incomes. It would, in the end, penalize through the inflation the very workers in whose interest this form of national suicide had been introduced.

It should be noted, further, that there is no such attainable thing as a full-employment goal. The continuous employment of 100 percent of the so-called labor force is not realizable. It is not even feasible and the heroic measures that would be required to achieve it would cost far more than the results would be worth. Among other procedures repugnant to a free society, it would involve an iron discipline over the workers to prevent anyone from taking time off to look for a new or better job; no one would be allowed to resist instantaneous transfer from one job to another or from one section of the country to another; no one would be allowed the privilege of not working for a time if such were his preference.

The Employment Act of 1946 does not mention "full" employment. At most, the goal set by the act is maximum employment, and section 2 of the act merely declares it to be the continuing policy and responsibility of the Federal Government "* * * to use all practicable means consistent with its needs and obligations and other essential considerations of national policy * * * for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment opportunities, for those able, willing, and seeking to work * * *."

The qualifications of this mandate are too often neglected. The practical means to be used in promoting the conditions under which useful employment opportunities are to be provided must be consistent with the Government's needs and obligations and other essential considerations of national policy. This strongly indicates that account should be taken of the public debt, the tax burden and its distribution, and many other relevant matters of national policy. It would certainly rule of a policy of continuous inflation.

Question 12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy?

Answer. The growth of private debt for selected years since 1939 was put into the record of the hearings before the Senate Committee on Finance by Under Secretary of the Treasury Randolph W. Burgess at page 665. The figures, in billions, are as follows:

	1939	1946	1956
Individual debt	$51.0	$60.5	$207.5
Corporation	89.0	110.5	249.0
Total private debt	140.0	171.0	456.5

Some details regarding the composition of individual debt in 1956 were given by Secretary of the Treasury George Humphrey at page 25 of the same hearings. They showed the following:

	Billion
Mortgage	$131.5
Consumer	41.9
Other	34.1
Total individual debt	207.5

A similar distribution of individual debt in 1939 or 1946 is not available. The high levels of mortgage and consumer debt in 1956 would indicate, however, that much of the phenomenal increase since 1946 has been in these two forms.

Both the total individual debt and corporation debt increased, between 1946 and 1956, at a faster rate than national income. The latter was almost exactly doubled during the decade, but individual debt rose by 166 percent, and corporation debt by 125 percent. Inflation has lessened the burden of debt to individuals and corporate debtors, but at the expense, of course, of the creditors.

A debt is a lien on future income for payment of interest and principal. If the debt is increasing faster than income, it means that the borrowers are reaching farther and farther into the future in hypothecating anticipated income. It is true that the overall total of national income is not the best indicator of the ability of the individual debtors to carry their debt, because it is possible that the incomes of these particular individuals are adequate to support their obligations.

The reverse side of credit is debit, or debt. For every dollar debt, someone somewhere in the national economy—or in the outside world—holds a dollar of credit, an asset against the debtor's liability. We cannot have a credit economy without also having a debt economy.

The question seems to imply, however, that the growth of private debt can in some way be a threat to the economy, but this connotation would hardly have been suggested if the reference had been to the growth of private credit.

In our complex money and credit economy, there is a vast interwoven fabric of debits and credits. Virtually every business has both bills payable and bills receivable, and the same holds for many individuals. Many others may own long-term corporation bonds and at the same time they may owe on a mortgage on a residence or business property. Banks hold promissory notes or bonds against the debt which they owe to depositors as deposit credits.

The Nation's growth has been possible, in very large degree, by the development of this complicated system of debt, with its counterpart of credit. The threat to economic stability in this situation arises when, for some reason, the income anticipations on which debt rests fail to be realized. When one debtor is forced to default, his creditor does not receive the payments on which he has relied to make the payments toward his own bills payable or other debt. However, it would be only when a substantial paralysis of the income flow had occurred that the general economic framework of the Nation would be endangered. Every day there are cases of individual and business failures to meet debt obligations when due, but these small shocks are easily absorbed because of the immense size and resources of the national economy.

This does mean that there can be no danger in an overextension of credit, or its counterpart, debt. It is the responsibility of every person or business firm to make certain—as certain as human judgment can be—regarding the character, capacity, and economic prospects of prospective debtors. The natural law of self-preservation may be relied on here to guard against an abnormal volume of unsound loans, and hence to prevent an accumulation of unsound debt that could become a threat to the economy.

The income-tax law must be held responsible, in part, for the rapid growth of business debt. It does this, first, by allowing interest as a deductible expense in determining net taxable income while not permitting a deduction for dividends; and, second, by hindering the kind of saving and investment that would go into equity, rather than debt, capital. It will be recalled that during the 1880's and 1890's many large railroad systems went through the wringer of receivership because of their topheavy debt capital structures. The corporation that resorts too heavily to debt rather than equity capital for expansion runs this risk today. This is no doubt fully realized by corporate managements, but the paucity of funds available for equity investment resulting from the excessive income-tax rates leaves them, too often, little choice. And so it can be said, with reason, that the intolerable income-tax rates present a major threat to the stability and vitality of the economy.

Question 13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy?

Answer. This question requests that consideration be given to the financial condition of the United States as a preface to discussion of the steps, if any, to be taken to counteract a downturn. The Employment Act of 1946 contains a similar proviso to the effect that the Government's action to create and maintain conditions favorable to employment opportunities shall be "consistent with its needs and obligations and other essential considerations of national policy."

The Government's financial condition may be summarized as follows:

1. As a result of the maldistribution of tax collections cited in the answer to question 10 (*b*), it has been necessary in recent years to raise the debt ceiling temporarily in order to accommodate necessary financing;

2. It will be impossible to incur any substantial increase of deficit financing without a permanent rise of the debt ceiling;

3. The budget for 1959 is the highest peacetime budget in our history;

4. The country is entering on a new phase of the arms race which, without careful control, will increase the military spending. The burden of defense requires, as the President has said, reduced spending on civilian programs;

5. The taxload imposed by all levels of government on the people exceeds one-third of national income;

6. A review of Federal Reserve Board monetary and credit policies reveals that we have not, since World War II, been entirely free from intermittent inflationary pressures, resulting in part from budget deficits and in part from the built-in commitments to inflation.

Respondents to the question are asked to take into account significant indicators of the Government's financial condition such as those listed above in determining the point at which it should intervene in the recession. Presumably, it would be proper to express a judgment that the financial condition is such as to preclude any intervention. If such an answer were given now it would be academic, because the Government departments are speeding up the use of unobligated balances of appropriations and the congressional bill hopper is full of legislative proposals to deal with the recession. In the sharp focus of concern on corrective measures, too little attention has been given to the solid foundations of the economy. Sales are off but consumers are still spending at an annual rate above that for 1956; production is down but the rate of industrial production is still some 30 percent above what it was a decade ago; gross private domestic investment is down, largely because of a runoff of some $3 billion in inventory in the last quarter of 1957, which will hasten the time when fresh inventory buying must begin; unemployment is up but more than 60 million persons are still working. Moreover, it seems to have been forgotten that unemployment has not suddenly risen from zero to more than 5 million, but from a normal and probably ineradicable minimum of some 2,500,000 to 5 million plus. For the 9 prosperous years in the period 1947–57 inclusive, unemployment averaged 2,511,000. The particular individuals unemployed were not the same through these years for the average duration of unemployment ranged from 8.1 weeks in 1953 to 14.7 weeks in the second quarter of 1955. Looking for a new job, reluctance to move, unsatisfactory wages or working conditions, and personal prejudice against steady work, were among the causes.

It has been stated that the unions prefer layoff to shorter work time because unemployment benefits would then become payable. And it is well known that the unions would fight for unemployment as against wage reductions. Yet the fact is inescapable that it is better in every way for people to be at work than to be idle and "on the dole." The latter becomes more attractive financially as the unemployment benefit approaches closer to the weekly wage.

The sudden, substantial increase of unemployment which occurred during 1957 is a serious matter for those directly concerned and for the whole economy. A prompt correction of this condition is essential to economic health. In order that effective measures can be devised and applied, however, it is necessary to gain as much understanding as possible with regard to the classes of workers affected. The following tabulations may be helpful to this end.

The table which follows shows the net changes in the labor force and emloyment between January 1957 and February 1958. The figures are in thousands.

Date	Civilian labor force	Employment					Unemployment
		Agricultural	Nonagricultural			Total employment	
			Wage and salary workers	Other nonagricultural	Total nonagricultural		
January 1957	65,821	4,935	52,493	5,150	57,643	62,578	3,244
February 1958	67,160	4,830	51,151	6,007	57,158	61,988	5,173
Net change	+1,339	−105	−1,342	+857	−485	−590	+1,929

The net increase of unemployment between the 2 months, minus the drop in employment, equals the net increase in the labor force. It does not follow, however, that none of the newcomers to the labor force was employed, or that all of them were. The class of nonagricultural workers other than wage and salary workers is a derived figure, being the difference between wage and salary workers and the total of nonagricultural works. It is of interest that this class should have increased by 857,000 in a period when all other classes of workers were losing ground. The composition of the other nonagricultural class is not known, but it must include proprietors, self-employed, and domestic servants among others.

The heaviest loss in employment during this period was in the wage and salary group. Some details regarding this worker class are given in the table which follows:

Employment of wage and salary workers

[In thousands]

Classification	January 1957	February 1958	Change
Manufacturing:			
Durable goods	10,006	8,850	−1,156
Nondurable goods	7,047	6,787	−260
Mining	832	793	−39
Construction	2,963	2,702	−261
Wholesale and trade	11,465	11,598	+133
All government	7,310	7,516	+206
All other	12,870	12,905	+35

Here we have a picture of the relative incidence of unemployment. Its growth has not been universal. The total increase of employment in wholesale and trade, all government, and all other, 374,000, is not large but it is against the trend. Manufacturing accounted for 1,416,000 of the decline and more than four-fifths of the total drop was in durable goods manufacturing. It is in this area that the wage-price spiral has been especially prominent. The hourly and weekly wages in construction are the highest in the whole class of wage and salary workers, a fact which may have some bearing on the decline of housing starts.

The question under discussion advances two mutually inclusive alternatives of Government action, and an assumption that by following these sources of action, the Government could counteract a downturn in the economy.

The assumption should be dealt with first. In order to select appropriate measures for counteracting the downturn, or recession, it is necessary to understand its cause. In addition to the points made above, this matter is discussed further in the answer to question 17. In anticipation of that discussion, it can be said here that the alternative courses of action indicated in the question rest, in common, on a fallacious theory of how to regain and retain prosperity.

This is the purchasing power doctrine. It assumes that what the country needs is for the people to have more money to spend. Underlying this doctrine, as an explanation of the recession, must be the further assumption that for some reason a great deficiency of income and of spending has occurred. But this assumption does not fit the facts, for there has been no slump in spending so great as to justify resort to "pump priming" expenditures. Consumer spending in the last quarter of 1957 was at an annual rate above that for 1956, although it was down from $283.6 billion to $282.4 billion as compared with the preceding quarter. Total gross private domestic investment in 1957 was down from 1956 by $2.3 billion, but it was still higher than in any year prior to 1956. The decline was mainly the result of an inventory drop of $3 billion in the final quarter of 1957. The inventory of United States corporations was at an all-time record high at the end of the third quarter of 1957, and even after the corporate share of the runoff in the fourth quarter, the year-end corporate total was above the average of any previous year. Total Federal spending from budget and trust funds will be around $85 billion in 1958, and the same or more in 1959. State and local government spending will be not far from $50 billion in these years. With personal and business spending at or close to record highs, if total Government spending of some $135 billion would not be sufficient to prevent an economic downturn or to counteract it, once begun, it is a counsel of futility to advocate more public spending. The cause and the cure must be somewhere else.

The aspect of the current recession that is of greatest concern is the unemployment situation. Advocates of more spending seek, by this means, to provide jobs for the jobless. Large public works would mean more Government spending and a tax cut would mean more private spending. In either case, however, the result would be more spending, for the private spending would be added to public spending equal to or in excess of the budget estimates.

Since time is of the essence, there should be no difficulty about the choice. A tax cut would begin to operate at once and its impact would be universal, affecting all taxpayers throughout the country. In contrast, a public works program would have a spotty impact, limited to some communities and some industries. The more worthwhile the projects selected, the greater the delay in starting because of site acquisition, suitable plans, letting contracts, and assembling workers and materials.

The "useful employment opportunities" referred to in the Employment Act means jobs in which workers earn a wage or salary by adding to the total output of goods and services. They do not mean useless activities such as leaf raking, boondoggling, or other forms of made work.

The great danger in "large increases in public works" is that these will include a high proportion of useless projects and made work. The ill repute the rivers and harbors bills have had over many years is well known and well deserved. Other kinds of public works, authorized hastily and without competent justification, are very likely to be of a kind with the traditional "pork barrel" projects. If an increase of purchasing power would really do the trick it could be supplied most expeditiously by printing and distributing more money.

Counsel is divided over the kind of tax cut, if any, that should be made, because of the confusion of thinking in regard to the puposes to be served. The purpose, as conveyed by implication in the above question, is to increase purchasing power. One naive objection to tax reduction is that taxpayers might save some of the cut rather than spend all of it. Because of the obsession over purchasing power, tax gadgets such as higher exemptions, splitting the first bracket rate, or a tax holiday, have found favor. If Government spending were to be correspondingly reduced, a tax cut would not increase total purchasing power, but merely transfer its spending from the Government to the people.

But no reduction of Government spending is intended. Rather, it will be materially in excess of the budget estimates for 1958 and 1959 because of a belief, in Government circles, that more spending now is a good thing, even if such action repudiates the carefully drawn

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budget plans. In consequence, the prospect of a sizable deficit is not only conceded, but welcomed by advocates of spending.

Quite apart from the current economic situation, the need for tax rate revision has long been apparent. The President recognized this need in the budget message for 1958, in these words:

"It is my firm belief that tax rates are still too high and that we should look forward to further tax reductions as soon as they can be accomplished within a sound budget policy. Reductions in tax rates would give relief to taxpayers and would also release funds for the activity and investment necessary for sustained economic growth through private initiative."

If the President's conviction has been traslated into action a year ago, the purpose of the tax-rate reduction would have been clear. It would have been to "release funds for the activity and investment necessary for sustained economic growth through private initiative." As long as economic growth is sustained there can be no recession. Now the administration and the Congress are under the gun of a decision about tax cuts intead of tax rate revision. The objective has shifted from sustained economic growth to curing the recession.

It is still not to late to act sensible and courageously. The aim should not be merely a tax cut to cure the recession. Rather, it should be tax rate revision to assure economic growth. Even if a proper, long-range plan for systematic tax rate revision would result in a deficit for 1959, the country would be in no worse position on that account than it would be if the deficit were the result of spending or ill-considered tax cuts. On the contrary, it would be in a much better position because the invigorating effect of the right kind of tax action would promptly expand the taxable income base and thus provide revenue sufficient to eliminate the deficit gap.

There is no dynamic thrust from public works spending or ill-designed tax cuts. At best they constitute a gigantic national dole which would burden us indefinitely because it cannot lift the economy off the ground. In sharp contrast, an orderly, forward scheduling of tax-rate revision would be dynamic, and if it were enacted promptly, the psychology of recession would be dramatically dispelled.

There are various reasons for the relatively static effect of a mere increase of spending through public works or an ill-designed tax cut, as against the dynamic effect of an orderly forward scheduling of tax-rate reform.

First, a mere increase of spending, which would be made possible by a deficit-financed increase of the money supply, would have the result of validating the high wage-cost level produced by the advance of wage rates faster than national productivty. By thus undermining the forces tending to hold down additional wage increases of this sort, it would mean doing business at ever higher wage and price levels instead of increasing the rate of business activity itself. It will be recalled that 4 percentage points of the advance of gross national product in 1957 over 1956 was the product of inflation and only 1 percentage point was real economic growth.

Second, a mere increase of spending would have little effect on incentive. In contrast, the assured prospect of reducing the excessive rates of income tax down to a more moderate level in a series of steps would vitalize the incentives to earn more, save more, invest more in the future growth of the country. As the First National City Bank letter for March 1958 put it: "The first problem of recovery is to brighten the outlook for profits. This can be aided by forbearance with respect to wage and tax demands on industry."

Third, the prospect of an indefinite series of deficits would delay recovery by impairing business and investor confidence, particularly with respect to the ultimate value of long-term investments. The futility of spending for economic recovery was demonstrated in the 1930's. The aggregate deficit for the fiscal years 1931–39, inclusive, was $24 billion. Gross national product rose from $76.3 billion in 1931 to $91.1 billion in 1939, a net gain of $14.8 billion. The industrial production index moved up during this period by 18 points (on the 1947–49 base) and the wholesale price index showed a net gain of only 2.7 points. Gross private domestic investment rose only from $5.5 billion in 1931 to $9.3 billion in 1939.

On the other hand, any deficit that might be incurred at the outset under a forward scheduling of tax rate reduction would be promptly terminated because of the expansion of the taxable income base as the growth of the economy was resumed.

Fourth, the effect of a sudden injection of a substantial amount of new money into the economy as a result of large-scale deficits would present the threat of resumption of serious inflation. The Federal Reserve authorities would have an obligation to move promptly to curb this inflation before it worked damage and hardship on that large segment of the people who are dependent on fixed incomes. A policy of strict restraint would tend to neutralize any beneficial results that might, even temporarily, follow from the inflation. It would be sheer folly to legislate restrictions on Federal Reserve action aimed at preventing the application of monetary policies of restriction.

The conclusion that has been indicated above is inescapable. Ill-designed tax cuts will prolong our misery. Soundly devised plans for orderly forward scheduling of tax-rate revision will put us back on the highway to economic growth and progress.

Question 14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

Answer. In one respect this question involves relative magnitudes. The total deficits from 1940 through 1946 were $215,027 million. Here is the source of the inflationary conflagration that could not be extinguished. In the 11 years 1947 through 1957 there were 6 deficit years, with a total deficit of $25,696 million, and 5 surplus years, with a total surplus of $15,905 million. The net budget deficit for the 11 years was therefore $9,791 million.

Superficially it would appear that a net total deficit of some $9.8 billion over an 11-year period would be inflationary on net balance. But there were 2 surplus years at the beginning of the period (1947, 1948), 2 at the end (1956, 1957) and 1 in the middle (1951). The surplus years prevented the deficits from having an uninterrupted inflationary effect. It is necessary, further, to consider the extent to which these particular deficits were financed by the commercial banks.

The following condensed tabulation summarizes certain relevant data:

Periods (fiscal years)	Totals for periods		All commercial banks, at end of periods			All banks, time deposits
	Budget surplus (+) or deficit (−)	Debt increase (+) or decrease (−)	Loans and investments	United States governments	Demand deposits	
	Millions	*Millions*	*Billions*	*Billions*	*Billions*	*Billions*
1946	[1]−$20,676	[1]+$10,740	$119.4	$84.5	$96.0	$48.8
1947–48	+9,173	−17,130	113.9	64.8	90.8	54.1
1949–50	−4,933	+5,065	121.8	65.8	95.5	56.8
1951	+3,510	−2,135	126.0	58.5	102.5	57.4
1952–55	−20,763	+19,152	155.3	63.3	113.0	75.5
1956–57	+3,222	−3,847	165.6	55.5	115.7	85.2

[1] These figures are put in to complete the record. They do not enter into the subsequent account, which begins with the opening of the fiscal year 1947, on July 1, 1946.

Certain deductions from these figures are obvious.

First, there was a sharp decline of commercial bank holdings of government securities, partly through redemption and partly through sales made in order to lend or invest in other assets.

Second, there was relatively small commercial bank participation in the deficit financing after World War II—$1 billion out of $5 billion debt increase in 1949–50, and $4.8 billion out of $19.2 billion debt increase in the 1952–55 period. In the answer to question 3 the Federal Reserve Board's emphasis on avoidance of bank participation in the Korean war financing was noted.

Third, there was a steady rise of bank loans and investments other than government securities. The net increase in these items from June 30, 1946, to June 30, 1957, was $76.1 billion. The increase of money supply, as indicated by demand deposits in commercial banks, was $17.7 billion. But time deposits in all banks rose during the period by $36.4 billion. The general view is that time deposits are not part of the money supply, although there is some disagreement with this view.

Fourth, the velocity of circulation, which is not shown in the table, appears to have risen considerably. In 1946 the rate for "other leading cities" was 16.5. For 1957 the rate in 337 other centers (a different sample than that for 1946) was 23. The transfer of a substantial part of the bank deposit credits from a demand to a time status was counterbalanced in some degree by this rise of some 50 percent in the rate of turnover of the active deposits.

As a general conclusion it can be said that in the periods of deficit financing—namely, 1949–50 and 1952–55—there was an increase in the money supply which constituted a potential contribution to inflation. But there were also increases in the supply in 1951 and in 1956–57, when budget surpluses were the rule. A more important factor appears to have been the increased rate of velocity. Finally, the shift of deposits into time accounts held the inflationary pressure at a lower level than would have been the case if all of these deposits had remained in the active demand accounts. It is significant that the velocity rate in the 337 other centers dropped from 24 in August 1957 to 22.9 in January 1958.

Question 15. Can full employment goals be attained while maintaining a dollar that has relative stable purchasing power?

Answer. It was said, in the answer to question 11 (*b*) that the term "full employment" is inappropriate and misleading because there can never be a literal realization of it without drastic police methods to keep everyone continuously at work. The language of the Employment Act, which refers to those "able, willing, and seeking to work," provides a more realistic description of the employment goal. Another way to put it would be the maximum employment attainable in a free society.

The maintenance of such an employment goal and stable dollar purchasing power will depend on whether or not employer can provide jobs, keep people at work, and sell their product for enough to cover costs together with a reasonable profit, within the limits of a given money supply. The principal reason why they might not be able to do this would be an increase of costs such as would require an inflationary injection of new money to keep the business going. And the principal source of cost increase would be the advance of wages at a rate faster than the growth in national productivity. When this kind of disproportion between wages and output occurs, costs are increased because, even if physical units of output are increased, it is the equivalent of paying the workers more for doing less. For a time this excess of wage cost may be offset by technological and other cost-reducing improvements, but this is not likely to continue indefinitely. Sooner or later, the employer faces the choice between a smaller scale of operations, which means some unemployment, or excessive loans to finance his higher costs. When all employers are in this situation, the Government is likely to step in with enough credit inflation to validate the cost of the excessive wage increases.

Maximum employment and stable dollar purchasing power are reconcilable only if wages are kept in line with national productivity.

Question 16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

Answer. No. These provisions become a factor in a spiral of rising costs and rising prices which eventually would compel resort to inflation in order to validate them. Escalator-induced increases of wages in manufacturing, for example, lead to higher prices for manufactured products, which, in turn, are reflected in a higher Consumer Price Index. As consumer prices rise, the cost of living factor or escalator clause in wage contracts produces an automatic wage increase, and so the spiral continues. The higher cost of manufactured goods also increases the cost of the things that farmers must buy, and this affects the parity relationship with higher support prices for major farm products. These higher prices also find their way into the Consumer Price Index and give another boost to the escalator.

Question 17. List and briefly discuss what you consider the causes of the present recession and what should be done to terminate it.

Answer. The present economic situation shows the following characteristics:

1. Recession, as indicated by rising unemployment and falling industrial output.
2. Inflation, as indicated by rising prices.
3. Impaired prospects for long-term growth as indicated by the low level of net growth of business capital and dependence on inflation to support the load of business debt.

One of the causes of the economic condition which is revealed by the above symptoms is the stagnation of profits and the declining prospect of profitability commensurate with effort and risk in business venturers. This should surprise no one, for it is self-evident that profit, or the prospect of profit, is the driving force of our economy. When that prime mover loses power, the ponderous machine which we call the national economy begins to lose momentum.

The source of the squeeze on profits has been the upper millstone of labor costs rising at a faster rate than national productivity and the nether millstone of restrictive money policy. Inflation has been with us for so long that it had become a way of life. The business community had not only become accustomed to it, but had relied on it to validate the steadily rising cost level established by the pattern of wage increases, and also to make endurable the mountain of business debt that had been issued as the principal means of business financing. On the other hand, in the best judgment of the Federal Reserve Board, inflation has been and always will be a menace to stable economic growth and the general well-being. Its credit restriction policy through the third quarter of 1957 did not go so far as to halt all expansion of credit, but it did reduce the availability of credit and increase its cost. It has always been clearly understood that a continually increasing money supply will be required to finance a rising level of costs. In the present instance this rising cost level is caused by excessive wage increases. It has been equally well understood that if the money supply is not increased, the first impact of the squeeze caused by rising cost and restricted money supply would be on profits, which the result that unemployment would follow. In the answer to question 11 (*b*) it was said that employment and economic stability are compatible goals provided that wage increases are held within the limits of the growth in national productivity. The people are paying the price now for disregard of this fundamental principle. They would pay a heavier price, for a longer time, if inflation were resumed and tolerated to permit continued disregard of it.

Excessive income tax rates are a serious impediment to recovery from the recession and to stable economic growth because they weaken the incentives to produce and to save, and particularly the kind of saving that is motivated by intent to invest in equity capital. The return to vigorous economic growth will require resumption of capital formation at a level much above that now prevailing. Healthy financing of new capital must be done, in far greater proportion than heretofore, through equity investment if we are to avoid inflation for the purpose of underwriting business debt financing.

The foremost policy objective now should not be merely to find a cure for the recession but to chart a course that will put the country back on the highway of national advance through economic growth. In achieving this end, the recession will, of course, be terminated.

It is suggested that the main goal can be achieved, and with it the secondary goal of curing the recession, by a combination of three major legislative programs:

1. Legislation to restrain labor monopolies and the power of the large labor unions to raise costs. This will eliminate the condition which forces us to choose between inflation and unemployment.

2. Legislation to reform the income tax rate structure by a forward scheduling of tax rate reductions. This will remove the roadblock to capital formation.

3. Legislation to apply strict economy in Federal spending without impairment of essential national defense requirements. This will leave a maximum share of the Nation's output for the people to use in their own way and to provide for long-term growth.

NATIONAL ASSOCIATION OF FOOD CHAINS,
Washington, D. C., April 2, 1958.

Hon. HARRY F. BYRD,
United States Senate,
Washington, D. C.

MY DEAR SENATOR BYRD: I am sorry that the enclosed statement was delayed by a series of circumstances, but hope that it will serve a useful purpose.

It was prepared by economists in the food chain industry, and represents the views of some industry leaders.

Sincerely,

JOHN A. LOGAN,

COMMENTS SUBMITTED BY JOHN A. LOGAN, PRESIDENT OF THE NATIONAL ASSOCIATION OF FOOD CHAINS, RELATING TO QUESTIONS POSED BY THE UNITED STATES SENATE COMMITTEE ON FINANCE CONCERNING ECONOMIC POLICY AND OTHER MATTERS AFFECTING THE AMERICAN ECONOMY.

I. CONTROLLING INFLATION

Controlling wide swings in the general price level while promoting economic growth in production, demand and employment, is perhaps the most difficult problem facing the American people. Since World War II, increasing international responsibilities, defense needs and the growing demand for other governmental services have resulted in mushrooming Government expenditures. In the same period, the private sector of the economy has been growing at a substantial rate reflecting in part the catching-up process growing out of wartime shortages and the expansion of needs traceable directly to a growing population, a rising standard of living, and improving technology. The combination of large governmental expenditures and a dynamic private economy has taxed all of our resources to the fullest extent. Large-scale unemployment has been virtually nonexistent and there have been only three measurable interruptions in the upward trend of the economy—the 1948–49, 1953–54 and the 1957–58 recessions. The first two of these recessions proved short lived while the third has not yet run its course.

The postwar period has also been characterized by a rising price level which in turn was interrupted only by the recessions previously noted. In three distinct periods, 1946–48, 1950–53 and 1955–57, the price level advanced rapidly, giving rise in many quarters to the fear that price stability is an unobtainable objective and that price inflation is inevitable. There is no evidence to be gleaned from our postwar experiences which can be cited to refute this view although it should be recognized that our Government's monetary and fiscal powers have not been closely coordinated in the fight against inflation at any time in recent years.

Prior to the accord between the Treasury and the Federal Reserve System in 1951, the latter was ineffective in combating inflation primarily because of its policy of supporting the prices of Government securities at or near par. This policy permitted the banking system access to a supply of reserves while avoiding any substantial losses on securities sold for this purpose. As a consequence, the banks found it possible to expand loans and investments in direct relation to demand.

Following the accord, however, the Federal Reserve gained effective control of bank reserves and hence the creation and extinguishment of bank credit. Some critics point to the 1953-54 period arguing that the extreme monetary ease fostered by the Federal Reserve led to the rapid inflation of the last 3 years. Others might well find fault with Federal Reserve timing at several points in the 1955-57 period, but it should be noted that these failings seem clear only in retrospect. Recognizing the limitations of Federal Reserve powers, monetary policy has been a successful force in realizing the objectives of the Employment Act of 1946 including that of promoting economic growth in production, demand, and employment and moderating the upward bias of the price level. It might be interesting to speculate about the possible extent of the rise in the price level in the years 1955 through 1957 had the Federal Reserve not pursued a policy of monetary restraint as it did.

Fiscal and other Federal Government activities have not contributed particularly to the curbing of inflationary forces in recent years. The surpluses in the Federal cash budgets of the calendar years 1956 and 1957 were relatively small. Government expenditures at the Federal and local levels have been rising steadily since 1955 when inflationary pressures were developing. Ignoring defense needs, international and domestic problems and political factors, expenditures might logically have been cut and/or tax rates raised in that period in the interest of slowing the rise in the price level and the improvement in overall business activity. However, the Federal Government has not been in a position to follow a truly compensatory fiscal policy at any time during the postwar period with the exception of the 1953-54 recession when timely tax cuts took effect and stimulated the economy.

While thoroughly coordinated and implemented monetary and fiscal policies hold some promise in achievement of price stability and full employment, there is one area where the logic of the situation and observed facts indicate that a certain relationship must exist if a stable price level is to result. Reference in this case is made to wage rates and the need to keep the increase in the general average of wage rates within the limits of the increase in the average level of productivity. Without this condition, no public or private action can be more than partially successful in providing both stable prices and full employment. With this condition satisfied, however, a variety of policy combinations might conceivably succeed in preventing inflation.

Compensation of employees makes up about 70 percent of the national income and consequently constitutes the bulk of the spending power in this country. It is inconceivable that any sustained rise in the price level could occur without a rise in employee compensation sufficient to sustain it—that is, a rise in employee compensation greater than the rise in production. If the rise in employee compensation is kept within the limits of the rise in physical output or if employee compensation per man-hour increases no more rapidly than output per man-hour, then any sustained rise in prices would be inconceivable. Any attempt to raise prices would merely result in reduced sales because the general public would not have the wherewithal to pay these prices.

With employee compensation contributing such a large fraction of total national income, the argument over whether inflation is caused by a "demand pull" or a "cost push" is to a large extent irrelevant; in either case it is employee compensation which is the source of the pull or the push. What happens in the area of profits, farm income, or the income of proprietors and professional people is relatively insignificant by comparison. In fact, it has been suggested that the price level is a function of wage costs pure and simple.

Examination of the facts suggests the same thing. The comparison of sales with compensation of employees for all United States corporations, indicates that the relationship has been amazingly close since 1929. This is what one would expect from the theoretical considerations. The relationship between the broad price indexes and employee compensation per unit of real sales is also very close.

The conclusion thus seems inescapable. The question of controlling inflation involves finding ways and means of holding the rise in employee compensation to the limits set by the rise in production. Attention must be focused at the place where wages are determined, that is, at the bargaining table between labor and management. For it is here where restraint must be exercised if at all. We require a general understanding by the public that our standard of living can only be improved through greater productivity and not at all through general increases in wages beyond the growth in productivity.

Our inflation problems are traceable directly to the pattern-setting industries, namely autos, steel and other metals. For example, the Ford settlement of 1955 touched off a round of annual wage increases which were not only in excess of productivity but were built in for successive years in long-term contracts. This inflationary pattern of recent years cannot be altered successfully unless the general public understands the consequences of these contracts, supports legislation that will equalize power at the bargaining table and thereby provide the means for effective resistance to increases in wages exceeding increases in productivity.

II. OBJECTIVES OF ECONOMIC POLICY

In light of the present world situation requiring as it does huge defense expenditures and substantial amounts of foreign aid to our allies and underdeveloped nations, the prime objective of economic policy in the United States must be the promotion of economic growth in production, demand and employment. Mere stability in production, demand and employment over the long run will result in increasing real costs of our defense programs and lessen our ability to bear the burdens of free-world leadership. Continued advancement in science and technology upon which an effective defense effort must be based is also the foundation for an expanding capacity to produce a greater volume of nondefense goods and services.

The objectives of rapid economic growth and broadened defense capabilities are mutually consistent and reinforce each other.

Employment of 95 percent or better of the labor force is a desirable objective in our society. If realization of this goal should conflict with maintaining a stable price level, there is little question about which goal would be chosen by the American people. The first aim is to maximize the production and income of the country.

However, the goal of maximum production and real income under the free-price system can best be achieved with a stable general price level. A stable price level offers the most concrete base for the formulation of plans by businesses and individuals, and the making of contracts which extend over a period of time, thus contributing to efficiency. It avoids the inequities that result from changes in the purchasing power of the money unit.

III. THE CURRENT RECESSION

On the basis of the facts now available, the current recession stems largely from the liquidation of inventories primarily at the manufacturers' level and from a general decline in plant and equipment expenditures beginning in the fourth quarter of 1957. Nearly all of the dollar change in the gross national product account in the fourth quarter of last year is directly attributable to a swing of $5.7 billions in inventories between the third and fourth quarters. The dollar decline in plant and equipment expenditures amounted to about $1.5 billion in the final quarter of 1957.

The current recession thus resembles those of 1948–49 and 1953–54 from the standpoint of causation. It remains to be seen whether the 1957–58 decline will be reversed shortly in the pattern of the other two postwar recessions. The answer depends to a large extent on the timing and magnitude of Government action in the fiscal area. This, however, should not be regarded as a substitute for earnest, intelligent action by private industry to stimulate business confidence and action.

With respect to palliatives, the Federal Reserve has completely reversed its policy of monetary restraint in effect through the fall of 1957 and has since moderated the decline in the money supply and has brought about a drastic change in the level of interest rates. On the other hand, the Treasury has proved to be a disruptive force in the money market since last November, offering several issues of medium- to long-term bonds in an attempt to lengthen the average maturity of the public debt. These offerings were made in direct competition with private offerings and increased congestion in the long-term bond market. In this way, the Treasury offerings neutralized in part of the efforts of the Federal Reserve in promoting monetary ease. It now appears that the April Treasury financing will be placed in the short-term sector of the money market thereby contributing to the effectiveness of Federal actions.

Late in March 1958, it is difficult to find evidence that Government action on the fiscal front designed specifically to curb the downward trend in busines has yet been sufficiently effective. The cumbersome nature of the expenditure side of fiscal policy as it is used in fighting a recession is illustrated by the fact that although many proposals are being debated in Congress, few positive steps have been taken. Expenditures of the Federal Government are trending slowly upward. It may well develop that Government expenditures will not increase sharply until after the economy has bottomed out and an upward trend is underway. Accelerating expenditures at that time might reinforce the upturn and complicate the problem of maintaining a sustainable rate of growth in the economy and a stable price level.

The revenue side of fiscal policy is being debated vigorously and the administration is resisting an immediate tax cut apparently because of the spector of budget imbalance a year or so in the future. Political factors aside, tax cutting remains one of the most effective weapons in the hands of the Government, its flexibility nearly matching that of monetary policy. Many economists have called for an immediate tax cut. The logic of this argument is difficult to deny. An across-the-board tax cut seems advisable in the present situation and such a move is clearly preferable to a broad increase in expenditures for public works and other projects which cannot easily be terminated when the need of stimulus to the economy passes.

In considering the tax-cut measure, it would be appropriate to examine the possibility of revising the overall tax structure in an effort to eliminate long-standing inequities. Reference in this case is made to certain of the excises and the personal income tax which might well be revised in the interest of increasing incentives and productivity. To quote a recent report of the Joint Economic Committee, "Constructive tax revision aimed at greater neutrality in the impact of our revenue laws on the ways in which taxpayers use the resources at their disposal has become more urgent than ever in light of the new challenges currently confronting the Nation." However, studies of basic revisions in the tax laws should not delay an immediate tax cut designed to accelerate the recovery in business.

IV. THE FUNCTION OF DEBT

Private debt has grown sharply in recent years in contrast to the near stability of the public debt. In fact, in the 10 years ended in 1955, the growth in the private debt accounted for about 90 percent of the increase in the gross debt of the people of the United States reflecting the rapid acceleration of spending in the private sector of the economy and approximate balance in governmental accounts.

The growth of this debt also reflects the equally rapid gain in the savings capacity of the American people since debt instruments represent the most important means by which savings are channeled into productive investments. For this reason, the vitality and the growth of our economic system are directly measurable by the increase in debt, whether it be public or private. Thus, as the economy expands, so so will the aggregate debt.

There is little doubt that debt creation and extinguishment are potentially destabilizing forces as far as the total economy is concerned. This, after all, is the rationale of an effective monetary policy. Monetary restraint such as applied by the Federal Reserve in the last 3 years limits the expension of credit and hence the growth in debt. In contrast, a policy of monetary ease such as that now in effect in this country encourages the creation of debt and the expansion of credit.

It is the function of monetary policy to limit the growth in debt to a sustainable rate. Otherwise, unbridled debt expansion will pave the way for contraction in the economy and deflation.

CHARLES TOWN, W. VA., *April 15, 1958.*

Hon. HARRY F. BYRD,
Chairman, United States Senate Committee on Finance,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: In accordance with your request of February 17, 1958, I am enclosing herewith a memorandum on the problem of price stabilization. It has seemed to me that I could make a more useful contribution by means of a carefully prepared analysis than through answering a series of questions.

Trusting this will be of use to your committee,

Sincerely yours,

HAROLD G. MOULTON,
President Emeritus, The Brookings Institution.

Enclosure.

MEMORANDUM FOR UNITED STATES SENATE COMMITTEE ON FINANCE

This memorandum will be focused not on the maintenance of economic prosperity but on the problem of preventing inflation. It will be divided into two parts: (1) What forces have been responsible for the great rise in prices in recent times—since World War II; and (2) Can the price level be controlled by Government policies?

I. According to traditional economic analysis a general rise in prices is caused by a disproportionate increase in the quantity of money in circulation as compared with the quantity of goods. The increased money supply is usually said to be the result of credit extensions either by private banking institutions or by the Government. During the period here under review Government deficit financing is commonly held to be of primary importance.

Since the end of World War II price movements show no correlation with the state of the Federal budget. The following facts should be carefully noted:

1. The period of most rapid postwar price advances was in the years 1946–48. In the last fiscal year of the war period, ending June 30, 1945, the cash deficit had been $49.5 billion. In the ensuing fiscal year this was reduced to $7.4 billions; while in the fiscal years 1947 and 1948 there were cash surpluses of $19.4 billions and $7.3 billions, respectively.

2. The next sharpest advance came between June 1950 and February 1951. In the fiscal year ending June 30, 1950, there had been a cash deficit of $4.2 billion. But in fiscal 1951 there was surplus of $5.8 billion.

3. The latest substantial advance in the wholesale price index came in 1956–57. In the calendar years 1951 through 1957 there was again no correlation between price trends and the budget situation. The table which follows shows the net yearly results of Treasury operations (cash basis) and wholesale prices during these years.[1]

[1] Annual Report of the Secretary of the Treasury, June 30, 1957, p. 400.

Year	Net surplus or deficit	Wholesale price index
	Millions	
1951	+7,593	114.8
1952	+49	111.6
1953	−5,274	110.1
1954	−232	110.3
1955	−2,702	110.7
1956	+4,471	114.3
1957	+2,099	117.6

In the deficit fiscal years 1953, 1954, and 1955 prices remained practically stable. In 1956 and 1957 there were substantial surpluses; meanwhile prices rose sharply.

One should not of course conclude from this inverse correlation that surpluses cause rising prices and that deficits cause falling prices. As we shall later see, the factors responsible for the price trend were nonfiscal in character. It should be added that the fact that budget deficits do not necessarily cause price advances does not of course warrant the conclusion that the state of Treasury finances and the growth of the public debt is a matter of no importance. For other reasons the maintenance of fiscal stability is a fundamental requirement.

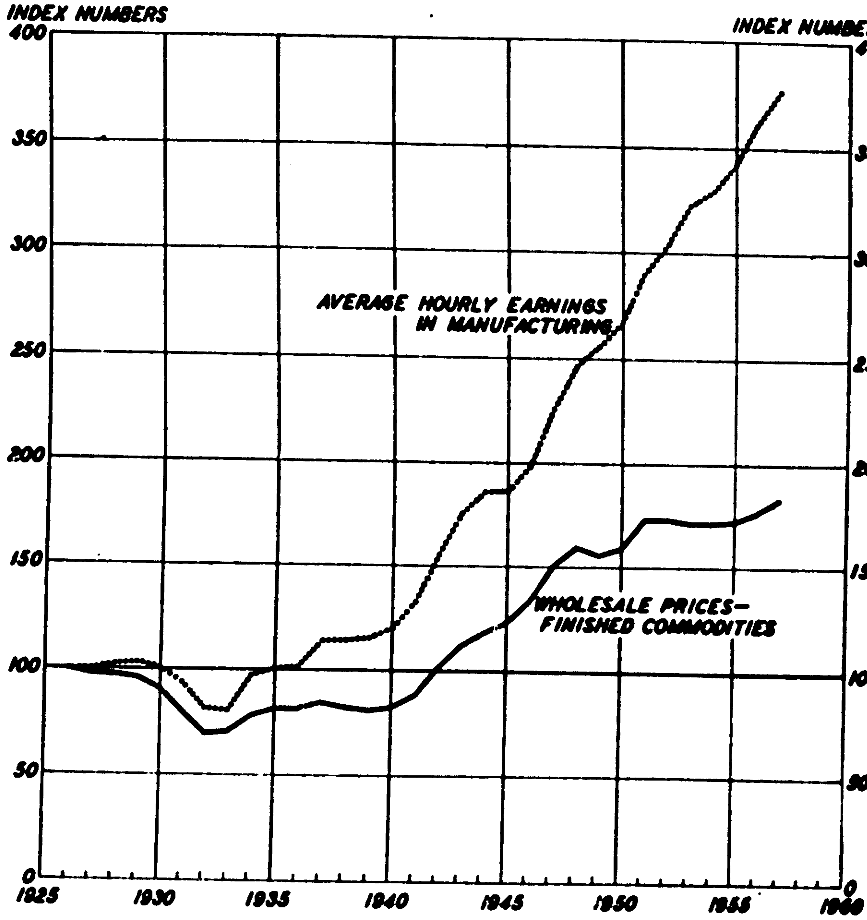
HOW MONEY GETS INTO CIRCULATION

The assumption has long prevailed that when credit currency is created the money supply is automatically increased without any corresponding increase in the quantity of goods. When more money is spent for the same goods the result is said to be rising prices.

This conception ignores the process by which money gets into the channels of circulation. Money gets into the hands of the people almost entirely through pay envelopes—enclosing wages, interest, rents, and dividends. The national income available for expenditure or saving is simply the sum total of the disbursements for wages, interest, rents, and dividends. In addition there are minor outlays for relief and subsidy. There are no other circuits through which money reaches the people. Hence, the supply of money as compared with the supply of goods is governed by the ratio of rates of pay for services rendered to man-hour output.

The supply of money as compared with the supply of goods will increase only if more money is paid out for the same productive output than formerly. Since wages and salaries account for over 70 percent of the total money income—rates of pay for work done are of decisive importance. The significance of the wage cost factor may be indicated as follows: At the present time a general increase of 10 percent in wage rates would increase money in the hands of the people by roughly $25 billion a year—an increase which manifests itself first as a cost of production.

The accompanying chart shows the trend of hourly earnings in manufacturing as compared with the movement of wholesale prices from 1926 through 1957. During the greater part of this period and especially since World War II wage rates have risen progressively faster than the wholesale prices of finished commodities.



This progressive increase in rates of pay is a primary cost factor—exerting an unrelenting pressure toward higher prices. While prices did not rise as fast as wages, profits were nonetheless well sustained. This was of course made possible by the offsetting gain from the increase in productivity that occurred during this period. Man-hour output did not however increase in proportion to rates of pay.

CAN MONETARY AND FISCAL POLICY PREVENT INFLATION?

The money income available for expenditure cannot be directly controlled by either Federal Reserve or Treasury policies. Since neither the Federal Reserve nor the Treasury is vested with power over wage rates, they cannot prevent more money being paid out for a given volume of production. Wages may rise irrespective of deficits or surpluses in the Treasury. Whatever the state of the budget, if wages and other costs are rising, prices will rise.

Raising interest rates cannot prevent a long-term upward price trend based on rising costs. Since the Federal Reserve officials have not been vested with authority over wage or other contracts they have no direct control over costs. To stabilize prices it would be necessary first to stabilize wage rates, interest, rental rates, customs duties, and excise and sales taxes.

The Federal Reserve and banking system may indeed affect the situation indirectly by outright restrictions on credit extensions; for obviously if more funds are not obtainable higher wages cannot be paid. But such a policy has serious economic repercussions, leading to business recession and unemployment.

RAMIFICATIONS OF THE COST-PRICE SYSTEM

Some sectors of the economy are not conducted on a strictly cost accounting basis. Historically, the great bulk of farm produce has been sold for what it will bring in local or central market places. Thus supply and demand has played a much more direct role than is the case in manufacturing or transportation.

In modern times, however, the greater part of agriculture has become articulated with the industrial cost-price structure. The relative decline of agricultural prices led eventually to Federal legislation designed to maintain agricultural prices at levels comparable to industrial prices. In brief, under the so-called parity principle it is the duty of the Government to keep the prices of the things the farmer has to sell to urban consumers in line with the things he has to buy from urban producers. The mechanism involves Government purchases to the extent necessary to support farm prices at the levels stipulated by the parity formula.

Thus agricultural prices are now linked directly with the industrial cost-price structure. Any increase in the level of costs and prices in mining, manufacturing, or transportation requires, under the law, compensating, upward adjustments in the prices of cotton, wheat, corn, and many other agricultural commodities.

To follow the complete circle of interconnection between industrial and agricultural prices, we may start with an increase in wage rates in the steel industry. A resulting advance in the price of steel products means an increase in costs over the wide range of industries using steel—notably transportation, construction, hardware, farm machinery, and automotive vehicles. These advances in costs shortly find reflection in the prices charged by these industries for their goods and services; and in turn (through the operation of the parity system) in the prices of farm produce and foodstuffs. In due course, the rising cost of retail prices of foodstuffs impels demands for compensating increases in wages. Where the escalator principle is incorporated in wage contracts, an automatic upward adjustment of wages is guaranteed. In this example we assumed the initial impetus came from wage increases in the steel industry. A similar sequence would follow whether the initial advance was in steel or transportation, or some other industry; and whether it began with wage increases, or independent advances in prices.

The impact of industrial price advances is soon felt throughout all sectors of the economy. A rise in the price of manufactured goods directly affects the costs of construction and supplies required by financial and service agencies, hospital and educational institutions, and in the manifold activities of Governments, Federal, State, and local. Moreover, as the cost of living increases, compensating increases in salaries, wages, fees, etc., become necessary in every field of activity. Finally, the rising costs of Government operations necessitate increased taxes which in some cases become a part of the industrial cost structure.

GAGING THE FUTURE OF PRICES

Two factors will be of decisive influence in determining the future trend of prices: (1) the rate of technological progress—which governs the output per man per hour; and (2) the wage and salary rates paid to employees. Increasing productive efficiency—a cost-reducing factor—exerts pressure toward lower prices. Increasing wages—a cost-raising factor—exerts pressure toward higher prices.

The outcome in the years ahead will reflect the relative weight of these factors—man-hour output and rates of pay. To state the alternative possibilities in simplest terms: (1) If rates of pay and man-hour output increase equally, prices will be nearly stable; (2) if rates of pay increase faster than productivity, prices will rise; (3) if productivity increases faster than wages, the price trend will be downward, assuming of course the existence of effective competition.

It is impossible to know whether the recent rate of technological progress can be maintained or increased. Since World War II we have witnessed an extraordinary burst of creative energy, resulting in a vast expansion of improved industrial plants, with installed equipment of ever-increasing efficiency. Another factor serving greatly to increase aggregate annual output in recent years has been a minimum of strikes and a sustained high level of operations. Thus one may well question whether the recent rate of increase in man-hour output can be sustained indefinitely. However, former fears that we shall soon be faced with decreasing productivity because of the exhaustion of virgin resources have been virtually eliminated. Even in agriculture, modern science and technology are combining to produce much higher yields per acre than was formerly deemed possible.[2]

On the cost side, it appears certain that continuing increases in wage rates will be a powerful force working for progressively higher prices of industrial products. The wage items (embedded in raw materials, transportation, fuel, and power, as well as directly in the manufacturing process) has, as we have seen, become of preponderant importance. And the economic and political power of modern labor organizations is such that continued pressure for higher rates of pay is to be expected. Escalator clauses in labor contracts, designed to lessen industrial strife, serve nevertheless to accelerate the inflation process.

The advance in wage rate, one may venture to guess, will in the future, as in recent years, continue to outstrip improvements in productive efficiency. If so, we shall have a progressive increase in the general level of commodity prices over the coming decades. Only a depression of major proportions, resulting in a substantial reduction of wage rates would reverse the trend. Even in such an event the upward movement would doubtless be resumed in the not distant future.

Respectfully submitted.

HAROLD G. MOULTON,
President Emeritus, the Brookings Institution.

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[2] For extensive discussion of the adequacy of our national resources, see the author's Controlling Factors in Economic Development.

NATIONAL GRANGE,
Washington, D. C., April 14, 1958.

The Honorable HARRY F. BYRD,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: In response to your letter of February 17, I am setting forth in the attached statement a number of my views relating to the Nation's economy. By the nature of things, I have not been associated closely enough with some of the matters included in your list of questions to venture informed comment. I have, however, given serious thought to the subject matter you have presented and I appreciate the privilege of submitting my views for consideration of the Senate Finance Committee.

May I say that you and the members of your committee are performing a vital public service in your current investigation of the financial condition of the United States. This is a matter of critical importance and on behalf of the National Grange I take this opportunity to express our appreciation and deep interest in your efforts.

Respectfully yours,

HERSCHEL D. NEWSOM, *Master.*

OPINIONS ON THE STATE OF THE NATION'S ECONOMY

By Herschel D. Newsom, master, the National Grange, in response to questions presented by the chairman of the Senate Finance Committee in connection with an investigation of the financial condition of the United States

It may be elementary but it is well worth reemphasizing that a basic objective in the operation of the Nation's economic system should be the attainment of an economic equilibrium in the system with a maximum of harmony between the major forces functioning in it.

Such equilibrium and harmony are obviously difficult to attain, especially since the many national and international elements influencing the character of the economy annually grow more complex. As a consequence, every possible effort must be made constantly in this direction, because the very survival of the American form of government is at stake.

The continuing test of strength between the free world and the Communist world, widely known as the cold war, is fundamentally a battle of economic strength. Any prolonged weakening in our domestic economy would surely decay the foundations of the anti-Communist drive.

Even aside from considerations of the cold war, if that were hypothetically possible, we are dedicated in the United States to the proposition that a capitalistic system can continue and flourish, providing for the people a degree of progress, freedom, and prosperity unmatched by any other system. Our present responsibility, therefore, is to demonstrate that capitalism is equal to the pressures and requirements of the industrial-atomic age.

As the Congress has fortunately recognized, there is ample reason to be persistent and deliberate in the current investigation of the financial condition of the United States. New dimensions are functioning in our economy. For example: Unprecedented concentrations of economic power have developed in both industry and labor. Taxing and spending for military-economic defense operations have reached critically high levels. The public debt with its accompanying charges has risen to an unparalleled height. And the magnitude of Government expenditures for all purposes has grown to a point that it significantly affects the entire economic structure.

Familiar economic elements are not acting in familiar ways. Commodity prices have been advancing, for example, during a period of declining consumer buying and rising unemployment. Inflationary and deflationary forces are at work simultaneously.

The traditional conceptions of inflation and deflation are being challenged by the abnormal experience of the current decade.

Classic definitions of inflation are now less than serviceable. It is not adequate, for example, to call inflation an abnormal increase in the quantity of purchasing power, or a situation of too much money chasing too few goods.

There are no critical or even widespread shortages of consumer goods. Stocks of most items have been more than plentiful. In many parts of industry, as in agriculture, productive capacity is not being fully utilized and production schedules have been cut back in response to slackening demand on the part of consumers.

Nor can it be said that there is an abnormal or even unusual quantity of purchasing power bidding up the prices of goods.

There is not, in short, a big excess of demand over supply—the circumstance long regarded as basic to inflation.

Inflation has now become something different and more complicated. To attempt to define it, in the light of currently inconstant conditions, is a hazardous business. At this stage, however, inflation appears to be a continuing decline in the value of money as the consequence of continuing institutionalized adjustments upward in the valuations of goods and services.

For the time being, at least, developments within our system have permitted the pressures for higher commodity prices, wages, rents, and compensation on the part of major sectors of the economy to overbalance the downward pressures traditionally expected and derived from a vigorous competitive situation.

En bloc adjustments upward in wage scales for entire industries, for example, and industrywide price increases for commodities and manufactured items have been a significant element in the institutionalized, massive upward pressure. Relatively unorganized but also concerted have been the progressive upward movements in rents and in compensation for personal services of virtually all types, including the trades and professions.

As each institutionalized sector of the economy has capitalized on its opportunities for upward revision, it has generated action in other sectors for what may be called compensatory increases.

The timing and amounts of the increases have in all instances been deft and this has been a notable characteristic of the entire upward progression. Almost invariably the intervals between increases, and the sums involved in each increase, have had the appearance of moderation or reasonableness. By avoiding the flagrant, no direct countervailing reaction on the part of consumers was ever set in motion. The current decline in consumer purchasing has little of the aspect of a buyers' strike.

A major reason for the relatively passive acceptance of the institutionalized rises that have served to depreciate the value of money, has been the cushioning role of agriculture in recent years. Agriculture alone among the major segments of the economy has been unable to organize itself for purposes of institutional bargaining or compensatory increases.

Farm income has declined progressively since the war period. As a result, increases obtained for transportation, processing, distribution and other aspects of food marketing have not been passed along to consumers in the form of corresponding increases in the prices of food items. Farmers have absorbed an important share of the increases and to this day continue in a disadvantaged position, with no reasonable recourse against the progressive rise in their costs and taxes.

To the extent that farmers have absorbed potential increases in food-item prices, they have smoothed the way for the upward progression elsewhere in the economy, but at the cost of increasing imbalance.

The classic consequence of progressive inflation is, of course, deflation—on the theory that "all that goes up must come down." If the deflation is severe, it customarily bears the name of recession or depression.

Deflation is a condition marked by a reduction in the volume of money and in the velocity of its movement, with a consequent reduction in the volume of purchasing power.

Part of the parodox of the day is that we appear to be experiencing simultaneously aspects of both inflation and deflation.

As prices have been moving upward in recent years, the supply of money has not increased proportionately. Indeed, increasing amounts of money have been siphoned out of normal channels of capital investment, savings, and private consumption by the progressive growth in Federal, State, and local tax levies.

The economic implications of current Government spending, especially for military equipment and services in this era of intercontinental missiles and hydrogen bombs, have not yet been adequately appraised. There is reason for the strong belief, however, that Government spending of the present magnitude not only bids up the prices of services (and certain categories of goods) but reduces (through taxation) the volume of effective consumer purchasing power.

The fact of the continuing "cold war" adds fresh complications to our already complex problem—the attainment of economic equlibrium in a capitalistic system where the forces of competition have been blunted, at least.

Because of the cold war we find justification for the unbalanced budget and an ascending public debt. Defense requirements serve to subordinate peacetime standards of "pay-as-you-go."

Obviously, survival of the Nation in the cold war supersedes all other consideration. We are assuming obligations and making expenditures directly and indirectly related to the war because the circumstances do not appear to allow any acceptable alternative. Until the international issues can be resolved, the United States cannot do otherwise than prepare its defenses and use its resources in every way calculated to assure us, ultimately, of a satisfactory conclusion.

Even aside from these enormously unsettling effects of the cold war, it must be recognized that the economy of the United States is a dynamic thing, undergoing constant evolutionary change.

The development of automation, the concentrations of economic power in large sectors of industry and labor, the rapidly expanding population, the expanding influence of governmental fiscal policy, the mounting importance of consumer attitudes, and the enunciation as Government policy "the full employment" concept, have all introduced new influences into the ever-shifting structure of the American economy.

These are not the only new and modifying elements, of course, but they are indicative of the economic inconstancy of our times. They point to the utter necessity for a continuing analysis of the American economic scene in order to provide the Nation and Congress with the best informed basis for actions in behalf of harmony and balance in our system.

They also point to the intricacy and interrelationship of the varied elements in our economy. The effect of any single factor can be appraised most usefully in terms of its relationship with the others.

The effect of deficit spending by Federal, State, and local governments since World War II, for example, was undoubtedly inflationary—if this spending could be isolated from the functioning of other factors. Under cold war circumstances, however, this spending may also have served as a vital determent to the deflationary tendencies of heavy taxation and expenditures for military weapons and equipment.

Management of the public debt, the functioning of escalator provisions in wage contracts, the level and timing of public-works programs, the managed contraction and expansion of credit, and the character of taxation are among the other major factors which modify, each in their own way, the Nation's economic balance. It is the aggregate effect, however, which must concern us.

In steering a course toward economic equilibrium, we also need to evaluate on a continuing basis the economic reaction of business management and the consuming public to events and circumstances which influence attitudes. At what point, and for what reason or set of reasons, does the attitude of a vast segment of the population change from one of confidence to caution—or from a disposition to buy instead of to save?

Intangible factors are also present in critical decisions by business and industry. As management undertakes to estimate consumer attitudes and business probabilities, it may decide to move boldly or proceed conservatively with respect to capital investment, expansion, and the willingness to assume financial obligations.

Nothing less than the most expert and objective analysis, carried on continuously, can be counted on to provide a reliable evaluation of the influences being exerted by the various factors of the economy—and their aggregate effect in the direction of inflation or deflation. Nothing less than such an analysis will provide the information and the guidelines essential to intelligent actions in and out of Government in behalf of economic equilibrium.

Under the Constitution, the Congress has the responsibility for making the basic fiscal and monetary decisions of the Nation. The manifold responsibilities of individuals of Members of the Senate and the House of Representatives, however, are well recognized. As the economy of the United States has become increasingly more complex, and vital, the Congress has faced an increasingly difficult and time-consuming job in appraising and understanding all its aspects.

The executive branch, under these circumstances, has been forthright in advocating fiscal and monetary policies. Yet each administration holding the Executive offices properly and naturally represents a particular economic viewpoint. This is not necessarily a comprehensive or completely objective viewpoint. Moreover, the opportunity is present, whether or not it is used, for political modifications of economic positions.

Considering the unsurpassed importance of economic policy and governmental economic action on the well-being and destiny of the Nation, these circumstances are less than satisfactory. As at least one major improvement, Congress should provide itself on a permanent basis with an advisory economic body of the most capable men available in the country.

Such a body or congressional Commission on Economic Affairs should be invested with a status commanding the highest possible degree of congressional and public confidence in its proficiency, integrity, and dedication to the national well-being. Obviously its membership should be selected without political consideration. Tenure in office and remuneration should be commensurate with the caliber, dignity, and scrupulous independence required of men engaged in such high assignment.

As the economic arm of the Congress and its appropriate committees, such a body could engage in a continuing, comprehensive analysis and evaluation of the elements influencing the Nation's economic health, serve as expert counsel to the Congress during its consideration of economic matters, and help to enhance the accuracy, speed, and effectiveness of the Nation's economic decisions.

NATIONAL FARMERS UNION,
Washington, D. C., April 8, 1958.

Senator HARRY F. BYRD,
Chairman, Senate Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: This is in reply to your letter of February 17, 1958, requesting certain information concerning the state of the economy and the growing numbers of unemployed.

May I say, Senator, that one of the major aspects of the situation that comes to my attention daily is the long-continued drop in farm prices and farm family incomes brought about by reduced effectiveness of the Federal farm income improvement program, by the tight money and high and rising interest-rate policies, and by the ever-increasing processing and marketing margins in the food industry and higher prices for the industrial products and professional services that farm families must buy for production and family living.

1. Deflation (from the agricultural standpoint): It's when the income level of the farmer declines (regardless of cause or actual direction of its movement, i. e., up or down or unchanged) in relation either to (1) his own past income level or to (2) the general income level of the country. In the first instance, the farmer's debts become more burdensome and/or the returns on his investment (land, equipment, labor, etc.) fall. In the latter case, there is the added disadvantage that the cost of things he buys currently will be rising relatively, in reflection of the increase in the proportion of the national income going to nonfarm.

Inflation (same standpoint): In general, this is the opposite of deflation, as defined above. However, it is questionable whether the term should be applied to an incline in the farmer's share of the national income until it approximates full parity with nonfarm income. This share now stands at less than 50 percent of parity, taking account of the farmer's investment, labor input, management responsibilities, etc. Inflation, of course, lowers the relative buying power of money received from fixed agricultural investments drawing fixed interest rates. It also tends to drive up the price of farmland, too often to a level that proves burdensome, if not disastrous, to the purchaser when and if there is a drop in farm income later on.

One of the anomalies of the past few years, of course, has been the deflation of the farm economy of this country taking place at the same time that the nonfarm aggregate was subjected to inflation.

2. Our Nation should maintain a constantly expanding economy equal to growing population and productivity per man with adequately distributed income and leisure such that human values will be at a maximum and all that is produced can be purchased and invested or consumed. Many changes in existing laws are required, some of which will be specified below.

3. The monetary controls prior to 1950 seemed, in my view, to meet the needs rather well. Since 1951, it has seemed to me that the pro-

gram has been operated more in the interest of large bankers and strong industrial corporations than in the general interest.

4. Certainly an outstanding factor in the decline of the dollar's value has been price administration by oligopolistic corporations to whom our laws and customs had given, either by commission or omission, the authority and right to exercise control over price through control over market supply. The most dramatic example, of course, is the steel industry which deliberately raised prices by $6 per ton and cut production, by this week to as low as 49.7 percent of capacity.

5. Management of the public debt and related monetary and credit policies of the Federal Government determine the rate of interest and the supply of money which have a pervading effect upon the rate of investment and of consumer expenditures in a multitude of ways.

6. Insofar as it is consistent with other national goals, the Government should maintain price stability. The national economic policy should be to maintain full employment with adequate leisure and opportunity for full development. Under current circumstances this can only be attained through continuous economic growth of consumption, demand, and production. To the extent that a growth rate required to maintain full employment is allowed to result in price inflation, the required institutional changes should be initiated so that these aims will not in reality be inconsistent.

The record since August 1956 seems to indicate clearly that monopolistic, administered pricing brings about price inflation even when unemployment is increasing and income deflationary forces are at work. This calls for means to require that boards of directors of such firms take national economic goals into consideration in establishing their production and price policies.

7. State and local governments in many cases are spending just about all they can afford or should be asked to spend, considering their sources of revenue and their current taxation devices. Federal expenditures have not been large enough nor directed to high priority national goals. Because it is based primarily on ability and can get at taxable wealth no matter where it moves, the Federal system of raising revenue permits of more equitable treatment both in collection and distribution.

8. Existing local, State and Federal tax systems, taken singly or combined, insufficiently promote an appropriate balanced national economic growth, provide unfair loopholes to a privileged few and place unfair heavy burdens upon those less able to pay.

9. I subscribe to the following paragraphs of the National Farmers Union program adopted by delegates to our recent national convention in Denver:

"National monetary and credit policies should be designed to make adequate funds available at minimum rates of interest so that desirable productive investment will be encouraged. Selective controls should be used to curb inflation if it occurs, and monetary and credit policies should also be used to maintain a positive expanding full employment economy.

"Federal budgetary policies should be geared to the needs of an expanding full employment economy with capital items separated from other expenditures and the cash budget separated from the authorizations budget."

10. (a) The United States monetary and credit or fiscal systems the past 5 years have been used as a sort of price-support program for large bankers and have contributed practically nothing to maintaining and fostering an expanding full employment economy with price stability, and distribution of income such as to sustain continued expansion.

(b) See 9 above.

11. (a) The paradoxical simultaneous existence of unemployment and inflation is due to the administration of prices through monopolistically maintained control of market supply on the part of huge agglomerations of economic power in key industrial corporate firms.

(b) Inflation of prices is not a necessary condition of full employment; but if necessary institutional changes are not made to make the two goals consistent, then I would prefer to have a little inflation rather than a lot of unemployment.

12. I believe that production conditions and the structure of distribution of goods and income should be so arranged that the minimum amount of credit is required to enable enterprising young people to acquire and operate the kinds of business investments and family living facilities they need without having to go into debt and thus take on the added burden of interest payments. To the extent that credit is needed to provide for private expansion that cannot be financed out of past income, funds should be made available for such productive and legitimately needed uses at an interest rate approaching as near to zero as administrative costs and the risk element will permit. Since credit resources arise in large part these days from national economic policy and not as the result solely of savings out of past income, there is no valid justification of interest charges to pay what many decades ago might have been necessary to obtain savings through inducing postponement of consumption by private citizens.

13. When the real per capita income of any economic group quits rising, it is time to take selective action with respect to the economic problems of that group. Certainly counterrecessionary action should be initiated at any time when the number of unemployed begins to rise, seasonally adjusted, to more than 2.7 percent of the civilian labor force. Major action should be put into operation when unemployment rises above 3 percent.

14. With the now acknowledged multiplier effect of a balanced budget in the framework of properly structured taxation and Governmetn programs, there is no need for a budgetary deficit. However, deficit spending cannot be given the major blame for price inflation during the past few years.

15. Yes.

16. Yes; they are required, but of course must be properly related to productivity increases and the general level of prosperity. Similar escalators should be incorporated in annuities, other fixed income securities and payments, and provided in appropriate ways for farm income and the income of other groups whose bargaining power is relatively weak in a generally administered price economy.

17. Causes of present recession:

Falling farm income over a period of 6 years.

Tight-money policy.

Other national economy policies that have favored the relatively strong and injured the weak.

Failure of the Federal Government to appropriate funds and initiate such national priority programs as school construction, teachers' salaries, loans for small business, urban redevelopment, elimination of pockets of chronic depression and underemployment, failure to extend minimum-wage legislation to all groups of workers, minimum wages too low, too slow a rate of power and resources development, and similar policies.

Too heavy an income flow going to the rich and high-income groups with too small an income flow to the poor and low-income group, the result being a failure to clear the market of the goods produced except for a temporary period, then the extravagant use of installment credit.

Resulting overinvestment in capital expansion relative to the growth in consumer income.

The drop in national confidence in our international position.

The vacuum of leadership in the White House which the Senate cannot under our constitutional division of powers fully compensate for; this vacuum of Executive leadership brought on a drop in confidence of both investors and consumers. This, in turn, caused a drop, in Keynesian terms, in both the propensity to consume and the marginal efficiency of capital. Thus, when too late, the tight-money policy was partially reversed, the increased quantity of available money was not sufficiently utilized, even at lower interest rates, to encourage continued expansion at the rate needed to maintain full employment.

What should be done to terminate it:

Enable farmers to earn a parity of income.

Eliminate all excise taxes immediately.

Raise personal income-tax exemptions from $600 to at least $800.

Close all existing loopholes in personal and corporate income taxes.

Require capital gains to be reported as any other income in Federal tax.

Expand, speed up, and initiate fully adequate Federal programs for school construction, increased teacher salaries, improved educational facilities and opportunities, and power and resource development.

Establish margin or price control on such basic key industries as steel, chemicals, and electronics.

Sincerely,

JAMES G. PATTON, *President.*

AMERICAN FARM BUREAU FEDERATION,
Chicago, Ill., March 26, 1958.

Hon. HARRY F. BYRD,
Senate Office Building,
Washington, D.C.

DEAR SENATOR BYRD: I am enclosing the statements of the American Farm Bureau Federation regarding the financial condition of the United States. We have followed the suggested questions which you sent to us on February 17.

As you know, the American Farm Bureau Federation is vitally concerned with the health of our total economy. We have been very much alarmed by some of the recent proposals which would result in the serious inbalance of the Federal budget. Another round of Government-induced inflation would seriously injure farm people.

If there are any areas of question, or if any part of our statement needs further explanation, please do not hesitate to advise us. We appreciate the opportunity to present this statement.

Very truly yours,

CHARLES B. SHUMAN, *President.*

Enclosure.

RESPONSE OF THE AMERICAN FARM BUREAU FEDERATION TO QUESTIONS SUBMITTED BY SENATOR HARRY F. BYRD ON BEHALF OF THE SENATE FINANCE COMMITTEE

1. Give a definition in your own words of deflation and inflation.

Inflation is a condition where the purchasing power of money is reduced by a rise in the general price level. This can be brought about in a number of ways; however, a common cause is Government policies which permit or cause the supply of money and credit to expand more rapidly than the supply of goods. In its more serious stages inflation is characterized by rapid rises in the general price level, stimulated by a lack of confidence in money, a desire to hold tangible assets, and the expectation of further price increases.

Deflation is a severe decline in business activity accompanied by serious unemployment, reduced national income, business stagnation, and a high rate of bankruptcies, all of which are aggravated by a lack of confidence in the economic outlook. This can be brought about by overexpansion and speculative excesses resulting from inflation, or by forces which result in a sharp contraction in the money supply. In a deflation the general price level will tend to decline, but this tendency may be offset to a considerable degree by rigidities in the economy, such as contractual wage rates and administered prices.

2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

The Federal Government has important responsibilities in this matter, because (1) the Constitution provides that Congress shall have the power to coin money and regulate the value thereof, and (2) the Government's financial operations are so large that they cannot help but affect the course of the general price level.

The following extract from the resolutions adopted by the elected voting delegates of member State farm bureaus at our last annual meeting indicates the general policies that we believe to be appropriate to the objective of avoiding inflation and deflation:

"Government policies which affect the supply of money and credit should be directed toward promoting a relatively stable general price level together with high employment and rising productivity. The Government also has a responsibility to so conduct its affairs as to inspire confidence that everything possible is being done to protect the economy from the extremes of inflation and deflation.

"In periods of relatively high employment and business activity, the Federal Government should not only balance its budget and keep it balanced to eliminate the need for deficit financing but also reduce the total national debt. If the budget is unbalanced in such a period, the Government should borrow necessary funds from nonbank lenders to the maximum extent possible to avoid the creation of new money. The existing national debt should be managed to prevent non-bank-held securities from being shifted to the commercial banks, as such a shift creates new money just as the sale of new securities to banks.

"In periods of declining employment and falling prices, these policies can be reversed to combat deflation. In such a period, for example, it may be desirable to reduce taxes to leave more purchasing power in the hands of the public even though this results in a deficit.

"If the budget is to be unbalanced to counteract a deflationary trend, emphasis should be on reduced taxes rather than increased Government spending.

"The Federal Reserve System can help to stabilize the price level by relating its policies to the country's needs for money and credit rather than to other considerations. The independent status of the Federal Reserve Board must be maintained. It should restrain the expansion of bank credit in inflationary periods and make it easier for the banks to extend credit if deflation threatens.

"The policies of Government agencies which make or guarantee loans should be coordinated with overall credit policies.

"In order to be effective in checking deflation, the Federal Reserve System must recognize the danger of a downturn and act before deflation has gone so far that public confidence in the outlook is undermined. In such a situation, prompt tax-rate reductions, especially in the lower income brackets, can be a valuable supplement to Federal Reserve action.

"It is generally recognized that it is more difficult to combat deflation than inflation with monetary and fiscal policies. It should be remembered, however, that our worst deflations have followed periods of inflation and that effective action to prevent inflation will go a long way toward preventing subsequent serious depressions."

Two points in the above quotation from our resolutions deserve special emphasis:

(1) It is highly important that the Government conduct its affairs in such a way as to encourage confidence in the economic

outlook. If people expect either inflation or deflation to occur, they are likely to act in such a way as to contribute to a realization of their expectations.

(2) The most effective means of avoiding deflation is to prevent inflation, because inflation leads to excesses and dislocations which make an economy more vulnerable to deflation.

While our resolutions stress the importance of Government policies to the maintenance of a relative stable price level, we recognize that the policies followed by private groups also affect the stability of the price level. Economic groups which have a degree of power over wages and prices should exercise such powers with restraint and consideration for the general economic situation. For example, we do not think it is sound for unions to demand wage increases or for employers to grant such increases with a view to passing them on in higher prices in a period of declining business and rising unemployment. In our view such action can only intensify a downswing in the economy. Likewise, in a period of high employment and general prosperity, we believe that both unions and employers should consider the inflationary aspect of wage increases that exceed gains in productivity and thereby force prices upward. More importantly, however, we believe that Government policies should be directed toward preventing concentrations of economic power which make it possible for private groups to exercise undue influence over wages and prices. In the business field this means that we must have effective programs to prevent the exercise of monopoly power. In the case of labor it means that unions should be subject to prohibitions against actions to restrain trade comparable to the prohibitions imposed on other groups. It also means that compulsory unionism should be prohibited by law.

The declaration of policy in the Employment Act of 1946 should be amended to remove any implication that the Government has a responsibility, or the capacity, to maintain full employment at all times. The assumption of such a responsibility by the Government can only lead to repeated doses of inflation, and eventual socialism.

3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942 to 1957. (You may wish to divide the period into two parts, 1942–50 prior to the accord, and 1951–57.)

The policies followed by the Federal Reserve Board prior to the 1951 accord with the Treasury contributed materially to the inflation which took place during this period. The policies followed in financing the extraordinary expenditures of the war period laid the basis for a postwar inflation. As long as the war lasted, however, this inflation was partially suppressed by wartime controls, product deterioration, and a high rate of savings. Since we, as a Nation, were unwilling to pay a substantially larger percentage of the war expenditures through higher taxes, it probably was desirable for the Federal Reserve System to support the Government bond market while the war lasted. In our view, however, it is extremely unfortunate that the wartime policy of pegging the Government bond market was continued for a number of years after the end of the war.

While we do not wish to attempt to evaluate the timing or the wisdom of individual actions taken by the Federal Reserve System since the accord, we are in agreement with what we understand to be the objective of Federal Reserve policies in the post-accord period. We feel that these policies have made a very great contribution to our economic welfare, by countering inflationary pressures.

4. Beginning in August 1956 there was an increase in the Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

The period from August 1956 through September 1957 was a period of very high employment and business activity. Consumer demand was at a high level; a boom was underway in the capital goods industries; and private debt was increasing rather sharply. Government spending was also at a high level. Prices were pushed upward by high-level demand and by wage increases which increased production costs in many industries.

Although private demand for goods and services was high, Federal policy must bear a heavy responsibility for the upward movement of prices and wages in this period. Numerous actions to stimulate the economy were taken as a result of the 1953–54 decline in business activity. In some cases these expansive actions undoubtedly had a delayed effect. The high level of Government spending undoubtedly contributed to an inflation psychology which in turn increased the public's willingness to spend. Government action in increasing the minimum wage of 75 cents to $1 per hour in March 1956 established a basis for wide-spread wage demands to restore historic differentials for skilled workers. The high level of business activity helped many unions to obtain wage increases, which were soon translated into higher prices.

The continuation of Government spending at a high level in the face of a high level of private demand contributed to higher prices even though the budget was balanced. Under the circumstances, the Government could have made a real contribution to price stability by reducing its expenditures and increasing payments on the national debt.

5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

The current public debt carries with it a built-in potential for future inflation. If debt management were to permit the shift of privately held Government bonds to the commercial banks or a shift of bank-held bonds to the Federal Reserve banks, the result would be an expansion of the money supply. When the money supply is allowed to expand more rapidly than the production of goods, an inflationary pressure is created.

On the other hand, policies which shifted the bond holdings of Reserve banks or commercial banks to private investors would contract the money supply and exert a deflationary pressure on the economy. It is an important task of debt management to handle the debt in such a way as to contribute to the stability of the price level and to an expanding economy. This means that debt management must take account of the economic situation. In recent years the task of doing this has been complicated by the large volume of debt coming due each year.

6. (*a*) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand, and employment.
3. Economic growth in production, demand, and employment.

(*b*) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

(*a*) The most important of these objectives is "economic growth in production, demand, and employment." Taken literally, objective No. 2 seems to us to be undesirable. Stability in production, demand, and employment would mean stagnation. We must have economic growth if we are to improve our living standards, or even to maintain present standards for a growing population.

We assume that objective No. 1 is intended to refer to stability of the general price level which means stability in the purchasing power of money rather than stability in individual prices. Individual prices must fluctuate in order for a free choice, or market, economy to work. Price-level stability is desirable as a means of creating a favorable climate for continuing economic growth, and to avoid the hardships that inflation and deflation impose on various groups. Economic growth in production demand and employment can continue for a time despite inflation, but inflation leads to excesses and imbalances which set the stage for an eventual crash.

(*b*) With relatively short interruptions we have had a fairly rapid economic growth in production, demand, and employment throughout the postwar period. Prices rose sharply in the early postwar years when the removal of price, wage and allocation controls released the inflationary forces which had been suppressed during the war. In this period and in the early months of tho Korean incident the Federal Reserve policy of pegging the Government bond market added materially to the inflationary pressures. The first postwar recession or adjustment was shortened by the outbreak of fighting in Korea. The inflationary rise in prices which occurred in the early months of Korea was so clearly aided by Federal Reserve policy, that it paved the way for the accord of 1951. After the accord the price level dropped slightly and then moved sidewise in a remarkable demonstration of stability for approximately 4 years. In this period, however, upward movements in nonfarm prices were offset by declines in farm prices. Considering the fact that the decline in farm prices was due to some rather special circumstances it would appear that there was some inflation in nonfarm sectors of the economy during this period despite the relative stability of the general price level. Beginning in mid-1955 prices began to move upward for reasons which have been discussed under question No. 4.

The most significant trends of the postwar period have been (1) the rise in prices which took place when suppressed wartime inflation was allowed to manifest itself; (2) the further inflation that was allowed to take place under the policy of pegging Government bond prices, (3) the relative stability in the general price level which existed for almost 4 years after the 1951 accord, (4) the renewal of inflationary pressures in 1955, and (5) the current downswing in business activity.

7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

In our opinion the overall level of current Federal, State, and local government spending is too high in relation to national income. The current high level of Government spending tends to be inflationary although this inflationary tendency may be temporarily offset at times by readjustments in the private sector of the economy. While we believe that it would be desirable to reduce the percentage of our total income that is spent by Government, we also favor a redistribution of responsibilities which would tend to reduce the Federal share and increase the State and local shares of total governmental spending.

8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

The present high level of taxation undoubtedly has an inhibiting effect on economic growth. This is particularly true in the case of Federal income taxes. The present level of Federal income taxes makes it more difficult for the private economy to accumulate capital for economic growth and reserves for bad times. Another important consideration is the fact that the present high level of Federal income taxes leads to a continuing pressure for special treatment of various situations. Special tax concessions erode the income-tax base, force the maintenance of high rates, and put a premium on ability to arrange personal and business affairs in such a way as to take advantage of exceptions to the basic law. Thus, tax considerations have become a big factor in many business and personal decisions.

The continued heavy dependence of many local and some State governments on property taxes discriminates against taxpayers such as farmers, the railroads, and others who necessarily have a high investment in real property.

9. Will you distinguish between fiscal policy (embracing expenditures, taxes and debt) and monetary and credit policy, and then relate them, one to the other. Please discuss these policies stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

Fiscal policy and monetary and credit policy both affect the supply of money and credit available to the economy and consequently the price level. As is pointed out in the question, fiscal policy involves government expenditures, taxes and debt. Monetary and credit policy relates to activities which influence the total volume of money and credit in the economy through such things as reserve requirements, discount rates, and the open market operations of the Federal Reserve System. Both fiscal policy and monetary and credit policy can either be inflationary or deflationary. The effect of an inflationary or deflationary action in the fiscal field can be offset by opposing action, or intensified by supporting action, in the monetary and credit field. A general outline of how monetary and credit and fiscal policies can be used to promote price level stability is set forth in the extract from our resolutions which was quoted in answer to question No. 2 above.

10. (*a*) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank

credits). Also please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

(b) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

(a) In general terms we believe that the United States has an adequate monetary system. The chief deficiency in our monetary system is the fact that it requires the Federal Reserve System to make numerous decisions with regard to the timing, direction, and magnitude of various actions. All human judgments are subject to error and it is often difficult for Reserve authorities to determine exactly what is happening in the economy at a particular moment. This is a problem which deserves continuing study; however, we do not have any recommendations with respect to it at this time.

(b) There are two basic inadequacies in the United States fiscal system: (1) The public pressures on Congress for increased expenditures are intense and specific while the pressures for economy are general and diffuse. As a result it generally is easier for the Government to increase expenditures than to reduce them. The only solution to this problem is for the groups that are interested in economy to do a better job of creating understanding of the need for restraining Federal expenditures and for Members of Congress and the administration to exercise their leadership on behalf of governmental economy. The base of the Federal income tax should be kept broad through the retention of reasonably low exemptions as a means of reminding all self-supporting individuals that Federal services are not costless.

(2) Congress has, to a considerable degree, lost control of the Federal budget. There are many expenditures which Congress cannot affect except by enacting changes in basic legislative authority. The fact that an expenditure is authorized by law is often taken as a primary justification for continuing it. Public pressures on Congress encourage greater attention to proposals for new programs than to a review of programs that perhaps should be reduced or eliminated. The existence of large accrued balances from previous appropriations makes it difficult for Congress to affect the amount that may be spent in any particular fiscal year. Finally, present legislative procedure results in the consideration of individual spending proposals with very little regard to the overall budget picture.

We have no simple panacea for the correction of these deficiencies. We believe that it would be helpful, however, if the legislative committees of Congress would spend more time on periodic reviews of existing programs with a view to eliminating or reducing programs whenever changing conditions justify such action. We also believe that it would be helpful if the Congress would develop some workable procedure for deciding affirmatively whether the Federal Government shall run a deficit or surplus in any fiscal year and the approximate amount of any such surplus or deficit. One approach might be to require that the Congress reconcile its actions in the fiscal field before adjournment each year (A) by specifying the amount that is to be paid on the public debt or the amount, if any, of deficit that is to be incurred and (B) by adjusting taxes and appropriations to harmonize with the overall target for a Federal surplus, deficit, or balanced budget. We, of course, realize that it may not be practical to control expenditures and receipts with the precision necessary to hit an exact target set by the Congress. The point, however, is that the Congress should affirmatively assume more responsibility for deciding whether the goal of current fiscal policy is a balanced budget, a deficit, or a surplus; and the general magnitude of any such deficit or surplus.

11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy.

(*b*) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

(*a*) A certain amount of what may be called frictional unemployment is to be expected even in a period of strong inflationary pressures. Individuals may become unemployed for a number of reasons, and in a free economy there frequently will be a need for readjustments which will produce unemployment in particular industries even in periods of inflation. The need for such readjustments can arise from overexpansion when demand is high, or from such factors as changing demand patterns, competition, and technological developments.

The seeming paradox of continuing inflation and rising unemployment may develop on a broader scale as a result of rigidities in our economy which cause prices and wages to remain steady or to rise when business is declining.

(*b*) No. Even a gradual inflation would work a hardship on many people and make the economy more vulnerable to serious depressions. A price rise of only 2 percent per year would cut the real value of the dollar in half every 35 years.

If people at large became convinced that it was the policy of the Government to foster a gradual inflation, they would be encouraged to act in such a way as to cause the inflation to proceed at a more rapid rate and this would increase the danger of an eventual crash.

12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy.

Private debt may reflect a transfer of savings, or the creation of new money through the expansion of bank loans. Anything that causes the supply of money to increase more rapidly than the supply of goods and services tends to be inflationary. When production and prices are pushed to a high level through the heavy use of credit, there is danger that a downswing will be intensified not only by a reduction in credit purchases but also by a reduction in the cash purchases of debtors who may seek to accelerated repayments in the face of uncertainty. The danger of widespread defaults on private debt is reduced by the fact that most private debts carry provisions for systematic repayments. Private debt currently is at a high level in terms of dollars; but it is not necessarily excessive when account is taken of our present population, and such factors as the value of the dollar, private assets, and national income. The extent to which private debt is a threat to stability largely depends on whether or not we can use available fiscal and monetary tools in such a way as to avoid unstabilizing effects. For example, when private debt is growing it may be desirable to reduce the Federal debt or to take other offsetting action. If we allow a serious deflation to develop, the present level of private debt probably would operate to intensify our difficulties.

13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy.

We do not believe that it is practical or desirable to determine in advance a fixed set of conditions which would justify major Federal action to cut taxes or inaugurate large increases in public works. The question of when such action should be taken is a matter of judgment. The decision should be based on economic trends and prospects rather than the immediate situation. In other words a situation that would not call for major Government action when the economic outlook appears likely to improve in the near future might justify major Federal action at another time when the economy seems to be in a downward spiral which is undermining public confidence. In cases where major Federal action appears to be indicated we prefer tax reduction to large increases in public works. While we believe that it is desirable to accelerate the construction of sound, well-planned public works that would be undertaken anyway in the normal course of time, when there is a slack in the civilian economy, we do not believe that a downturn in business activities should be used as an excuse for make-work projects or other public works which are unsound from an economic standpoint. Tax reduction can be put into effect much more rapidly; and terminated more promptly than a public works program; it is more in keeping with a free choice system; and we believe that it would be more effective than pump priming.

14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

The real basis for our postwar inflation was laid during the war when truly enormous deficits were financed to a large degree by selling bonds to the commercial banks. While postwar deficits have contributed to inflation, this contribution has not been a major factor in comparison with the rise in the public debt which took place during the war years. Other important factors in the postwar inflation have been (1) pentup consumer demand, (2) the continuing high level of Federal expenditures, and (3) the policies followed by the Federal Reserve System in pegging the Government bond market prior to the Federal Reserve-Treasury accord of 1951.

15. Can full employment goals be attained while maintaining a dollar that has relatively stable purchasing power?

No. In our opinion efforts to maintain full employment on a continuous basis will lead to inflation which ultimately will result in a crash and serious unemployment. A relatively stable purchasing power can be maintained only by letting natural forces in the economy operate to bring about the adjustments which inevitably are needed from time to time. On occasion some of these adjustments will result in temporary increases in unemployment.

16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

No. The basic idea of adjusting prices and wages on the basis of a formula is fallacious. In our opinion it is impossible to devise a formula that will tell you exactly what adjustments should be made in prices or wages in any given time. In a period of rising prices escalator clauses have an inflationary effect. If widely used, such clauses can produce a spiraling effect.

One effect of using the cost of living index as a basis for wage adjustments is to make it possible for temporary prices in one sector of the economy to cause wage increases, and consequently, price increases in other sectors. For example, the food prices that go into the cost of living index are not adjusted for seasonal variation. Under certain conditions, a seasonal increase in food prices may result in wage increases. Such wage increases contribute to price rises which tend to prevent a reduction in the cost of living index when food prices decline seasonally. In recent weeks we have seen an increase in the cost of living—which was brought about, in part, by frost damage to the Florida vegetable and citrus crops—result in wage increases at a time when unemployment was rising. It seems to us to be completely indefensible to allow an increase in food prices resulting from seasonal influences or a temporary situation, such as a freeze, to force an upward adjustment in wages. Such a development is particularly unfortunate when unemployment is increasing.

The use of the cost of living index as a guide to wage adjustments is also made inappropriate by the fact that it is impossible to take adequate account of such things as changes in quality and variations in trade-in allowances in the determination of a statistical price index. The undersirability of escalator clauses from an economic standpoint is further emphasized by the fact that there is little evidence that unions would be willing to accept any substantial reduction in wages if the cost of living index were to decline substantially. On the contrary, there has been a tendency for unions to insist that increases made on the basis of increases in the cost of living be incorporated into the basic wage structure in subsequent union-management agreements.

17. List and briefly discuss what you consider the causes of the present recession, and what should be done to terminate it.

It is unreasonable to expect a free choice, market economy to move upward at all times. When business is good and profits are rising, production is stimulated with the inevitable result that some industries oversupply the market. Our economy has been moving upward with relatively minor interruptions ever since the end of World War II. In recent months the capital goods boom, previously referred to, has resulted in a great expansion of productive capacity. At the same time that productive capacity has been increasing, prices have been rising in response to rising wages and other costs. Under these circumstances it is not surprising that we have run into a period of readjustment.

The basic things that we need to do to terminate the recession are (1) to avoid rushing into unsound programs which could set the stage for a serious inflation later, and (2) to allow some time for economic forces to work out adjustments and set the forces of recovery in motion.

We see no justification for a major expansion of public works. It is not yet clear that a reduction in income taxes would be warranted at the expense of a large Federal deficit. It would, however, be desirable to explore the possibilities of reducing Federal spending and simultaneously making a corresponding reduction in Federal taxes.

One of the things that is needed under present conditions is action to encourage increased consumer and business spending. To this end it would be most helpful if business and labor would cooperate in programs to reduce costs and prices.

CHAMBER OF COMMERCE OF THE UNITED STATES,
Washington, D. C., April 28, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR HARRY: I am pleased to attach a statement of the chamber's views pertaining to the questions you sent us in connection with your investigation of the financial condition of the United States. This reply has been prepared jointly by our economic research and taxation and finance departments.

I certainly agree with you as to the necessity of our maintaining a strong and sound economy. I congratulate you and the Finance Committee upon the study you are making.

Cordially yours,

PHILIP M. TALBOTT, *President.*

Attachment.

STATEMENT OF THE CHAMBER OF COMMERCE OF THE UNITED STATES ON THE FINANCIAL CONDITION OF THE UNITED STATES, SUBMITTED TO THE SENATE FINANCE COMMITTEE IN RESPONSE TO THE QUESTIONS POSED BY THE CHAIRMAN ON FEBRUARY 17, 1958

Question 1. Give a definition in your own words of deflation and inflation.

There are no hard and fast definitions of these terms; they are used in different ways by different people and by the same people for different problems or purposes.

Definitions, of course, are necessary and useful to keep discussions on the same grounds and to aid logical analysis, but they do not in themselves convey truth as to cause and effect relationships. Just as every "sale" is also a "purchase," so inflation or deflation can be defined from different points of view.

For purposes of public policy it would seem sensible to define inflation and deflation as complex economic processes by which the general level (average) of prices is raised or lowered causing a reciprocal reduction or increase in the purchasing power (value) of the monetary unit as a generalized medium of exchange and store of value.

Inflation, looked at this way, is a flow of money spending in excess of the current supply of goods and services valued at stable prices. The result is a rising average price level. This could occur:

(*a*) When total spending was stable and physical output shrinking;

(*b*) When both output and money spending were shrinking but with output declining at the more rapid rate;

(*c*) When money spending increases more rapidly than output.

Deflation occurs when the flow of money spending is insufficient to absorb the current supply of goods and services at stable prices. The general price level, therefore, falls. As with inflation, deflation can occur under different sets of circumstances—whenever the flow of money spending falls faster or rises more slowly than the flow of real goods and services coming to the market place. Sometimes inflation is identified with prosperity and boom, and deflation with a decline in business activity or employment. But such terminology may be confusing, since rising prices may be associated with either "overfull" employment or underemployment. The same is true for falling prices.

These statements in themselves still do not reveal the causes of why disproportionate changes occur in the rates of money spending and the flow of goods and services.

Inflation and deflation, as with all economic events, are compounded out of interaction of several causes. The crucial variables are: (1) the supply of money; (2) the desire of the public for more or less liquidity and their preferences as to the composition of their assets; (3) how costs of production are determined; and (4) how output responds to changing cost and demand conditions.

In the process by which the general level of costs and prices move up or down, incomes are a vital link. The national payroll is, in a sense, the conductor of inflation. Some definitions focus attention on income-price relationships. From this point of view inflation occurs when, as a Nation, we pay ourselves more dollars without producing more real product. Real output is then rationed out by higher prices.

All these definitions, of course, greatly oversimplify the problems. The processes of inflation and deflation are too complex in modern economic life to be clearly defined or described in a few short and simple sentences.

Question 2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are requires, then make specific suggestions.

The economy of the United States cannot avoid either inflation or deflation completely. In a free economy characterized by diffused decision making and continuous dynamic change, the course of economic progress can never be completely smooth and painless. A great strength of a free economy is its ability to adapt to changing demands, technological innovation, population shifts, and altered conditions in supplies of basic resources. Some fluctuation in the price level, and other economic variables such as output and employment, is inevitable, necessary and desirable.

What we want to avoid is the violent swings which go beyond the range of normal economic adjustment—mass unemployment on one hand and persistent inflation on the other. In other words we seek orderly growth with relatively stable prices.

To achieve this goal in ways which will foster and preserve free competitive enterprise is no easy task. Fundamentally, it depends on the values of the public and whether we can muster the political courage to face the issues.

To avoid inflation we must:

(*a*) Vigorously apply monetary restraints in periods of boom when total demand is straining against the limits of physical capacity.

(*b*) Vigorously apply fiscal retraints during a boom to prevent overloading the economy with demands that cannot be fulfilled. This requires substantial budget surplus which can be achieved only by restraints on Government spending and a tax level and structure which will provide the necessary revenues without depressing healthy productive activity at the same time.

(*c*) Vigorously promote competition in all markets for goods and labor services. Unless monetary and fiscal policies are applied to a competitive market structure, inflationary pressures cannot be kept in check without enormous costs of unemployment and other economic maladjustments. Monopolistic wage determination and other wage-cost-price rigidities are probably the greatest barrier to adequate control of long-run inflationary movements.

(*d*) Deliberately shun, during a business contraction, unwise antirecessionary policies which create massive inflationary pressures after the slump has passed. Massive spending programs, for example, which come to fruition after recovery has set in and become long-run Government programs competing with other demands on the economy, not only do not help in recession, but they create greater instability by accentuating the upswing during a boom.

To avoid deflation, policies consistent with those above are required. It should be pointed out again, however, that "deflation" in the sense of falling prices is not synonymous with "recession." Nor is "inflation" in the sense of rising prices the same as "prosperity."

Fluctuations in the level of economic activity manifest themselves in 2 ways—or a combination of 2 ways: (*a*) in price-income cycles and (*b*) in output-income cycles.

In the first case money incomes fall because prices fall; the output, employment and real incomes remain fairly stable. In the latter case money incomes fall because output and employment fall with prices remaining fairly stable. Adjustments through prices are much to be preferred from a welfare standpoint, because society does not lose the real income as it does when adjustments are made via changes in output and employment.

There is grave danger that we "outlawed" deflation in the sense of downward price adjustments by developing a market structure shot through with wage-cost rigidities. If this is true, prices are flexible upward but not flexible downward, and we will have a built-in systematic inflationary bias over the long run. We will still have recessions, but mainly in the form of falling sales, output, and employment.

To prevent both price inflation and price deflation, as well as over-full employment and recession, the system must be kept as flexible and competitive as possible, and both antirecession and antiinflation policies must be consistent so as to eliminate systematic biases arising both out of the structure of the economy and public policies.

If we are to avoid major inflations and deflations, it should be a matter of declared public policy that we aim to do so. For this reason, the Employment Act of 1946 should be amended to espouse explicitly reasonable stability of the general price level as a policy goal.

Question 3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942 to 1957. (You may wish to divide the period into two parts, 1942–50 prior to the accord, and 1951–57.)

The Federal Reserve policy, starting in 1942 with the war, was primarily aimed at providing money which the Treasury Department could use to meet Government expenditures. Between 1940 and 1946, the Federal Government spent more than $383 billion—with the help of large-scale action on the part of the Federal Reserve System. During this period, the Treasury borrowed approximately $200 billion. The Federal Reserve System and commercial banks supported the Treasury by increasing their holdings of Government securities by approximately $90 billion.

Beginning in 1942, in March, the Federal Reserve System committed itself to see that the Treasury Department was supplied with all the credit necessary to finance a war and further, that the level of interest rates on Government securities would not be allowed to rise during the war.

During this period, the Federal Reserve System subordinated normal monetary functions to war finance. As a result there was very little effective restraint on the expansion of the supply of credit or money. Selective credit controls enacted by Congress and moral persuasion were used by the Reserve System in an effort to hold down private borrowing. In addition, price controls helped to suppress, at least temporarily, some of the inflationary effects of wartime financial policies. But inadequate tax collections, the great increase in Government expenditures, price controls and rationing had delayed effects. The increases in personal income resulted in an abnormal rate of personal savings; consumer credit did not increase in the usual proportion; business firms accumulated large amounts of savings. When World War II ended, businesses and people of the country were holding tremendous amounts of liquid assets. From 1940 to 1945, personal savings amounted to nearly $137 billion and gross business savings, $74 billion. This was an explosive inflationary setting.

When the war ended, the Federal Reserve System seemed to have two choices: to continue support of Government bond prices without regard to economic conditions, or to use monetary policies to curb inflation. The Treasury Department and the Council of Economic Advisers defended the position that easy-money policies of World War II should be continued. They felt that increased interest rates on the national debt would add greatly to the problem of refinancing and cost of debt maintenance; that refunding would be a very serious problem; further, that to permit Government bond prices to decline would set off a monetary panic and destroy faith in Government credit and that the proposed restrictive policies would not be effective against inflation.

Those who advocated continuing easy-money policies had two major objectives: to hold down interest charges on the national debt; to facilitate Treasury refunding and to stabilize the prices of Government bonds—and, incidentally keep rates low for borrowers. Others felt that we should follow the traditional policy of restricting credit and money in order to hold down inflation, and that we should allow the interest rates on Government securities to advance at least to the point where credit restraint would be effective; that there were adequate weapons available to prevent panic in the bond market or disruptive monetary effects; and that the Federal Reserve Board should buy only sufficient Government's to keep the market "orderly."

It is quite evident that in the 1946–47 period the Federal Reserve faced the dilemma of dual responsibility—economic stability and Treasury debt management. Its actions indicate that it was convinced that the public debt was of such magnitude and importance that it should take preference over antiinflationary policies and restrictive measures should be used only when they did not interfere with the support of the Government securities market.

The Douglas committee and its investigations found this to be the case. In 1948, the bond-support policy became a very clear-cut issue as the Federal Reserve System's holding rose $11 billion during 1 year. During this period the impossibility of restraining credit and currency expansion, while at the same time supporting Government bonds at par was clearly demonstrated.

In 1949, during the mild recession, the Federal Reserve Board took action to ease credit by lowering reserve requirements for member banks. At the same time, however, the Federal Reserve System was trying to maintain a fixed low rate pattern of interest rates on different kinds of Government securities. To do this it actually sold Government securities, thus tightening credit one way while loosening it in another. Here again the conflict between Treasury debt management and appropriate monetary policy was clearly apparent.

With the Korean war in the summer of 1950 and the reversal of our economic situation, the Federal Reserve raised discount rates in an effort to curb inflationary trends. Installment credit controls were also enacted under the Defense Production Act of 1950. Again the conflict ensued. When Treasury notes were put up for sale, the Federal Reserve had to buy large amounts which more than offset other antiinflationary measures.

In March 1951, when the famous Treasury-Federal Reserve accord was reached, it was decided that the Federal Reserve System would no longer peg the prices (and interest rates) of Government securities. Instead it was to return to serving its primary function of directing national monetary-credit policies to meet changing economic conditions. Within such a framework, however, it was agreed that the Federal Reserve would help to maintain an orderly market for Government securities. Following the accord, the antiinflationary measures taken by the Federal Reserve helped to keep the Korean war inflation fairly well in check—although much of the damage had already been done.

During the 1953–54 recession the system demonstrated its flexibility by substantial easing of credit conditions. In fact, Federal Reserve officials have subsequently stated that it is possible that they eased credit too much too fast and thereby overstimulated the economy in 1955 which contributed to the boom and inflation of 1956–57.

In 1958, in face of a business contraction, the Federal Reserve has taken a series of steps to ease credit and reduce interest rates. Many feel that the tight-money policy of last year was not reversed quickly enough at the first signs of the downturn. But with prices still rising, uncertainty and the dangers of overstimulation, the early caution of Federal Reserve officials is understandable.

In conclusion several points should be made:

(1) Clearly national monetary policy cannot and should not be subservient to managing the Government debt. To make it so would

lead to the bankruptcy of inflation and throw a most important tool of countercyclical economic policy out of the window. For several years from 1946 to 1951 the Employment Act was, as a practical matter, a one-sided ineffectual statement because monetary policy was hamstrung in order to make the Treasury's lot more comfortable.

(2) Since 1951 Federal Reserve actions have generally been in the right direction. There will always be disagreement as to whether monetary measures are too early or too late, too forceful or too timid, but such criticisms should not be allowed to undermine the vital functions which the System must perform. In general, Federal Reserve officials are to be commended for the manner in which they have pursued their duties, unruffled by the pressures they receive from all sides.

(3) Since the accord, the Federal Reserve System has confined its open market operations to the short-term Government securities market. The so-called "bills only" doctrine is still a matter of considerable debate among economists and in financial circles. Federal Reserve officials argue cogently for their position of influencing the market rather than "making the market." In general we believe this position is sound, as long as open market operations are not made the principal instrument of credit policy, but are used in conjunction with other policies which shorten the time lag between monetary action and the final effects on terms of credit in the market.

(4) We endorse the general position of the Federal Reserve Board in holding that general, indirect monetary controls are the appropriate means of restraining inflationary and deflationary movements in the money market. Direct controls, except for regulation of stock market credit and providing minimum standards for prudent commercial bank operations, are not consistent with a free market system. Selective controls over terms of particular kinds of credit—for example, consumer installment credit—are administratively not feasible and are inimical to freedom of consumer choice and efficient resource allocation. It is sometimes argued that general monetary policy discriminates unfairly against certain classes of borrowers. No doubt this is, in part, true. But it is hard to imagine a more arbitrary and discriminatory method of credit rationing than to replace general monetary policy by direct controls and rationing by Government fiat. The solution to market imperfections is to improve the flexibility and competitiveness of the market mechanism, rather than sabotaging the machinery by direct Government intervention.

Question 4. Beginning in August 1956 there was an increase in the Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

The Consumer Price Index started to climb in 1956 and is still moving upward. The various factors contributing to the increase in the index did not operate throughout the whole period with the same strength, but the combination of factors and their interaction has been sufficient to keep the upward trend going, albeit with some loss of momentum from September 1957 to the present. Briefly the chief factors were these:

(*a*) A major investment boom starting in 1955 and reaching its peak in 1957. Contributing to the rapid acceleration of business investment was the bouyant consumer demand in 1955, the tax cut of

1954, and antirecessionary easy monetary policy followed in 1953 and during most of 1954.

(*b*) Expanding Government expenditures during this period. From 1950 through 1957, Government purchases of goods and services (Federal, State, and local) increased from $76.6 billion in calendar year 1954 to $86.6 billion in calendar 1957. Even though the Federal administratitive and cash budgets showed a surplus in the fiscal years 1956 and 1957, the rising Government demand contributed to the pressure on resources and prices.

(*c*) An intractible wage-cost push situation. Wages in manufacturing are a case in point. From January 1956 to December 1957 average gross hourly earnings in manufacturing increased from $1.93 per hour to $2.11 per hour—an increase of almost 10 percent. Output per man-hour in manufacturing increased less than 2 percent during this period. The inescapable result was a period of substantially rising unit labor costs. When money wage rates are rising over broad sectors of the economy well in excess of productivity improvements, some part of the higher per unit costs must come out of higher prices.

In summary, 1956-57 was a period of economic overload. On top of a big investment boom were growing demands for defense and other governmental services at all levels of Government. In addition, people were demanding more goods and services for private consumption, and at the same time labor was demanding wage increases far larger than existing prices and productivity could support.

Question 5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

As a complementary tool of countercyclical financial policy, debt management now has great importance because of the present size of the Federal debt and because of the special role such debt plays in the asset structure of financial institutions. The Federal debt now amounts to about two-fifths of the economy's total debt. It is the only debt that is entirely free from credit risk. Short-term Federal debt serves as a principal liquid or operating reserve asset of banks, other financial institutions and business corporations. Longer-term Federal debt functions as a major investment asset of individuals and savings institutions and competes with other investment mediums in absorbing the economy's money savings. The types of Government securities issued thus have a significant effect on the liquidity of the entire economy and on the market for other securities.

Debt management has two major aspects. It involves refunding operations affecting the maturity arrangement of outstanding debt. It also involves the expansion or retirement of debt in response to the current cash deficit or surplus of the Government. The maturity composition of the debt has its most direct tie with credit and monetary policy while the changes in the amount of debt are most immediately related to fiscal policy. Both aspects combine to determine the composition of the total Government debt at any given time and together exert a significant influence on economic balance.

Management of the Federal debt makes a primary contribution to economic stability by arranging a maturity composition of that debt that will support and not impede development of appropriate credit and montetary policy. In general, such a debt distribution would be one with maturities well spaced over a period of years. This kind of maturity distribution is also important for administrative reasons in debt management.

There is, of course, constant need for a large volume of short-terms issues to meet the basic liquidity requirements of banks, financial institutions, business corporations, and others. In a period of economic slack or depression this liquidity may be expanded by issuing additional short-term obligations. In the subsequent period of expansion the volume of these issues may be reduced somewhat by refunding operations or by retirements out of surplus.

To change the existing debt structure, however, takes time. Financing decisions of the past necessarily impinge heavily on the present and the future, and debt management actions must continually be a compromise between what may be most appropriate for the current economic situation and what may be appropriate in terms of a longer run view of economic stability. This balance in judgment relates primarily to the volume of very short-term securities which may be outstanding at any time. Because the liquidity of such securities is not readily influenced by credit and monetary measures, the greater the proportion of the debt in these issues the less responsive the economy will tend to be to restrictive credit and monetary action when such measures may be appropriate.

From the point of view of economic stability, the maturity distribution of outstanding debt should always be such that moderate changes in the level of interest rates will have an important effect on the liquidity positions of holders, thereby influencing spending and lending decisions. To attain this, a sizable portion of the debt should be spread out over intermediate and long-term maturities so that when interest rates decline, and the market prices of these securities therefore rise, liquidity positions of holders will come to be regarded as more adequate than formerly. Conversely, when interest rates rise and security prices decline, holders will tend to view these positions as less adequate. Such a spread maturity distribution would limit the dependency of debt management on current interest rates and security market conditions and, on the other hand, would increase the sensitivity of the entire economy to interest rate changes.

Within the standards set for debt balance, current debt management can operate to reinforce or offset in part the impact of a Federal deficit or surplus. For example, a deficit in a recession period may be made somewhat more effective if in its financing the emphasis is placed on the use of shorter-term obligations. The expansive effects will tend to be greater and will support an expansionary credit and monetary policy to the extent that such issues are absorbed by the banking system and foster expansion in the money supply. Conversely, a surplus in a boom period will be more effective as a restraint on expenditures if it is used to retire short-term debt rather than to purchase long-term securities in the market. The restraining effects will tend to be increased and will reinforce restrictive credit and monetary policy if the repayment of debt reaches the holdings of short-term issues by the banking system, thus affecting bank liquidity positions.

Debt management actions to promote economic stability through shifts in terms and maturities of security offerings are limited by the necessity of meeting existing market conditions. Public debt must be handled so that the investing community will be receptive to new issues from refunding operations and will take additional debt into its portfolio. While public debt differs from private debt instruments in quality, public debt instruments compete with similar securities of private origin in the market. In short, the debt must be in such form that it is readily assimilated in the market.

There are other practical problems of debt management to be resolved. Recently, acceleration of corporate tax payments has resulted in a concentration of Treasury receipts in the first half of the year while Government outlays are more evenly distributed. This necessitates a seasonal pattern of short-term borrowing and repayment of borrowing even if the cash budget is in annual balance.

Debt management must develop its policies and feel its way not only in response to immediate Treasury needs, to investor preferences, but also with regard to the cost of servicing the debt. From both the standpoint of interest cost and economic stability there are many alternative arrangements of a given debt. Problems of current interest cost must be weighed against the costs to the Federal budget and the economy in general if debt management decisions are excessively inflationary or deflationary. They must also we weighed against possible future interest costs under different economic circumstances. Debt management decisions thus must consider both the present and future, as well as the implications of action on the effectiveness of other instruments for achieving economic stability.

Question 6 (a). Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand, and employment.
3. Economic growth in production, demand, and employment.

There is no doubt that the Nation faces a "trilemma" of trying to achieve three partially incompatible goals at the same time: price stability, high employment and output, and economic growth.

While these goals are partially incompatible, they are also, in part, mutually interdependent. Sustained economic progress depends on the avoidance of major booms and busts. Lapses from high employment levels will be shorter and less severe if the maladjustments of inflationary surges are kept to a minimum. At the same time, however, if we try to achieve too high a rate of economic growth and set unrealistic continuous full employment goals, chronic or sporadic inflation will eventually force a conscious choice among the three objectives.

If conscious choices must be made among the three goals, most people rank them in the following order:

(*a*) Fairly high levels of employment.
(*b*) A reasonable degree of stability in the general level of prices.
(*c*) High rates of economic growth.

With mass unemployment the whole economy suffers the loss of real income in addition to the penalties visited upon particular individuals. Inflation on the other hand is a cruel and capricious tax on individuals, and on society generally if it precipitates, as it is likely to do, periodic contractions in output and employment.

While a high rate of economic growth is desirable for several reasons—e. g., rising levels of living and defense capacities—there is nothing sacred about any particular rate of growth. Ultimately the rate of economic progress depends on several factors. Among the more important are:

(a) The choices people make in the market place—how much current output in real terms they collectively indicate they wish to devote to capital formation rather than current consumption.

(b) Public and private investment in skills and education which upgrades the quality and productivity of the labor force.

(c) How rapid an exploitation and application of new technological development takes place.

(d) The total business climate which either encourages or discourages risk-taking investment and managerial efficiency. Obviously, the kind of tax system we have is an important factor in setting either a favorable or unfavorable growth climate.

High pressure growth financed by inflation is dangerous because it is chaotic growth which chokes itself off and creates disorder in the system. Inflation is an uneven process. Some prices and incomes rise rapidly and others are sticky or lag behind. Investment plans and ordinary business decisions, difficult at best, cannot be made on a rational basis. The whole structure of production, prices, and incomes becomes distorted, creating maladjustments which must be painfully corrected through the catharsis of recession or depression. In short, a sustained and sustainable rate of growth requires that we avoid both extremes of overemployment and underemployment.

Though the three goals as we have seen are closely interrelated, they are difficult to achieve simultaneously. Especially, it will be difficult in the foreseeable future to reconcile demands for continuous high employment and general price stability. This is so for a number of reasons:

(1) In periods of economic growth, change, and rapid technological advance, the economy has a low inflationary threshold because of short-run immobilities of resources, bottlenecks, and wage-cost rigidities. Under such conditions price increases may manifest themselves at a point below a "politically tolerable" level of employment.

(2) Strong labor monopolies make full use of the bargaining powers conferred on them by the "maximum empoyment" commitment of the Federal Government and the legal immunities inherited from the past which they enjoy. As a result, wage rates and costs go up year after year, and never come down. Until action is taken to correct the fundamental noncompetitive elements in the market structure to which anti-inflationary monetary and fiscal policies are applied, high employment will be bought at the high price of chronic or recurring inflation.

(3) Monetary and fiscal policies as now conceived and applied have a serious inflationary bias. Monetary policy to curb inflation evokes loud cries of pain and anguish, and during recession spending schemes are set in motion which result in a systematic expansion of inflationary government spending converging during boom periods. Unfortunately, there appears to be political preoccupation with one goal—full employment. As long as this preoccupation persists, policy may be expected to err on the inflationary side.

Question 6. (b) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

Clearly, since World War II, "full employment" has taken precedence over the other goals of public policies. In the immediate postwar period some open inflation was inevitable as a result of the methods used to finance the war and to suppress their price effects by direct controls.

The great increase in the money supply produced by war deficits and the very liquid state of business and individuals provided ample inflationary fuel for an excess in money demand. To complicate matters, as has been pointed out previously, debt management policy and monetary policy were directed at keeping interest rates and charges on the Federal debt as low as possible rather than holding inflation in check. It was not until the Treasury-Federal Reserve accord was reached in 1951 that any serious attention was given to the problem of inflation. It is indicative of postwar public and political attitudes that reasonable price stability was not made an explicit policy goal in the Employment Act of 1946.

In the past 2 or 3 years, the importance of controlling inflation has been more generally recognized. Although we have yet to face the issue squarely, at least some attempt has been made through monetary policy to discipline inflationary demands on the economy by consumers, business, and government.

Monetary policy, however, has been given little support in the form of fiscal and other measures to balance the three policy goals. During a prolonged period of rising prices, labor became accustomed to very substantial annual increases in money wages, and a vicious form of wage leadership has developed among union leaders. Annual wage demands have replaced, in a sense, excess liquidity as the prime generating force of inflation.

In our tax policies we have shown little recognition of the effects of the tax structure on economic progress. Expediency rather than rational choice seems to have dictated tax policy. Each year additional spending requires more and more revenue and tax reform is forced to take a back seat. Punitive marginal rates of taxation discourage investment, create inefficiencies, and restrict the mobility of capital. It is quite possible that uneconomic tax laws have been a major factor in the poor showing we have made in productivity gains during the past 2 years.

In sum, postwar experience, even most recent experience, does not provide convincing evidence that as a nation we have really accepted price stability and economic growth as policy goals on a coordinate level with high employment—much less learned how to reconcile the three goals in public policy measures.

Question 7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

To assess the impact of current Federal, State, and local government spending on the economy, is a large question which cannot be answered in short compass. For purposes of a summary discussion, government expenditures can be grouped into three major categories:

(1) Purchases of goods and services from the private business sector;

(2) Purchase of the personal services directly (government employment);

(3) Transfers of income from one group to another.

The first and second kind of expenditures are both income-creating and income-absorbing.

When the government spends to buy goods and services it adds directly to total demand for the output or product of the economy. Part of these expenditures go to buy military and civilian goods and supplies from private industries. As such they create jobs and income for the private sector of the economy, but they also use or absorb resources and output that might otherwise be available for production and consumption (or use) of private consumer goods and capital goods (producers' goods).

When the government spends to buy the personal services of government employees it also creates jobs and incomes directly, but here also it diverts labor away from possible private employments.

In a market economy, production and employment respond to demand. When the government spends on goods and services, this action considered by itself raises the level of total demands on the economy, stimulates increased output and raises total money income. If the economy is already operating at a high level of employment, additional government demand, not offset by a reduction in private demand, will be inflationary—will merely bid up prices and money incomes without increasing real output. But if unemployed resources exist (unemployed labor and excess capacity), an increase in government buying will usually increase both money incomes and output as unemployed resources are drawn into production. Even in an underemployed economy, however, increasing government spending may also raise prices with little increase in employment and output. This will happen if most of the spending is directed toward industries where there is little or no excess capacity or to segments of the labor market where little unemployment exists. Hence, it is important to realize that the income and employment creating potential of more government buying depends not only on the volume, but also the direction of the increased expenditures, as well as on the existing level of economic activity.

In addition to the direct income creating effects of government purchases, changes in the level of government spending produces secondary or induced changes in the level of private spending. An increase in new income created by government spending makes possible some additional consumer purchasing which stimulates still further increases in private spending and payrolls until the process of adjustment is completed.

Of course, reductions in Government spending work in the opposite direction. Such reductions decrease total demand both directly and indirectly. Hence, during periods of inflation, curtailment or postponement of Government buying helps to damp down inflationary pressures by keeping total demand within the system's physical capacity to produce.

Obviously, today, Government spending on goods and services is an economic variable of major importance. In the forseeable future the Federal budget will remain large in relation to the economy as a whole, to say nothing of the increasing demands made by State and local governments. To be sure, "waste" will always be a problem which can be kept within bounds only by constant hammering of public opinion and generalized pressure for "economy" in the use of public funds, but Government budgets are large primarily because people, rightly or wrongly, demand (or appear to demand) a large volume of services, defense and others, through the agency of Government.

Of the many problems raised by big government, two are singled out here for special comment:

(1) The combined impact of Federal, State, and local spending on the economy is so great, that we cannot afford "bull in the China shop" fiscal policies. Government budget considerations cannot be confined solely to governmental activities, but must include the economic health of the Nation and how it is affected by Government fiscal policy. At least we must take care that Federal spending policies do not magnify and accentuate fluctuations in the level of private business activity.

(2) As the Government sector of the economy has grown in relation to the private sector, there is a growing usurpation of the discretionary right of the consumer to use his income as he sees fit. In the public sector choices must be registered through the political process rather than through the market place.

Public services are not subject to market evaluation and control. They have an irreversible quality which is unresponsive to changing economic circumstances, consumer preferences, and technology. There is no discipline of the profit and loss statement. For this reason, as the public sector of the economy grows as a proportion of the whole, less and less is the economy subject to consumer sovereignty and market pressures; therefore, it is likely to become less and less efficient in the use of resources.

The third category of Government spending—transfers of income—also has important economic effects. In modern times these so-called "transfer payments" constitute a large and growing segment of Government expenditures. Transfers really represent a redistribution of incomes. In making transfers, the Government does not purchase goods or services, but merely takes money from one group, or taxpayers generally, and turns it over to other groups who then spend it (or save it). In some cases, the original taxpayer may receive his own contribution back, fully or partially, as the beneficiary of such transfer. Anyone who receives interest on a Government bond, for example, pays all or part of his own interest income when he pays his taxes.

Most transfers are made according to statute for some real or imagined social purpose; e. g., veterans' benefits, unemployment compensation, social security benefit payments, relief, farm subsidies, and the like. At the Federal level, some are handled through trust fund arrangements and others through the budget proper (but not all trust fund expenditures are transfers; some trust fund outlays are used to buy goods or services).

In 1929, Government interest and other transfers at all levels of Government—Federal, State, and local—amounted to $1.9 billion, 2.2 percent of the national income. In 1957, such transfers amounted to $25.9 billion, or 7.2 percent of the national income—a considerable growth in both real and money terms.

Obviously, transfers of such magnitude do have important economic effects, but they are difficult to evaluate. It is usually argued that transfer payments tend to change private spending-saving habits since under our progressive tax system it is presumed that tax receipts come from higher income groups with lower consuming propensities, while the transfer payments are received, primarily, by lower income recipients who have a higher propensity to spend on consumer goods. More of the income going to higher income groups who save at higher rates, it is argued, tends to find its way into investment expenditures for capital growth, while if the same income were diverted to lower income groups, more of it would be spent on consumption. It is easy to point out that in many cases the reverse situation exists. Interest payments may go to higher income groups who own proportionately more Government securities. Farm subsidies go to the prosperous large-scale farmer. Social security payments may be made to individuals with large investment incomes, and other examples could be cited.

Whatever the long-run impact of saving-spending habits of the country, there is no doubt that changes in the level of transfer payments do exert considerable influence on the level of total demand, since the amount of such transfers in a given period of time are not necessarily related directly to tax collections of the same period. In periods of declining national income (and tax revenues), many transfers increase, e. g., relief payments, unemployment compensation, and the like. These transfers keep private disposable income from falling as rapidly as national income, and thereby keep consumer spending from declining as much or as rapidly as would otherwise be the case. Conversely, in periods of prosperity, when national income (and tax revenues) are rising, these same transfer payments decline. As a result, disposable income and consumer spending do not rise as fast, and inflationary pressures are damped somewhat as a result.

Much has been said in recent years of the effectiveness of transfer payments as cyclical cushions, though their importance has probably been somewhat exaggerated. But it is still true that they do make our economy more "shock resistant" and thus make normal economic adjustments less dangerous.

There are other ways of grouping Government expenditures for purposes of assessing their economic impact. Some expenditures are really investments in productive forms of "social" capital—highways, schools, etc. Others represent current operating costs of necessary governmental activities. Still others represent pure waste—unwanted or unnecessary Government programs which divert resources from private use to no good end. Even necessary Government activities carried on at excessive costs are partially wasteful and, therefore, to a degree, a drain on the economy in terms of possible additions to output which are not realized on their account.

There is, unfortunately, a great predisposition on the part of the public and Government officials to overload the economy with all sorts of demands without regard to the real costs involved. Government services are not free, their real cost is the private production and consumption which must be sacrificed.

Our tax system is partly responsible for this state of affairs. Each group wants something, thinking that someone else will pay. Overloading the economy, while overlooking the costs simply imposes a cruel tax of inflation. As a nation, we cannot escape the costs of this overload.

Question 8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

Our present combined tax system—Federal, State, and local—is chaotic and, in many ways, most uneconomic. At the Federal level, we have a hodgepodge of indiscriminate excises, punitive corporative levies and confiscatory personal income and estate taxes. This system is superimposed on a multifarious structure of State and local taxes. The combined result is a conglomerate tax system which defies description or commonsense. A rigorous evaluation of its economic effects is next to impossible.

Certain features of the tax system, however, do stand out so sharply as to permit some general observations. There can be no doubt that the present tax system, in aggregate and in detail, seriously affects the performance of the economy and the pattern of economic growth. It capriciously changes the allocation of resources and distribution of income. It affects the volume and direction of private investment and almost dominates methods of business and personal finance. It changes the structure of industry and the pattern of regional development. It limits the diversity of job opportunity and penalizes efficiency. In short, it is an irrational system.

The present corporate income tax is uneconomic for several reasons. Ultimately, it is paid for by the consumer and the stockholder in the form of higher prices and lower rates of growth than otherwise would be possible. Its discriminates unfairly against equity financing in favor of debt financing. It penalizes efficiency and encourages wasteful expenditures. The 52 percent rate discourages marginal or risky undertakings and narrows investment opportunity. In addition, because of differences among industries as to composition and durability of capital assets, it unfairly discriminates against those industries having to make continuously heavy outlays for replacement of depreciable assets.

Progression in personal income tax rates is carried to ridiculous extremes at the upper end of the income scale. The small revenue yield from high surtax rates is purchased at great cost in the form of disincentives, public and private resources devoted purely to tax compliance and avoidance, and restricted investment opportunities. Such tax features cannot be justified on the basis of equity or economics. They represent an attempt by the electorate to "get something for nothing" and probably do more damage to the low-income groups in real terms than to those in higher income classes.

High personal rates are also an especially onerous burden to small business. Traditionally and potentially, earnings are the most important source of new capital for growing, small enterprises. High and highly progressive personal rates not only penalize success and efficiency, but expropriate the major source of new flows of equity capital to small business. It is a ludicrous posture on the part of the Congress to be piously devising all sorts of schemes to help small business when the Congress, through tax policy, is one of the chief causes of its plight.

Federal excise taxes now in force are highly discriminatory. They are the prolonged result of "temporary" wartime revenue measures. Transportation and communications taxes, especially, distort the flow of commerce and change the structure of industry. To the extent that excises belong to a well-balanced tax system, they should be very low rate, broadly based, and nondiscriminatory.

At the State and local level, tax systems are largely conditioned by insatiable demands for revenue by the Federal Government. Although property taxes still form the backbone of local systems, State and local needs cannot be met from this source alone. Moreover, individual localities and States are limited in their tax autonomy by what other governmental units do. Under such circumstances, in the competition for tax sources, the Federal Government has an undue advantage. In addition, the Federal Government has reached down to tax purely local activities and functions—poolhalls, cabarets, local telephone service, etc. As a result, the system as a whole departs more and more from accepted economic principles of taxation.

State and local tax excesses are largely self-correcting. The costs and benefits of governmental services are more clearly evident to the electorate. And uneconomic taxes show themselves clearly in the results—migration, slow rates of growth, etc.

Those who are addicted to our particular form of federalism with its emphasis on local autonomy, responsibility, and diversity, cannot view Federal encroachment and tax usurpation with any degree of equanimity.

Clearly, the time has come when we should establish certain principles of taxation at the Federal level, and rid our tax system of those features which, in the long run, work against balanced economic growth and against federalism as we know it.

Question 9. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy, and then relate them, one to the other. Please discuss these policies stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

Fiscal policy is compounded out of the expenditure and taxing activities of Government and the considerations which go into determining spending and taxing plans. On the spending side, both the volume and the kinds of expenditures must be considered, just as on the tax side both the kinds and rates of taxation are equally important. The Congress ultimately has the unshiftable responsibility for fiscal policy.

Monetary policy refers to the activities of both the Treasury and Federal Reserve officials which affect the money supply and the terms of credit and other loanable funds. Generally speaking, the Federal Reserve Board and the System has the responsibility for carrying out monetary policy. In discharging this responsibility, it has three major tools of control by which it can ease or tighten the monetary and credit conditions:

(1) Changing rediscount rates at which member commercial banks may borrow additional reserves; (2) changing the required reserve ratio for member banks within legal limits, and thereby increasing or decreasing the actual or potential lending capacity of the commercial banking system; and (3) buying or selling Government securities in the open market and thereby increasing or decreasing total bank reserves and the lending capacity of the banking system.

Debt management represents a marriage of monetary and fiscal policy and is inseparable in practice from either.

The main issues in the continuing debate over stabilization policy arise out of differences in opinion and judgment as to the combination of fiscal and monetary measures which are feasible and desirable in light of prevailing or anticipated economic conditions. Theoretically and practically, it may be possible to achieve a full employment level of aggregate demand in a variety of different ways. Furthermore, to complicate matters, fiscal and monetary operations react and interact upon one another, making it difficult for the nonspecialist to see through the maze of complications which beset officials charged with policy responsibilities.

In the final analysis, the major policy questions must be resolved through the political process wherein there is considerable room for legitimate differences of opinion, both as to the ends to be served and the means to be employed. The sources of disagreement are chiefly these:

(1) Granted that a high overall level of output and employment and a fairly stable general price level are desired, how would the composition of total output be affected by different combinations of monetary and fiscal measures? One combination will expand governmental output at the expense of private investment and/or consumption. Another will favor private investment at the expense of consumption or vice versa. Some are more conducive to more rapid economic growth than others. And so it goes. Only the naive or tyrannical will petulantly or arrogantly demand conformity to his set of values.

(2) Given the impossible—an agreement on ends or values—what kinds of measures are most efficient in promoting those ends? This is a matter of understanding and judgment. There are numerous and serious practical problems in manipulating fiscal policy to achieve stability of demand. These are well known but often forgotten. Monetary policy, too, has its limitations, some of which are pointed out below. Unnecessary confusion often develops because proponents of different sets of policies fail to make clear when they are talking about values related only indirectly to overall stability and when they are expressing judgments as to the efficacy of different means.

(3) What do prevailing economic conditions portend? Even when limited agreement is achieved on matters of ends and the efficacy of means, there will always be differences in judgment as to the correct interpretation of current economic events. The old question of forecasting need not detain us here. Suffice it to say we cannot know the unknowable or the unforeseeable. Uncertainty, itself, confers certain differential advantages and disadvantages on various policy combinations.

(4) Finally, how can agreement be reached when economic understanding is lacking and misunderstanding can be used to private or political advantage? There will always be vocal, worried people who do not know what could or should be done, but demand "some kind of action." Some are aware of their limitations; others are not. They may genuinely believe not only that inconsistent aims can be achieved simultaneously, but, also, that there are simple unobjectionable ways of reaching them.

Fiscal and monetary operations are inextricably related. Spending, taxing, and debt transactions all affect the money supply. Indeed, Government fiscal activities are part of national monetary policy, viewed in a broad sense. As potential stabilizers, monetary and fiscal operations or both complementary and competing, depending on the circumstances and the social goals which loom beyond the issues of economic stability. The brief discussion which follows is intended only to show how various poliices are related, not to espouse particular policy combinations or doctrines.

(1) In a sense, fiscal policies determine appropriate monetary policies and vice versa. During inflation, a reduction of Government spending reduces total spending on output directly. Such cuts, therefore, reduce the amount of monetary pressure needed on private spending needed to keep aggregate demand within noninflationary bounds. At the same time, higher taxes curb private spending directly by absorbing income and shrinking the money supply. Indirectly, tax hikes also depress the demand for investable funds by lowering expected net rates of return on investment projects and raising interest costs.

In the opposite situation, recession, increased Government spending, and lower taxes both operate in converse manner to increase demand directly and indirectly in both the public and private sectors.

In both instances, fiscal policies complement or reinforce monetary policy. Looked at another way, credit restraints during inflation would not have to be as stringent, or credit ease during recession would not have to be carried as far as would be the case in the absence of reinforcing fiscal policies. Some observers feel strongly that by the judicious use of appropriate fiscal measures, monetary policy would carry a lighter burden and some of the criticisms as to its uneven impact and adverse influence on the structure of industry could be avoided.

If monetary policy can be supplemented by fiscal aid, the reverse is also true. Those who advocate a greater reliance on fiscal measures must realize that to have maximum effectiveness, fiscal policies require cooperative monetary arrangements. In fact, the hoped-for results from stabilizing changes in Government spending and taxes will not come to pass unless monetary authorities permit an expansion of the money supply or restrict its growth as the occasion may require. Changes in the velocity of money, to be sure, must be taken into account, but in the main, the above generalization is substantially correct.

(2) Monetary and fiscal measures have competing aspects. In a sense, these may be more apparent than real, since the combination of policies selected should reflect a social consensus as to the composition of output as well as the desired level of output.

In some cases, monetary and fiscal policies may appear to conflict and be working in opposite directions—one stimulating and the other depressing. Monetary policy is more quickly reversible as economic conditions change and will usually lead ad hoc fiscal measures. At other times when, for other reasons, changes are being made up or down in the level of Government spending and taxing, monetary policy might be used to offset or soften transitional effects as a stabilizing procedure. In other cases, apparent conflicts merely represent a more complete integration of the several kinds of stabilizing procedures. For example, if it were desired to cut inflationary pressures without curbing exuberant growth, Government could drastically cut spending, raise personal income taxes, especially on the great mass of income receivers, while the monetary authorities followed an expansive monetary policy. Or to take another hypothetical example for illustrative purposes, during a recession the Government might drastically reduce personal taxes to encourage immediate consumption at the expense of private investment and home building with monetary authorities cooperating to keep credit fairly tight, even in the face of a business contraction.

Monetary and fiscal policies do conflict when they work at cross-purposes to bring about results that are not really desired by the public or the Government—when through lack of knowledge, political perversity, or hysteria, the right hand does not know what the left hand is doing or does not take into account what the left hand is doing. In reality, there is no such thing as "stabilization policy," but a combination of policies which may be consistent or inconsistent, rational or irrational, planned or coincidental, fortuitous or unfortunate—and no one is apt to be completely satisfied with the results. At least, we can strive to make public policy more rational, consistent, and truly reflective of the underlying values held by the individuals comprising the social organism.

(3) Fiscal and monetary policies actually merge in the cash and debt operations of the Treasury. It is impossible to tell where one leaves off and the other begins. Tax collections reduce the money supply and bank reserves, while Government expenditures increase the money supply and bank reserves. When the Treasury borrows, what happens to the money supply and bank reserves depends upon who buys the securities (who lends the money): and when public debt is retired, the monetary effects depend on who holds the securities (to whom repayment is made). Even debt funding operations are not neutral. Quite different changes take place in the money supply, bank reserves, and the interest rates when refinancing changes the structure of the debt—the kinds of debt instruments, maturity pattern, interest rate pattern, and the ownership distribution of the debt among nonbank lenders, commercial banks, and Federal Reserve banks. All Treasury transactions have important repercussions on monetary policy.

Debt management issues have been covered elsewhere in this statement. Suffice it to say here that the Treasury can undermine or offset monetary policy by debt policy, and the exigencies of debt management create conflicts between appropriate monetary action and the opposite kind of Treasury action. This has been an acute, continuing problem since World War II, because of the legacy of a large public debt.

Nowhere are the conflicts in stabilization policies more acute than in the debt management field. Because of the large floating debt—short-term debt and other debt falling due within 1 year—the Treasury must be in the money market almost continuously to reborrow and refinance. During periods of credit restraint (inflation), the Treasury must pay higher interest rates. But this raises great political outcry because higher debt service charges add to the budget. Some legislators and private citizens demand "easier money" (and potentially more inflation) to "save" a few dollars on interest charges—even though inflation would drive up other governmental costs and rob the public in other ways through higher prices in the private sector.

Ideally, debt management could play a positive role in stabilization policy. During inflation, the Treasury could fund from short- into long-term securities, even though the cost of debt service would be increased. This process would work in the same direction as credit restraint, divert funds from private spending, and reduce private liquidity. During the recession, for example, the Treasury could fund from long- into short-term securities. This action would ease credit, release capital for private use, and help meet the public's demands for greater liquidity.

As we now conduct our debt policies, they not only do not aid stabilizing monetary policy, but load it down with additional burdens. Perhaps, this is as it should be. Some would argue that the Treasury should deliberately follow a policy of long-term funding during recession when interest rates are lower and avoid long-term funding during times of inflationary higher rates. According to this view, the Treasury should attempt to keep the interest service charges in the budget as low as possible without creating an impossible continuous funding problem. Under such circumstances, the Federal Reserve authorities would, then, take such Treasury action into account by following a more vigorous policy of credit restraint during inflation and a more plentiful easy-money policy during recession than would be required if the Treasury followed a countercyclical debt policy.

In fairness, it must also be pointed out that to use debt policy as a positive countercyclical device, presupposes a Federal debt with some manageable maturity pattern spaced out over time. Because of the awkward pattern which now exists, Treasury officials are almost forced to fund "as they can" without regard to burdens imposed on the Federal Reserve credit policies. Over the years, if the debt can be stretched out to give the Treasury breathing space, stabilizing debt policy may have some promise—provided the Congress also develops a more rational attitude in these matters.

(4) The statutory debt ceiling is another disturbing element in the fiscal-monetary environment. In spite of the fact that Congress must both appropriate money for spending and levy the taxes to raise revenue, it maintains a statutory debt limit to discipline itself. But when the public debt is continuously bumping against the ceiling, serious problems are created; not only are the prospects of flexible fiscal policy seriously weakened, but the goal of reasonable economic stability is placed in jeopardy.

In a business downturn, a budget deficit will surely arise even if the Government does nothing. What is to be done when tax receipts fall and the Treasury cannot meet its obligations? Should the Government add to economic woes by raising tax rates and postponing payments? It is a foregone conclusion that Congress will be forced to take action to raise the debt ceiling to avert financial crisis.

Defenders of the debt limit rightly fear uncontrolled fiscal license. To the extent that the debt limit makes it easier for legislators and administrative officials to resist pleas from special interests and Government bureaus for more and more spending, it probably has some merit. On the other hand, it may be doubted whether the debt limit itself helps very much to control inflation. Debt retirement is highly desirable during an inflationary boom at which time budget surpluses are available, and the debt limit by itself exerts no discipline on spending. Furthermore, current spending in any period is, in large measure, determined by past congressional decisions—decisions which later bring a converging stream of claims on the Treasury which may exceed current revenues and the debt limit. When this happens, the credit of the United States or the debt limit must give way, and there is really no choice in these alternatives.

Ultimately, the will to resist irresponsible spending must come from a desire to prevent inflation and to keep governmental activities within their proper sphere. To be effective, Congress must exercise foresight, rather than hindsight, and be willing to face the future inflationary implications of current action. To place the emphasis on a rigid debt ceiling places the line of defense where it cannot be very effective, and at the same time it may unwisely restrict the use of appropriate fiscal policies during a recession.

Finally, as has been pointed out elsewhere in this statement, no combination of monetary and fiscal policies can be completely effective in controling long-run secular inflation unless something is done to correct the wage-price rigidities of the labor and product markets to which those policies are applied. That we have rising prices even during recession attests eloquently to the truth of this assertion. This does not mean that we should abandon attempts to achieve stability via appropriate monetary and fiscal policies. On the contrary we should recognize their limitations and set about to improve their effectiveness by correcting the monopolistic market structures through which all monetary and fiscal policies operate.

Question 10. Omit.

Question 11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

Prices are normally thought to rise during a boom and fall during a recession. However, if upward pressures on costs are strong enough and not readily reversible, prices may not fall and may even rise in recession.

Here briefly are the conditions and pressures affecting consumer prices which can produce an inflationary recession:

First, in well-unionized industries, substantial money increases are granted. Union leaders compete with each other or follow each other in getting more—more than existing prices can bear. In addition, wages will rise substantially in many industries on the basis of existing contracts previously negotiated. With the trend to 2- and 3-year contracts, wage increases cannot be postponed even in the face of failing demand.

With wage rates rising, costs will also rise unless wage increases are offset by increases in physical output per man-hour. In recent years, money wage increases and fringes, on the average, have tended to be approximately twice as big as can be absorbed by improvements in productivity for the economy as a whole.

Also, we can expect a spillover of wage demands into the service and trade industries in response to the large wage bargains in the strategic industrial sector. In fact this spillover should, as a matter of equity, occur to preserve some valid relationship in wage-rate differentials. But in the services possible productivity improvements are somewhat limited. Therefore, rising wage costs are not offset by spurts in productivity. The prices of services with their high labor content have risen year after year, come war, prosperity, or recession, as an examination of the consumer price index components will readily show.

Thus it is that in a recession we have the twofold impact of (*a*) falling demand and (*b*) continuously rising costs.

In such a situation, one cannot predict precisely how prices will be affected. Where costs are rigid or shift upward at the same time that demand is shifting downward, anything can happen to prices. For the economy as a whole it becomes perfectly possible for recession and a rising consumer price index to occur simultaneously.

Question 11. (b) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

It has not been proven that we face a "lady or the tiger" decision between a seriously creeping inflation or a politically intolerable level of unemployment.

It is true that as the economy approaches high levels of unemployment, upward price pressures grow. We then face a choice in public policy between approaching further toward a perfectionist level of full employment and the maintenance of a stable price level.

Whether or not we fail to maintain the purchasing power of the dollar depends, in the last analysis and with all types of policies considered, on how strictly we interpret the goal of "full" employment.

If we set our employment goals too high in this regard, we will probably have to accept an inflationary creep with all the dangers of that growing into a gallop and runaway inflation. The dangers of this policy seem too clear.

The Employment Act refers to "maximum levels" of production and employment. The word "full" was deliberately avoided by the Congress in writing that act. If we permit some flexibility in our goal of high-level employment, and if we do not follow fiscal and monetary policies which have a systematic inflationary bias, and if action is taken to correct labor-market practices which generate a continuous upward thrust on costs, it should be possible to preserve the purchasing power of the dollar.

In short, we should not accept a gradual inflationary trend as desirable or even necessary. Until we have exhausted efforts to meet the problem, we should pursue policies which assume the existence of a zone in which we can have both adequately high employment levels (with elbowroom necessary for market adjustments) and adequate price stability (with flexibility in individual prices and probably some flexibility in general indexes).

Question 12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy.

Debt may be either a curse or a blessing for both debtor and creditor—depending on the circumstances.

A rapid growth of private debt or an abrupt decline of borrowing and lending can and do have serious unstabilizing effects on the economy. An excessive reliance on debt for long-term financing of private capital investment also has serious implications for stability.

The fact remains, however, that we live in a debt-credit economy. Debt performs essential and important economic functions. It is the financial manifestation of the time dimension in the economic processes of our highly specialized exchange economy. It is used as one vehicle by which money savings are continuously channeled back into productive activity. It provides mobility of capital and thereby permits more effective use of our resources. It permits consumers to smooth out time patterns of consumption. And it is an essential ingredient in the process of economic growth.

While we have had a great growth of private debt in the past decade, we do not appear excessively debt ridden by historical standards. Private debt is a much smaller segment of total debt that it was in 1929 (largely because the public debt has loomed so large). In terms of the gross output of the country, private debt is relatively smaller than in any year prior to 1941. Per capita private debt is much higher in dollar terms than in prewar days, but lower in terms of current income. Net corporate debt per dollar of profits is not high by historical standards. Personal debt, to be sure, has risen markedly in postwar years as a percentage of disposable personal income, but the patterns of consumption have also changed, and for several reasons personal income is much more secure than it used to be in prewar days and earlier.

These observations are not intended to minimize debt problems, but to put them in perspective. In aggregate, the growth of private debt in recent years does not pose serious economic problems. Much more important is the composition of the debt, how rapidly it increases, what internal shifts take place, and the income-liquidity foundations under debt.

As long as we have a flexible debt structure in terms of time pattern of maturities, degrees of liquidity, forms of debt instruments, and the like, major shifts in the community's desire to change the composition of assets holdings can be accommodated without collapsing the whole structure and disrupting economic life. From the standpoint of flexibility and liquidity, our private debt structure appears to be much more safe and potentially much less dangerous to stability than was the debt situation which existed in the 1920's.

Two questions of the private debt situation, however, should be examined carefully:

(1) To what extent has private debt been incurred on uneconomic ground as a result of Government action? In the interest of stability we want the growth of debt to take forms which can be adequately supported by reasonable expectations of future flows of income. Moreover, we want particular debt excesses to be continuously self-correcting so as to minimize the dislocations and repercussions on the rest of the system when defaults or changes occur in particular segments. Capricious intervention by Government in credit and debt markets may in itself be a disturbing element which jeopardizes overall stabilization policy. A comprehensive study of the many leading-guaranty activities of the Federal Government would be necessary to assess the economic effects of such programs.

(2) How does our tax system affect private debt relations and our capital structure? From the standpoint of stability (and for many other reasons), a broad-based, diversified flow of venture capital in equities, is much to be preferred over long-term debt financing of investment. Yet we continue to put up with a tax system that discriminates seriously in favor of debt capital. Minor dividend credit on personal income taxes is no real solution. In any serious effort

at tax reform we should eliminate those features of our tax laws which encourage private indebtedness and favor debt financing by business over equity financing.

Question 13. See responses to questions 9 and 17.

Question 14. How much of a factor, in your opinion, has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

Deficit spending since World War II has not been the chief cause of postwar inflation, but deficit spending during World War II was, without doubt, the biggest single cause of the immediate postwar inflation—especially rapid increase in prices during the period 1945–48.

During World War II Federal deficits greatly inflated the money supply. In addition, wartime borrowing from the Federal Reserve System and commercial banks added greatly to bank reserves and the lending capacity of the banking system, and thereby made possible a further increase in the money supply by a multiple expansion of bank credit.

During the war the inflationary effects of deficit financing were partially suppressed by price controls and the public's willingness to accumulate cash balances and other liquid assets because of the unavailability of goods. After the war, as is well known, the public began to use the inflated money supply more actively to finance previously deferred demands. Starting from a highly liquid postwar base, the velocity (or turnover) of the supply of money increased steadily (with only a minor pause) through 1951.

Indirectly, the wartime deficits contributed in another significant way to the postwar inflation. The legacy of a large Federal debt and its mismanagement put severe strains on monetary policy which otherwise could have been more vigorously used to damp down the explosive inflationary fires. Until the Treasury-Federal Reserve accord of 1951, monetary policy was directed at keeping interest rates low on Government secruities rather than curbing inflationary credit expansion. In order to help the Treasury with the uncomfortable task of debt refinancing, the Federal Reserve supported the bond market at the expense of the public at large. In short, the exigencies of debt management forced an easy money policy onto the country at a time when the supply of money was already dangerously inflated by the wartime deficits which produced the large debt in the first place.

During the Korean war, Federal deficits were less inflationary; they were partially offset by a more vigorous monetary policy which the accord of 1951 made possible. The largest deficit did not occur until 1953, by which time the major inflationary pressures had been brought under control. Even so, the money supply grew substantially and the velocity increased rapidly during this period—especially during the years 1951–52.

It should be pointed out that rapidly rising Government expenditures, even though covered or nearly covered by taxation, may create excess demand and inflationary pressures. Given our present tax structure, inflation of prices and incomes increases tax revenues more than proportionately and helps to cover growing Government expeditures. To be sure, such a process also raises the costs of Government, too, but where there is a lag in Government spending, deficits in real term may be concealed for a time by inflationary finance. In other words, inflation may precede a deficit rather than follow it during a period of rapid mobilization when future commitments of Government are increasing sharply. In part, this happened during the Korean episode.

During the inflation of 1956–57 current Government deficits could hardly be made a whipping boy since cash surpluses were achieved in these years. There is considerable evidence and feeling among analysts that our more recent inflationary problems have arisen from wage-cost patterns which now grip us and from expansive private spending rather than governmental spending—a matter which we analyzed at length in The Mechanics of Inflation (1957). In this period the inflation was financed or "validated" by increases in the velocity of money, rather than by significant increases in the supply of money.

This is not to say that past deficits have played no part in recent inflationary experiences. They have—through debt management and the continuing influence of past deficits on the composition of the financial assets of the Nation. For example, short-term Treasury debt is highly liquid and serves as a "near money." It is doubtful if velocity of the money supply proper would have increased as rapidly if we had not had this great pool of liquidity in Government securities, and if Treasury debt refinancing had not kept the pool replenished.

Inflations are complex phenomena. Government deficits are only one element in a given situation, though, at times they may be the crucial element. Certainly, continuous deficits financed by central banks or the banking system will produce advanced inflation. Historically, nations have taken this route to avoid the hard political problems of honest public finance. Temporary deficits, of course, need not be inflationary if budget surpluses are also the rule in prosperous times. Even past deficits, however, may become inflationary subsequently unless monetary and fiscal policies are adapted to changing economic conditions. Fiscal discipline is the handmaiden of responsible government.

Question 15. Can full-employment goals be attained while maintaining a dollar that has relatively stable purchasing power?

Steps necessary to maintain a dollar that has relatively stable purchasing power may but need not jeopardize a reasonable goal of adequate high-level employment.

The pursuit of anti-inflation policy in Government activity will affect employment levels; to produce desired results there must be some employment effects. The issue arises over the degree of these effects and their implications.

This is a question on which further information and analysis would be useful. It is dangerous to make oversimplified generalizations in the absence of better evidence.

However, we believe that (1) there is no proof at this point that reasonable full-employment goals cannot be attained with a stable dollar and (2) that, lacking such proof, public policy should be pursued on the assumption that we can have both reasonably full employment and reasonably stable price levels.

Many argue that holding the line on the general price level will induce excessive joblessness. It appears to us that this is making too quick an assumption on just where the inflationary threshold of the economy is. We believe that no one has yet, conclusively, demonstrated that successful prosecution of a sound anti-inflation policy involves intolerable levels of unemployment.

We should beware of undocumented statements that sufficient restraint must provoke recession of noticeable proportions. The reason: Such an assumption would, without question, produce public policies well calculated to foster further inflation.

As pointed out in the responses to questions 6 (*a*) and 11 (*b*), reconciling high levels of employment, price stability, and economic growth will not be an easy policy task. The pessimists rightly stress the inherent difficulties and our political weaknesses. The optimists attack the implicit premises of those who view creeping inflation as inevitable. They refuse to admit that the special features of our economic and political environment, which generate persistent cost pushes or produce inflationary biases, cannot be changed. The outcome will depend, in large part, on how important the public regards general price-level stability and our willingness to accept some normal fluctuations in both the price level and employment as a necessary and inevitable concomitant of economic freedom.

Question 16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

Widespread use of escalator clauses in wage and other contracts is good evidence that the public has little faith in the financial integrity of the Government or its ability to control inflation. General acceptance of the inevitability of creeping inflation will increase the demands for all sorts of escalators and accelerate the process. There is good reason to believe that they may be inimical to economic stability.

In some cases, escalator provisions may be accepted in lieu of higher wage demands and, hence, be anti-inflationary or less inflationary than wage contracts without them. But widespread use of escalators accelerates inflation, whatever its generating or initial causes may be. They reinforce inflationary pressures and create intolerable distortions in the distribution of income—with resulting divisive social strains. The more vigorously particular groups seek to nullify or minimize the impact of inflation on themselves, the more the unprotected groups suffer and the more persistent are the demands for equality—via, of course, more inflation.

Escalation for everyone would, of course, be self-defeating. It would produce runaway inflation and economic collapse. Paul McCracken, a present member of the President's Council of Economic Advisers, put the issue squarely, a few years ago, in these words:

"Price inflation is the way market forces endeavor to boil the surplus purchasing power out of the system. But if we set up escalator machinery by which as fast as the excess is removed it is promptly pumped back into the economy, the end result of a policy of slowly rising prices is certain to be prices rising not so slowly (Michigan Business Review, September 1955).

Question 17. List and briefly discuss what you consider the causes of the present recession and what should be done to terminate it.

The present recession, like most recessions, developed out of maladjustments of the previous boom and, in the main, represents the normal growing pains of economic progress.

Business cycles are complex phenomena. They cannot be discussed "briefly" or the causes "listed" in a very meaningful way. There are many theories of the cycle—most of them not incompatible. Different theories merely focus on different strategic variables, processes, or relationships. But there is fairly widespread agreement on the following:

1. Business cycles are primarily investment cycles.
2. Business cycles are intimately related to the process of growth.
3. Business cycles are inevitable and normal in a free economy. While widely deplored, they must be faced realistically. They cannot be eliminated, but they can be kept within a normal range of necessary self-adjustment of the system.
4. Because of their cumulative, self-reinforcing nature, there is always danger that business fluctuations may go beyond the normal readjustment and create new maladjustments. It is the task of public policy to prevent excessive inflationary and deflationary pressures from becoming cumulative, but public policy should not try to eliminate the cycle or prevent necessary market readjustments from taking place. As to what can be done about the current recession, the national chamber's position has been stated recently by its president, Mr. Philip Talbott, in a letter to Members of Congress. The text of the letter follows:

"You and your colleagues are vitally concerned with what the Government might do to stimulate economic recovery. The actions the Congress takes during the remaining months of this session could revitalize or might seriously weaken our Nation. I share this concern and would like to give you the benefit of our thinking.

"(1) The first line of defense, of course, is a flexible credit and monetary policy. Fortunately, the Federal Reserve System increased credit restraint as early as 1955. Since last November, it has relaxed this restraint, and the situation should be continuously reevaluated, as the Federal Reserve is doing, and additional steps should be taken by the Federal Reserve, if needed, to reduce the cost of credit and to increase its availability.

"In connection with monetary policy, the public debt should be so managed that it tends to increase the liquidity of the banking system and the economy during a period of softer markets, such as the present. As bank reserves and liquid assets grow, the pressures on their owners to put them to more remunerative use will help put a floor under recessionary tendencies, and this, in turn, will help to sparkle recovery and reemployment.

"(2) We already have a measure of built-in public-revenue flexibility in our income-tax system, so that tax liability drops more rapidly than income, thus leaving more funds in the hands of the taxpayer. Increases in Government spending in the form of unemployment compensation, relief, and the like occur automatically when unemployment rises. These, in a sense, constitute a second line of defense, and have already gone into operation without requiring Government discretionary policy decisions to buoy up the economy. They do not depend on any uncertain forecasting of the business outlook.

"(3) As a third major step, the Government already has accelerated a number of existing procurement and construction programs, such as in the case of highways, other types of construction, including military construction, as well as military and other procurement. Steps to stimulate residential construction have been taken.

"(4) As a fourth step, the national chamber has recommended a tax cut and tax reform to provide greater incentive, both to buy and invest. Even though this will involve a short-run, temporary deficit, we think the growth which will be stimulated by such tax cuts and tax reforms will, in a short time, cause revenues to increase and again bring the budget into balance.

"The foregoing procedures or steps should be adequate to arrest the recession and allow normal recovery through necessary readjustments to take place. The wrong medicine or an overdose may do more harm than good.

"We have grave doubts about the wisdom of a massive Government construction program on a WPA, or PWA, or any other basis. The proposed Community Facilities Act of 1958 would be a case in point. Any such massive ad hoc program is exceedingly awkward, cumbersome, and slow, both in launching projects and terminating them when improvement has taken place.

"Furthermore, since it is so difficult to terminate them, the projects may compete for scarce labor and materials just when the recovery of the private economy is getting underway. This could slow down recovery and expansion. Upward cost and price pressures could stop such recovery in its tracks.

"The full impact of a massive public-works program would not be felt for, perhaps, as much as 2 years. Then, according to numerous prognostications, our military expenditures also will be rising still higher. The two programs would compete against each other for tax dollars and possibly for scarce resources. The Federal budget would build up to unprecedentedly high levels. This would not be in the public interest because it would generate inflation and defer further tax cuts and tax reforms.

"It does not seem wise to use the current situation as a device to promote long-range Government programs. To give every public spending proposal an 'antirecession' cloak, is an easy thing to do. To do so, obscures the fundamental choices which Congress and the voters must make—how the Nation's resources are to be allocated among private and public uses. Government spending should be determined on a long-range basis as to what services we really want Government to provide. Each spending proposal should be judged on its individual merits, and decisions made on that basis.

"For these reasons, we hope that Congress will not embark on any new, general public-works programs or other measures of doubtful effectiveness, and that you will do what you can to encourage a sound tax program and allow the other steps already mentioned to demonstrate their effectiveness.

"Your reaction to this line of approach will be appreciated."

Sincerely yours,

PHILIP M. TALBOTT, *President.*

NATIONAL COAL ASSOCIATION,
Washington, D. C., March 25, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR MR. CHAIRMAN: By letter of February 17, 1958, you transmitted to Mr. L. Newton Thomas, president, National Coal Association, a series of questions incident to your committee's inquiry entitled "An Investigation of the Financial Condition of the United States."

I am directed by President Thomas to transmit to you the enclosure which responds to selected questions. No attempt has been made to answer all of the subject matter inquired about.

Trusting these responses are of some benefit to you and the committee, I am

Yours very truly,

TOM PICKETT, *Executive Vice President.*

REPLIES TO SELECTED QUESTIONS PROPOUNDED TO MR. L. NEWTON THOMAS, PRESIDENT, NATIONAL COAL ASSOCIATION, BY THE SENATE FINANCE COMMITTEE INCIDENT TO AN INQUIRY ENTITLED "INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES"

(For convenience in presenting this material, the questions as numbered in the interrogatory are repeated and the answers follow)

1. Give a definition in your own words of deflation and inflation.

Deflation is a period of generally falling prices, with growing unemployment which is spotty at first and which then tends to spread throughout most of the economy. Inventories are high and production schedules are cut, due to decreased demand. Fixed-income groups benefit, while wage earners tend to lose. Consumers dip into savings and credit use generally is off, as debts are being liquidated. Taxes become increasingly burdensome to all.

Inflation is the opposite of deflation, though not necessarily due to the same factors. These developments characterize excessive rather than mild inflationary or deflationary movements.

2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

The best way to avoid excessive inflation or deflation is to allow business to operate with minimum restrictions. It is impossible to avoid completely all inflationary or deflationary movements, although it should be possible to avoid excesses. Our economy is too complex to expect neither. It is becoming increasingly difficult to transmit or communicate the forces of demand and supply to all areas of the economy. Some lag is inevitable, one of the reasons why we can have inflation and unemployment at the same time.

In theory, it might be possible to achieve a complete absence of either inflation or deflation, but this condition can be secured only through vastly increased Government controls of industry, thus placing our economy in a governmental straitjacket and just about bringing about an end of free enterprise. Current business restrictions, such as excise taxes, high corporate income taxes, and unequal tariff barriers, tend to prolong periods of inflation or deflation before normal economic adjustments can be effective.

Laws which are needed to improve the economic health and well-being of this country will be referred to in my answers to certain of your other questions. However, in connection with the overall economic situation, it might be advisable for Congress to establish an independent committee of economists, businessmen, and labor leaders to determine danger signs in the economy; to recommend necessary actions by Congress; and generally to exercise a type of economic stewardship. This committee should be composed of outstanding individuals and should be independent of control by any branch of the Federal Government. While the President's economic advisers and the great number of economists now employed in Government permit the Nation to acquire a cross section of the best economic thinking, a committee such as that suggested could have more prestige and exercise more influence than any agency constituted at present. There is some doubt that economists now in Government can ever be completely objective.

6. (a) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States: (1) price stability; (2) stability of production, demand, and employment; (3) economic growth in production, demand, and employment.

(b) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II, during the most recent 2 or 3 years, and especially since 1957.

With respect to the first part of this question, economic growth is the most important of these three objectives, though for the best interests of the country such growth must be orderly. Price stability and stability in production, demand, and employment are of course required; but "stable" should not mean static, but instead should mean a steady and even rise. Upward swings of the business cycle with rising prices and employment, as well as capital expenditures, are healthy as long as they do not get out of bounds. This Nation, however, cannot continue indefinitely on an upward trend without an occasional reversal. The role of Government should be to see that such reversals are readjustments and not recessions or depressions. Economic growth through expansion in demand creates new opportunities for investment and for capital expenditure generally. A climate of optimism exists and inflationary forces may or may not be effective at the time. A healthy growth in our economy is essential to meet the demands of growing population and our constant striving for a higher standard of living. It is doubtful that economic growth could develop without upward price movements. The danger, of course, is that inflationary forces may get out of hand. This is where the Government can be most useful to the economy.

The most important postwar trend, particularly in the last year or so, has been the narrowing of profit margins. Producers have had to contend with continued high taxes, especially the corporate income tax, and with revenues which have not kept pace with costs. The inadequacy of revenues has resulted from the mushrooming of competition since the war and the holding down of prices because of this. Suppose we take the bituminous coal industry as an example, the industry with which I am closely associated. Since the war the price of coal at the mines has increased very little. Through mechanization and economies we have managed to absorb increased wage and other costs. Yet increased freight rates and growing competition from other fuels has made it difficult to maintain profitable operations.

Undoubtedly a major factor in the present slowdown in capital expenditure has been the discouragement to investors and managements as a result of these same narrower margins. The businessman wants some assurance that rising cost and lowered margins will not become a permanent part of the business landscape.

An important characteristic of the postwar years has been the transition in business from service competition to price competition. The necessity for price competition has been an outgrowth of the very rapid postwar expansion in the capacity for producing consumer goods and durables. The rise of the discount house and the breakdown of the various fair trade laws are symptoms rather than causes of this new type of competition. Associated with it have been such developments as the growth of establishments which cut across many lines of distribution. Food stores in many cases are no longer simply engaged in the sale of food products. The automobile industry also has been increasingly characterized by price competition, as is evidenced by the discontinuance of many older agencies, chronic overproduction, and longer and longer credit terms.

A phase of the entire issue is the increasing acceptance by consumers of a multitude of credit plans for financing personal purchases. One of the major problems of our economy today is that of the use of credit. Increasing private debt, whether long-term or short-term, always presents a serious problem for the national economy when the amount of personal obligation reaches a high point relative to income. In inflationary periods, the consumer can expect his income to increase considerably if he is a wage earner. On the other hand, people with fixed incomes find it increasingly difficult to finance purchases either on credit or otherwise. Yet personal credit facilitation can become a boomerang, as in the case of the auto industry where a combination of extraordinary selling activity, almost completely new models, and easy credit, frequently running to 36 months, has plagued the auto industry and kept inventories high for the past 2 years. With so much of the economy depending upon the automobile industry for support, such "cheap" credit not only postpones other purchases during the time of its application to the individual, but merely delays the inevitable day of judgment.

7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

I shall confine myself to answering the portion relating to Federal Government spending, since this is obviously the most significant factor. Large Federal spending for the most part does not result directly in the creation of consumer goods. Much of it is devoted to national defense and foreign aid. For this reason, I believe that such spending creates a strong inflationary tendency by withdrawing scarce resources, including labor, from the production of goods which the people of the United States need and want to buy. Tremendous Government spending also is generally inflationary because it is common knowledge that the Government is not a very good bargainer pricewise—that is, in making contracts it is very much inclined to overpay the producers of goods. Incidentally, if pump priming is used by the Government as a deliberate policy, I would assume that along with it would go a calculated effort to keep the prices of goods and services involved at high levels. Excessive Government spending is, in the long run, bound to be inflationary, I believe, since it is accompanied by a continually increasing public debt. The point will finally be reached (and I think it shows signs of being reached right now) where the Government, as a larger debtor, simply cannot afford to pay off the principal, or even the interest, in dollars having the same value which they had when the money was borrowed. Finally, the Government, in the postwar period as well as earlier years, seems to have adopted the view that continuing inflation itself is a good thing, or at least that it is preferable to a trend in the other direction. Even if the latter and more conservative view is made the basis of Government action, I think that inflation will result because of the tendency to overcorrect deflationary elements. In this connection, I think that the sharp upward trend of the stock market during the past few days, in the face of bad business news, clearly reflects a fear of inflation outweighing the fear of lower profits—in other words, a flight from the dollar. By both inflation and deflation is meant to excessive or abnormal trends referred to in my answer to questions 1 and 2.

8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

Here again I will confine my answer to the effect of Federal taxation. As between a rapidly increasing public debt and continued high taxes, I would consider the latter the lesser of two evils. At least it would lack some of the more important inflationary aspects mentioned above. At the present time, however, it appears that we unfortunately are going to have both a continuation of high tax rates and a marked increase in the public debt. There may be some relief in the form of an increased personal exemption, or even in the form of some slight reduction in rates across the board, but I do not think this will be of much significance in stimulating the economy to produce more goods. The sharply graduated tax on personal incomes is a very serious deterrent factor in the face of the obvious need for expansion of our economy. People who have money to invest find that a good deal of it is skimmed off by Federal taxes. Furthermore, there are a good many tax-sheltered investments, such as tax-free State and municipal bonds and funds of various types which can be taken advantage of by the really wealthy taxpayer. Obviously, the investment of money in these fields does not promote the growth of the economy.

Our industry is primarily interested in percentage depletion as a tax relief device. Contrary to popular opinion, percentage depletion is by no means a loophole, but is a perfectly proper and legitimate tax deduction. This sort of deduction, in times of sharply rising costs, is in fact a good deal more equitable and realistic than the deduction for depreciation. The latter has been under sharp, and quite justified, attack recently because it is based on cost. The result is that the dollars recovered tax-free through the depreciation allowance are, in most cases, grossly inadequate to maintain the taxpayer's capital investment. Since depletion is measured by income, there is at least a rough adjustment of the amount of the deduction as the general price level rises. In the long run the depreciation allowance will have to be adjusted in somewhat the same manner, if the inflationary trend continues. But here again is a case where the Government simply cannot afford to do equity very quickly. The tax loss involved in putting depreciation on a replacement basis would be tremendous. Again, the matter of the effect of divergent trends on the economy is important, for under deflationary trends the tax gain here would be high.

The corporate tax rate is, of course, quite large. I believe, however, that this is not as serious a matter for the development of the economy as a whole as are the very high personal income tax rates. There is certainly a very good argument for reducing the corporate tax rate to 50 percent simply on the rough justice theory that the Government should be no more than an equal partner.

11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

(*b*) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

Inflation and unemployment can exist side by side. This is the result of the failure of economic communication. The automobile industry and certain other major businesses are experiencing unemployment while prices in many other areas continue to edge upward. It is possible to have unemployment in durable goods and inflation elsewhere in the economy. Much of the responsibility for this lies in the "stickiness" in the movement of prices. The credit system tends to keep prices up because people are still paying for purchases made in 1956 and 1957, when business was better by most standards. Until unemployment in the auto, steel, railroad, and other basic industries can transmit its effects to consumer prices generally, creeping inflation will continue to exist. A major reason for this discrepancy between prices and employment is the existence of easy consumer credit in virtually all lines of durable and soft goods.

With respect to the second part of this question, some inflation, as well as deflation, is inevitable in a free economy, assuming, of course, that this is what we have today, a conclusion with which I disagree. Gradual inflation is not the same as excessive inflation. The former is a natural part of any noncontrolled economy. The Government's role should be two-fold: To prevent excessive inflation, and to stand by with assistance, both direct financial and indirect through the reduction of taxes and other devices, when excessive inflation has brought about (1) unemployment, (2) a slowdown in capital expenditures, and (3) a retrenchment in industrial expansion plans. Capital outlays largely are due to expectation for increased demand for the products and services of industry. Part of this, of course, is mildly inflationary. Again, as I have stated elsewhere, an increasingly dangerous factor in the national economy is the growing size of Government expenditures. The vast amount of public funds poured into the economy through this door prevents the free operation of economic forces which otherwise might bring about adjustments between inflation and deflation.

15. Can full employment goals be attained while maintaing a dollar that has relative stable purchasing power?

The answer to this is "Yes," if what is meant is "relatively stable." The American people certainly do not want instability. The Government should use every device at its command to see that a relatively stable dollar is maintained, curtailing unnecessary Government spending when times are good and increasing this when times are bad. This goal, of course, is less easily attained when defense needs are large. It is impossible to expect a smoothly operating economy when defense needs are as at present and in addition to this, large Government funds are being expended for a multitude of purposes, many of which should be carefully reviewed as to justification. The danger is, of course, that curtailment of nondefense needs in order to maintain a more balanced budget may mean postponement of such needs for a considerable time, as at least in the foreseeable future, there appears to be no chance for curtailment in defense expenditures.

17. List and briefly discuss what you consider the causes of the present recession and what should be done to terminate it.

The major causes of the current recession are:

(1) Excessive use of consumer credit, bringing about curtailment of consumer expenditures until current obligations are liquidated;

(2) Narrowing profit margins for producers and distributors, brought about in large part by increasing wages and other costs on the one hand and relatively fixed revenues on the other; and

(3) Heavy Government expenditures due in large part to defense needs but which have the effect of preventing free communication of economic forces on the operation of factors which would adjust our economy between excessive inflation and deflation.

Among the steps which should be taken to remedy the situation should be the following:

(1) Tax reduction—especially in personal income taxes, although it is important to reduce business taxes, probably to 50 percent or perhaps less;

(2) Elimination of excise taxes and other taxes which are only indirectly related to the basic purpose, or purposes, originally underlying their imposition. For example, the transportation tax should be dropped. It no longer is needed to discourage transportation either of passengers or of freight. If the tax on coal were eliminated, for example, the amount saved would equal the recent rate increase requested by the railroads;

(3) Adoption of a policy, publicly stated and fully implemented, for taking Government out of competition with business, and reduction of the Federal budget wherever possible;

(4) Affirmative action on the recommendations of the Hoover Commission on Economy in Government; and

(5) Establishment of a completely independent economic committee staffed with highly qualified business and academic leaders who would recommend to the Government desirable action concerning consumer and industrial credit and anti-inflation devices. The committee should establish an economic barometer, to be used as a warning of excessive inflation or deflation.

To summarize: The Federal Government has become such an important factor in our economy as a result of its spending programs, especially in connection with defense, that its actions tend to obscure normal trends in economic forces of demand and supply. Until Government participation is reduced to a minimum, private enterprise will continue to experience artificial inflations and deflations.

The bituminous-coal industry, representing the utilization of a natural resource, is particularly susceptible to such artificial stimulation, because coal, unlike many other industries, is a derived industry—that is, its success or failure generally depends upon the economic health and well-being of its customers.

O

85th Congress }
2d Session }

COMMITTEE PRINT

INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES

COMMENTS OF ECONOMISTS, PROFESSORS, AND OTHERS IN RESPONSE TO THE QUESTIONNAIRE

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE
EIGHTY-FIFTH CONGRESS
SECOND SESSION

CHAPTER 5

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INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES

THE AMERICAN BANKERS ASSOCIATION,
DEPARTMENT OF MONETARY POLICY,
New York, N. Y., April 30, 1958.

Senator HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: You will find enclosed my answer to the questionnaire enclosed with your letter of February 17. I hope it will be helpful. Let me express my appreciation for the opportunity of participating in this questionnaire and especially for your courtesy in granting me an extension of time to finish my answer. It so happened that my agenda was unusually full over the past 2 months and it would have been impossible for me to finish my reply by April 1.

Would you be good enough to let me know whether or not your committee plans to print my reply, and if so, what the publication date will be?

Sincerely yours,

E. SHERMAN ADAMS.

Enclosure.

HOW CAN WE ACHIEVE ENDURING PROSPERITY?

Answer of Dr. E. Sherman Adams, Deputy Manager, American Bankers Association, to the Senate Finance Committee's questionnaire of February 17, 1958

(These comments reflect the personal opinions of the author and should not be regarded as representing the official views of the American Bankers Association.)

There is broad agreement that our major economic goal is to achieve enduring prosperity. This clearly implies the maintenance of high levels of production and employment and a reasonably stable price level. It also implies a satisfactory rate of economic growth.

These elements of economic stability are not in conflict but are inseparably interdependent. No one of them can be achieved on a sustainable basis without the other two.

Conflict would exist if we were to push any one of these objectives to an extreme instead of aiming at good overall performance. If we were to strive for maximum growth at all times, our economy would be dangerously unstable. If we were to try to maintain maximum employment at all times, we would have inflation. Even the pursuit of maximum price stability might at times interfere with satisfactory growth, employment, and production. Our aim, therefore, should be a balanced mix of these ingredients of enduring prosperity.

NOT 1 PROBLEM, BUT 2

Most of us have long been accustomed to thinking of the problem of economic instability as consisting of the problem of the business cycle, the problem of mitigating booms and recessions. But today something new has been added. Indeed, economic instability now consists not of 1 problem, but 2. In addition to the age-old problem of the business cycle, we are now confronted with a new problem: That of preventing a continuing depreciation of the dollar over the years, popularly known as creeping inflation.

This new problem has emerged because of the inflationary biases that have developed in our economy over the past several decades. These biases constitute a new and serious problem not only because they push up prices during good times but more especially because they prevent prices from ever readjusting downward. In short, price increases have tended to become irreversible.

This has never been the case before in the United States. We have had periods of price inflation, to be sure, but they were invariably followed by periods of deflation. Throughout our history, major wars always caused inflation but prices always subsequently returned to approximately prewar levels until World War II. The inflation of World War II has become permanently imbedded in our economy.

And so has the inflation of the Korean war, and, for that matter, most of the price inflation of 1954–57. In fact, even during the recession year of 1958, we are witnessing a further rise in the most important price in our economy, the price of labor.

These inflationary biases have actually been at work in our economy for several decades but until recent years their effects were somewhat obscured, first by the wartime inflation and then by the unusual character of the postwar period. They became somewhat more apparent during the Korean war period but it has only been over the past 4 years that they have emerged clearly to the general view.

The pattern of the past 4 years has been, in brief: A period of boom aggravated by inflation, then a recession aggravated by high prices, and for the period as a whole, further erosion in the purchasing power of the dollar. The problem of economic stability for the future may be essentially that of preventing a repetition of this pattern—or of preventing it from becoming worse, if the people should lose confidence in the long-run integrity of the dollar.

The new resistance of our economy to price declines has its bright side, of course. Our past periods of price deflation have often been extremely painful and it is certainly reassuring to know that we will in all probability not experience such severe deflations in the future. But this is no reason to minimize the dangers of inflation that loom ahead.

The emergence of this long-run inflationary threat has fundamentally changed the whole problem of maintaining economic stability. We should try to come to grips with the fundamental elements of this new problem and to think through its important implications for public policy. We should no longer think in terms of anticyclical policy alone; we should think in terms of anticyclical plus anti-inflation policy.

IMPLICATIONS FOR PUBLIC POLICY

Let us consider some of the implications of this problem for public policy.

During a period of business expansion, prices normally tend to rise. However, if public policymakers are aware that price increases may never be reversed, they will naturally feel that it is highly important to try to combat rising prices. The net result is likely to be that some inflation will occur anyway but that economic growth will be either retarded or interrupted by a recession.

Similarly, when a recession starts, there will be a strong reluctance to adopt corrective measures promptly for fear of starting the inflationary spiral again. The existence of the inflationary biases in our economy give real justification to this reluctance. The net result, however, is likely to be that inflation will be merely retarded temporarily and that recovery will be delayed.

There is urgent need, therefore, to do what we can to correct or offset these inflationary biases in our economy—in addition to improving our techniques for combating the business cycle itself. We have already made great progress with respect to this latter problem, but very little with respect to the former.

Before suggesting what might be done, however, let us examine the nature of these two distinct, though related, problems: creeping inflation and the business cycle.

OUR INFLATIONARY BIASES

There is obviously ample room for debate as to whether our economy really does have serious inflationary biases, and if so, what should be done about them. Rather than attempting anything like a comprehensive treatment of these questions, I should like here simply to single out four major aspects of this subject that deserve particular attention: (1) industrial wage and price policies, (2) Federal fiscal policies, (3) interest rates, and (4) the Employment Act of 1946.

(1) Let us look first at the delicate and crucial area of industrial wage and price policies. I use this inclusive phrase because although some people are willing to talk about inflationary wage increases and others to talk about inflationary pricing policies of business, I fear we will continue to make little progress with this basic problem until we recognize that these things are inextricably interrelated. Interacting together, they have produced the ominous wage-price spiral.

The basic facts of this situation are too well known to require elaboration here. When wages, including fringe benefits, rise more rapidly than productivity, the result is bound to be higher prices. And when business concerns follow pricing policies designed to pass along to the public most or all of their added labor costs (and sometimes more), then the result is a formidable wage-price spiral. And that, as is well known but not always acknowledged, is just what has been happening in this country in recent years. Indeed, this process has become such a national habit that it has aptly been referred to as institutionalized inflation.

Your questionnaire contains only one reference to this basic problem; namely, the question regarding the effects of escalator clauses in wage contracts. It goes without saying that escalator clauses tend to be inflationary—practically by definition. On the other hand, the elimination of such clauses would not by any means solve the wage-price spiral.

It has been suggested that one approach to this problem should be to try to speed up the improvement in industrial productivity. There are opportunities for doing this, of course. Featherbedding has become so imbedded in the railroad industry that we seldom even bother to mention it any more. Another prize example, as everyone knows, is the residential construction industry. Certainly these obvious opportunities for improving productivity should not be ignored but, looking at the matter realistically, progress in these areas will not solve the wage-price spiral either.

Since this is not my field of competence, I shall refrainfrom trying to prescribe what should be done. Certainly we should be hesitant to infringe the freedoms either of business management or of organized labor. On the other hand, when the combined actions of these two groups seriously threaten the stability of the American economy at this critical juncture of history, then they pose a problem that we cannot afford to ignore. Mere exhortation and appeals for statesmanship are not likely to have much lasting effect. There is clearly need for carefully thought-out modifications in the rules under which this game is played.

OUR INFLATIONARY BUDGET

(2) Another major source of inflationary bias in our modern economy is the fiscal policies of the Federal Government.

One serious defect is our working philosophy with respect to the Federal budget. Years ago, the goal of balancing the budget during good times was adequate. But this is not an adequate goal today because of the enormously increased magnitude of the budget. At present levels, a balanced Federal budget is inflationary. Yet, although this is true—for a number of reasons, most of which are quite familiar—most people are content merely to balance the budget, or have it show a nominal surplus, even at the height of an inflationary boom.

With a budget the size of ours, sound fiscal policy calls for a combination of tax and expenditure policies that will produce substantial budgetary surpluses for debt reduction during periods of active business. This will take a lot of educating, of course, and, also, political courage, but the sooner we recognize the need the better.

Another inflationary aspect of the Federal budget is the existing system of high price supports for farm products. This, too, of course, is another complicated problem, but it is at least clear that we should work toward a lower, less inflationary level of farm support prices.

THE CHEAP-MONEY FALLACY

(3) Another inflationary factor I would like to mention is the widespread bias in favor of low interest rates. This is a very difficult thing to measure, and, since I am a monetary economist who has been connected with the banking business for a good many years, perhaps I

am inclined to exaggerate its importance. Nevertheless, this is certainly not a matter to be lightly dismissed by anyone who is seriously interested in preventing inflation.

The main points here are quite simple, though they are not generally appreciated. Many people, including some in public office, seem to think that the one price that should be held down at all times is the price of borrowing money. This may have highly inflationary consequences. For one thing, monetary policy cannot combat inflation effectively without restricting the supply of credit, and this cannot be done unless interest rates are permitted to rise. Also, over a period of years, if interest rates are kept at artificially low levels, this is bound to aggravate the inflationary imbalance between the supply of savings and the demands for loanable funds.

This could become increasingly serious over the years ahead if inflationary tendencies are not kept in check. At some point, rising prices can discourage people from saving money, especially if the reward for saving is low. This danger may seem remote today, but it is not something to be pooh-poohed. If such a psychology ever should develop among the people of this country, we would be in serious trouble.

For these reasons, I believe that the existing bias in favor of low interest rates is a threat to economic stability. Those in public life who make a fetish of low interest rates at all times are doing great disservice to the American people.

(4) Finally, there is the inflationary bias contained in the statement of economic objectives in the Employment Act of 1946. This could be easily corrected by an amendment making it clear that one of the primary objectives of public economic policy in the United States is to avoid inflation. I believe that such an amendment might have a salutary effect over the years.

THE PROBLEM OF THE BUSINESS CYCLE

In addition to these inflationary biases, we have the venerable problem of the business cycle.

There is, of course, a vast literature about the business cycle, and there would be little point in trying to summarize it here. There are two points, however, that may be worth emphasizing.

First, despite the progress that has been made, there is still a great deal that we do not know about the business cycle and how to deal with it. There is need for encouraging and stepping up the research that is being done in this area. It is almost unbelievable to contrast the vast scale of our research in the physical sciences and in industry—and the pride we take in such research—with the appalling paucity of research being done on this vital problem of economic instability. Perhaps this is something for your committee to ponder.

Second, although there is much we do not know about the business cycle, there is one basic fact we do know; namely, that we cannot achieve economic stability unless we curb inflationary booms. Yes; this sounds simple enough, but, unfortunately, it is all too often ignored—and that applies, of course, to public as well as private policymakers.

You ask the chief causes of the current recession. In oversimpified terms, this recession is primarily an inevitable reaction from the inflationary boom that preceded it. In turn, the factors responsible for the boom were the usual cyclical factors that you will find enumerated in any economics textbook, aggravated by the inflationary biases already discussed, and, also, aggravated by certain governmental policies, chiefly:

(1) Excessive stimulation of residential construction. This caused an enormous inflation in construction costs, and this, in turn, aggravated inflation in other segments of the economy. It also contributed to the speedup of industrial construction that featured the 1956-57 boom. Now that we really need an expansion of residential construction, many markets have been saturated and much of our ammunition has been used up. Public policy with respect to housing has had a destabilizing effect on our economy, whereas, if wisely conceived, it could have an important stabilizing influence over the course of the business cycle.

(2) Unwise Government spending. The annual "pork barrel" bill, for example. To say the least, Congress did not do an outstanding job of curbing unnecessary or postponable Government expenditures.

The basic need, clearly, is for more widespread understanding of the importance of restraint during the expansionary phase of the business cycle—both on the part of the Congress, and also, of course, on the part of the public generally.

THE ROLE OF CREDIT CONTROL

There is widespread agreement that financial measures—monetary and credit policies, debt management, and fiscal policies—can make an important contribution to economic stability. This view seems to be reflected in your questionnaire, and it is one with which I am in general accord, though with one reservation; namely, that as a practical matter, I doubt whether Federal debt management can ever operate as an important anticyclical technique.

Let us first consider the role of credit regulation—what its record has been in recent years and what can be expected from it in the future.

Prior to the Federal Reserve-Treasury "accord" of 1951, monetary policy in its traditional role of an economic stabilizer was, of course, practically inoperative. Since then, Federal Reserve policy has become a highly flexible and useful weapon for helping to mitigate the swings of the business cycle.

In general, the monetary authorities have exhibited great skill and courage in administering monetary policy. There have been some errors of judgment from time to time, naturally. That is to be expected. On the whole, however, allowing for the difficulties inherent in this task, the record has been excellent. It seems clear that, on balance, monetary policy has made a useful contribution to the stability of the economy over this period.

On the other hand, experience since 1951 has also demonstrated afresh the important limitations as to what the Federal Reserve can be expected to accomplish with its existing powers—which consist chiefly of its ability to regulate the availability of bank reserves. For one thing, the policies of nonbank lenders and investors have not always responded promptly to Federal Reserve policy—a case in point being the progressive liberalizing of installment credit during

1955. Also, even bank lending policies may not have been as responsive to monetary policy as is generally supposed.

This, naturally, raises the question as to whether additional controls over private credit may be needed to supplement the Federal Reserve's existing powers. Various suggestions have, of course, been made along these lines, and some of them may deserve consideration. In general, we should avoid new controls unless they promise to have important stabilizing results. It would certainly be foolish to put credit in a straitjacket of excessive regulation and to leave undone other things that need urgently to be done. On the other hand, if careful study indicates that additional credit controls are really needed, then we should adopt them.

The most obvious weakness in the credit picture is the fact that governmental credit agencies have at times pursued policies in direct conflict with national monetary policy. A few years ago, for example, when the Federal Reserve was tightening bank credit to curb inflation, the Federal Government, through Fannie May, was simultaneously pumping new funds into the mortgage market. At the same time, the Federal home loan banks greatly increased their advances to Federal savings and loan associations. Numerous examples could be cited.

Plainly there is need for better coordination of the policies of Government credit agencies with Federal Reserve policy—not vice versa. This is obviously a complicated problem that cannot be cured simply by passing a law. Nevertheless, it might do some good if the Congress were to enact a law making it clear that it is a primary responsibility of every Government agency empowered to grant or guarantee credit, to see to it that its credit policies are at all times consistent with Federal Reserve policy.

Before leaving this subject of credit regulation, two additional points deserve emphasis:

(1) It should be clear that economic stability cannot be achieved by credit controls alone. They can make an important contribution but we should not expect them somehow to offset the unstabilizing effects of unwise policies in other areas. Indeed, it would be highly dangerous to rely too heavily on what can be accomplished by monetary policy.

(2) If monetary management is to be permitted to make its full potential contribution to economic stability, then it must have widespread understanding and support—or at least toleration. This imposes on all of us, especially on men holding public office, an obligation to refrain from irresponsible criticism of the Federal Reserve authorities and of their policies. There has been an ominous tendency in some quarters in recent years to attack credit restraint in a highly irresponsible manner. If continued, this could eventually have serious consequences for the stability of our economy.

THE ROLE OF FISCAL POLICIES

So much has been said and written about the anticyclical use of Federal fiscal policies that I shall confine my comments to a few specific points:

(1) It seems clear that fiscal policies could be used much more effectively in combating economic instability than they have been in the past. It should be possible to achieve a better scheduling of Federal public works and especially to cut down on postponable expenditures during periods of active business.

(2) There is need for establishing a tradition of greater responsibility with respect to tax policy. This would make it possible to use tax policy more effectively as an anticyclical weapon. Many who oppose cutting taxes at the present time to combat the recession are opposed because they fear that the tax cut might not be sensible in form and that it might not prove to be temporary. We should try to work toward a rational policy of raising tax rates during booms and lowering them during recessions.

(3) There is clearly a need for better budgetary procedures within the Congress. Some progress has been made in this direction but tax and appropriation bills are still enacted without adequate consideration of their relationship to the overall budget situation. Another item here is the matter of the item veto—one item that could be enacted without the loss of a single vote.

(4) It may well be that our tax system needs to be thoroughly reformed. Indeed, a case could probably be made that our present tax system tends to be inflationary. In any event, given the inflationary bias our economy does have, it certainly does not make sense to have a tax system that penalizes saving and encourages borrowing. If it must lean in one direction or the other, it should be the opposite direction.

FINANCIAL MEASURES WILL NOT SUFFICE

Even if we strengthen our credit and fiscal policies, these will not suffice to achieve economic stability. Notably, whether we like it or not, there remains the wage-price spiral. Financial measures may temper this spiral, slow it down at times, but they cannot, as a practical matter, keep it under control. Wage negotiations reset the valves that control a substantial part of the money flow through our economy. When these valves are opened too rapidly, their effects cannot be offset by tightening the financial valves without causing a business recession and unemployment.

As previously suggested, this problem of the wage-price spiral is one that must be dealt with directly. Until we face up to this problem, our economy will continue to be threatened with chronic instability.

In addition, and in conclusion, there is one more matter to which I should like to invite your attention: namely, the matter of organization for policymaking within the Federal Government. Here we are today confronted with a problem of crucial importance: the problem of maintaining a stable economy in a world where the very survival of civilization will in all probability depend upon our success. The question I raise is whether we are adequately organized to deal with this complex and momentous problem.

To be sure, the Federal Reserve System has a fine staff, and we now have a Council of Economic Advisers, also equipped with an excellent staff. In addition, various individuals are invited from time to time to present their views to quite a variety of congressional committees, and some of these committees in turn have good staffs of their own.

And, of course, there are other agencies and groups that participate in the formulation of public economic policies.

But do all of these groups and procedures add up to the most effective organization that we can possibly put together for dealing with the vital problems with which we are confronted? You are obviously in a much better position to answer this question than I am. From this distance, however, it would seem to me that this may be a question to which Congress should perhaps devote careful consideration.

April 30, 1958.

COLUMBIA UNIVERSITY IN THE CITY OF NEW YORK,
DEPARTMENT OF ECONOMICS,
New York, N. Y., April 12, 1958.

Senator HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: Under separate cover, I am today mailing to you the statement I have prepared in answer to your letter and questionnaire of February 17. I must again apologize for the fact that unexpected pressures of university work and typing delays have prevented me from getting the statement into your hands by April 1, the date you had suggested.

I found it most effective to group the questions you had posed into three main sections, dealing with the causes of the post-1946 inflation; the causes and cure of the present business recession; and longer run economic goals. For your possible convenience, the central argument of these sections is presented in a two-page summary at the beginning of the statement.

It was a great pleasure to prepare this document for your committee. Although it comes a little late, I hope it may still be of service to your committee in their crucially important deliberations.

Sincerely yours,

JAMES W. ANGELL,
Professor of Economics.

THE FINANCIAL CONDITION OF THE UNITED STATES: THE POST-1946 INFLATION, THE CAUSES AND CURE OF THE PRESENT RECESSION, AND LONGER RUN GOALS

Reply to a Questionnaire From the Committee on Finance, the United States Senate by James W. Angell, Professor of Economics, Columbia University, April 8, 1958.

SUMMARY

1. Inflation and deflation are defined here in terms of the movements of the prices of mass-consumption goods.

2. The chief cause of the inflation after 1946 was the excessive expansion of aggregate monetary demand. This expansion was due to a number of factors, chiefly the postwar readjustment in this country and postwar reconstruction needs abroad, the cold war, the policies of the Treasury and the Federal Reserve, the policies of Congress and the Executive with respect to taxation and nondefense spending, and State and local government spending. Greater restraint by Congress with respect to nondefense spending, more powerful tax measures and greater monetary restraint would, in combination, have prevented any substantial inflation.

3. The present recession is in part a reaction from an overexpansion of the current output of finished products, and "inventory recession"; but is in part a reaction from the overexpansion in the last 2 or 3 years of plant and equipment. This last is what makes it so ominous, because an overexpansion of capacity may take years to work off. The situation is rapidly becoming critical, and is beginning to look like 1929–32, not 1953–54. It is critically important to our vital national interests to stop the recession and start a recovery at the earliest possible moment, not only because of the suffering which a serious depression would impose on our own people, but also because of the severe damage it would do to the economies of our now-friendly trading partners abroad, and thus to our international political position. It could easily lose us the cold war. Because time is required for countermeasures to take hold, a number of steps should be begun at once: first, personal and corporate income tax cuts, and possibly excise tax cuts; second, a much greater easing of monetary policy; and third, increased government expenditures, especially on unemployment benefits, foreign aid, and assistance to State and local government construction projects. No one of these three types of measures will alone do the job, but the psychological impact and the direct effects of the combination of the three will. The greater the initial effort the sooner will recovery start, and, therefore, the shorter will be the period for which the measures must be continued. They will also be correspondingly less expensive. The postrecovery inflationary danger can be entirely avoided if Congress and the Federal Reserve later enforce sufficiently strong restraints, in the form of increased tax rates, reduced government spending, and tight monetary policy.

4. The major long-run economic goals should be full employment, price stability, and the maintenance of economic freedom. To achieve them, price stability should be made an explicit objective of monetary policy by amendments to the Employment Act and the Federal Reserve Act; the Federal Reserve Act should be amended in several ways, and a National Economic Commission should be established to coordinate, in the light of the goals just described, the operations of all the governmental and quasi-governmental agencies that have financial or fiscal powers. The ultimate and only key to the real achievement of these goals, however, is necessarily the will and self-discipline of the Congress and the President.

INTRODUCTION

The letter addressed to me by Senator Byrd on February 17, 1958, included a list of 17 suggested questions. For brevity and clarity, I shall combine most of them into four main groups, which I propose to take up in the following order:

I. The definition of inflation and deflation.
II. The causes of the United States inflation since 1946.
III. The causes and cure of the present recession.
IV. Longer run economic goals and means to achieve them.

A fifth group of questions, concerning technical aspects of our monetary and fiscal system, is best handled for the present purposes in connection with the discussion of the other groups.

I shall not undertake any detailed statistical analyses. Such analyses have been made many times, and at best tell us where we have been in the past. As I understand it, the chief interest and concern of the committee is rather with where we are now and where we are going.

I. THE DEFINITION OF INFLATION AND DEFLATION

So many definitions of inflation and deflation have been used in the past, for so many different purposes, that no one definition can be regarded as necessarily "right." The terms have commonly been used to describe the movements of one or more groups of prices that are thought to be especially significant. They have also been used, however, to describe the effects and sometimes even the supposed causes of such movements. Moreover, absolute and continued fixity of prices is presumably impossible in a competitive individualistic society. Therefore, any definition must include some statement about how great or how rapid a price change can be, before it is described as constituting inflation or deflation. All of these matters involve questions of judgment and preference, on which equally competent students may disagree.

Without further discussion, I shall define inflation and deflation in terms of the movements of the prices of those kinds of goods and services which are typically bought in some volume for their own consumption by the great majority of the individuals and households in the country. This means, in effect, bought by the lower and middle income groups. Hamburgers and overcoats are in; diamonds and caviar should not be. As to the permissible degree of fluctuation, before inflation or deflation can be said to exist, I do not know what the "right" maximum range is, but I suggest that it be set at not more than 3 or 4 percent above and below the figure for some selected base year or base period. Finally, since products and tastes change with time, I suggest that the base period should never be more than perhaps 10 years in the past.

To summarize, I shall define inflation as existing whenever an appropriately constructed index of consumer prices rises more than 3 or 4 percent above an appropriately chosen base figure, which relates to a period not more than about 10 years in the past.[1] And so conversely for deflation.

II. THE CAUSES OF THE UNITED STATES INFLATION SINCE 1946

The fact that the United States has suffered from a serious inflation since 1946 is beyond dispute, no matter what measurements are used. From the end of the Second World War in 1945 to March 1958, consumer prices (Bureau of Labor Statistics) rose about 60 percent, wholesale prices 73 percent. From the 1946 low to the 1957 peak the money value of our gross national product—our total output—rose some 50 percent more than the estimated physical quantity of the output itself, which implies an average price rise for the aggregate of all goods and services of about 50 percent. Whatever figure we take, the fact that there has been a very substantial and injurious inflation in

[1] The statistical problems involved in constructing an appropriate price index are substantial, but will not be explored here.

the last 12 years is incontestable. It is worth emphasizing, however, that the inflation did not proceed at an even pace. Half of it took place in the 3 years immediately after the end of the war. Thereafter, price leveled off until the Korean War, which forced them up by another 13 percent of the 1949 figure. Then they again leveled off until early 1956, when a new "creeping" inflation began which is still continuing, despite the current recession.

The damage which an inflation of this size does is familiar to everyone. It eats away the real value of all incomes and all wealth that are fixed in dollar terms, notably bonds, mortgages, saving accounts, annuities and life-insurance policies. Since 1946 these have lost a third of their value, and since 1938 a half. This process of gradual invisible confiscation is not so serious for the well-to-do, who usually have sufficient knowledge and opportunities to protect themselves if they wish, but for the lower income groups it can be catastrophic. It constitutes an unplanned but powerful change in the distribution of wealth and income, in favor of equity holders and debtors. There is no general reason to think that this redistribution is socially desirable, nor to think—as some allege—that without slow but fairly continuous inflation the growth of real output would be seriously hampered.

The causes of the inflation since 1946 have been numerous, interconnected, and hotly debated, both among political leaders and among professional economists. There has been a great temptation to single out some one "cause," in order to attach the blame for inflation to a particular group, policy, or political party. My purpose here, however, is not primarily to try to fix responsibility, but rather to examine the past in the hope that it will suggest how to set up better arrangements in the future.

It seems quite clear that three principal sets of factors either directly caused or at least powerfully contributed to the size and duration of the generally inflationary movement since 1946. They are: (1) the great increase in aggregate monetary demand—in the total volume of actual dollar spending on goods and services by individuals, business firms, and governments; (2) the downward inflexibility of many classes of money costs and money prices; and (3) the considerable number of so-called cost-push forces, which have tended to raise current monetary costs at each point in time relative to current product prices, and have thus encouraged or even compelled business firms to raise these prices further. It is worthwhile to look at the more important of these factors, not in the expectation of discovering some new and unheralded cause—on the contrary, they are all long familiar—but because I think significant conclusions about future policy will at once be forced to the front.

1. Increased aggregate monetary demand

The fact that aggregate monetary demand increased enormously after the end of the Second World War is self-evident. From the end of 1945 to the end of 1957 this aggregate demand, as measured by the number of dollars' worth of gross national product which was bought, more than doubled. In itself, this was fine. But over half of the rise was due to the successive increases in prices; less than half was due to increases in actual physical output itself. Why did money demand run so far ahead of physical output? A series of factors were responsible, some operating only at certain times but others throughout the post-war period. The chief ones were these:

(*a*) *The financing methods and controls of the Second World War.*—The severe wartime restraints on consumer spending (chiefly rationing, price controls and savings bond campaigns) created an enormous backlog of potential demand, while the fact that more than half of the cost of the war was financed by floating salable or redeemable bonds meant that when the war was over and the controls were abruptly removed, ample spending power would be available. Much of the price rise to 1948 was for all practical purposes inevitable, given that the wartime controls were removed suddenly rather than gradually.

(*b*) *The enormous foreign and especially European need* for imports of goods for relief, rehabilitation and reconstruction after the war—imports which could come in the main only from the United States.

(*c*) *Treasury interest-rate policy to 1951*, with the reluctant acquiescence and support of the Federal Reserve. The result was, of course, that the interest rates on all Federal securities, and also in the short-term money markets at large, were kept low (even long-term taxable governments never rose above 2½ percent); the commercial banks and the general public remained very liquid, and the door was thrown open to a general expansion both of credit and of aggregate spending in the private sector. This cast added fuel on the fires started by the first two factors listed.

(*d*) *The international policy of Soviet Russia.*—This compelled us to resume gigantic defense spending of all sorts, with and ever since the Korean war, in amounts which in recent years have exceeded 10 percent of our entire national product.

(*e*) *Congressional policies.*—The Congress, with the acquiescence of the executive branch, has in general liked to spend, as on rivers and harbors, housing, highways, veterans' bonuses, farm-price support schemes, and subsidies to shipping and air transport. But it has not been nearly so eager to raise taxes high enough to cover all this and defense spending too, let alone enough to reduce the Government debt. Indeed, tax rates have been substantially lowered; and the gross Federal debt, including business-type activities, is now some $50 billion larger than at the postwar low, in 1948.[2] Moreover, the total money volume of Federal Government expenditures has more than doubled since 1948, and is now some $37 billion per year higher than in 1948. Most of this, of course, is the increase due to defense spending, but not all of it. Even had the budget been kept balanced, this great increase in Federal spending—an increase which was an original or independent source of disturbance—could not have been kept from having a tremendous expansionary and even an inflationary effect.[3]

[2] But the direct gross debt of the Federal Government proper increased only half as much by roughly $20 billions.

[3] Even if the increases in tax receipts keep pace with the increases in Government spending, so that there is no budget deficit, the effect of the spending is likely to be expansionary. In general, money which is obtained from taxes is spent, and is spent quickly. If Government spending and tax receipts are balanced at much lower levels, however, so that more money is left in taxpayers' pockets, there is no assurance that the taxpayers will spend correspondingly more than they did at higher tax levels: They may decide to wait and see—to hoard, thus reducing total current sales and output. The expansionary effect of higher Government taxes-plus-spending disappears when tax rates get so high that they discourage private economic incentives, but there is no evidence that this has happened on any large scale in this country, despite all the complaints.

(*f*) *State and local government spending.*—This is smaller in total than the Federal spending, of course, but it has more than doubled since 1945, and is now two-thirds as large as the Federal total. In the same period the combined debt of the non-Federal government bodies has nearly tripled. These operations, too, are an independent expansionary force.

(*g*) *The great waves of technological innovation and invention.*—In themselves, they need not have led to overall price increases, but they greatly increased the short-run demands for capital goods. Given the generally easy monetary and fiscal policy which has prevailed most of the time since 1946, they inevitably increased the pressures toward expansion and inflation.

(*h*) *The postwar transformation of the capital markets.*—Since 1945, the financial intermediaries other than the commercial banks—chiefly the life-insurance companies, the mutual savings banks and the savings-and-loan associations—have grown enormously, as is familiar. Their combined assets now exceed those of the whole commercial banking system. Their growth is in itself undoubtedly desirable. But the institutions involved, which are now the biggest collectors and investors of capital funds, can and do escape in appreciable degree, at least for substantial periods, from the types of restrain which the Federal Reserve has sought to impose at intervals since 1951. The effect has certainly been to retard and even prevent contractions in the monetary demand of their customers for investment goods, which might otherwise have taken place; and I believe the effect has also been positively expansionary.

(*i*) *The great decrease in the liquidity demands of the general public.*—Changes in this demand are most easily measured by changes in the quantity of money which people wish to hold, relative to the volume of business they are carrying on. Specifically, they can be measured, at least roughly, by changes in the ratio between the gross national product and the money stock (currency plus adjusted demand deposits in the hands of the public). This ratio, or the income velocity of money, was at an alltime low in 1945–46, but by the third quarter of 1957 it had risen by 67 percent. This was nearly 3 times as great as the percentage increase in the money stock itself in the same period (26 percent). In itself alone, it would have provided more than enough additional spending power to buy all of the increase in the country's physical output which actually took place after 1945, at constant prices, even had the money stock remained unchanged at the 1945–46 level. This rise in the velocity of money, or (relative) dishoarding, was in large part simply a symptom of the effects of the other factors listed earlier. But in some degree it can perhaps also be regarded as an independent factor, reflecting a real change in attitudes from the pessimism of the 1930's.

(*j*) *To summarize*, the major independent or original factors in the overexpansion of our monetary demand since 1945 have been: (1) To 1949, the immediate aftereffects of the Second World War, and the policies of the Treasury and the Federal Reserve; and (2) since 1949, Russia's international policy, congressional policies with respect to nondefense expenditure and with respect to the relation between total expenditure and taxation, and State and local government spending. In the last 3 years 27 percent of our national output has been sold directly to governments. This has been the great primary or independent source of the expansion in our aggregate monetary demand. The effects of technological innovation, the transformation of the capital markets and the change in liquidity demands have also been marked, but they were in the main either of secondary importance, or were symptoms rather than independent causes, serving primarily to reinforce the other factors. The question of whether the Federal Reserve could or should have imposed more restraint than it actually did will be considered later.

2. Downward inflexibility of many monetary costs and prices

These inflexibilities are familiar, and need only to be listed. They include such things as rents, taxes, freight rates, and most interest charges; legally set minimum-wage rates; union wages and fringe benefits established under contracts (especially contracts containing escalator clauses, which in large part seem to work only in the upward direction); the customary prices charged for most personal services; and so on through a long list. The inflexibility is not absolute, of course; it is a function of time. In due course contracts expire and obligations are fulfilled, and can be renewed at different terms; and even tax rates are sometimes lowered. In the short run, however, these inflexibilities hinder or prevent price cuts, and hence hinder or prevent the correction of previous price increases that may themselves have been inflationary.

Another major type of inflexibility is that which results from monopolistic or quasi-monopolistic business organization and practice. The most common consequence is what are usually called administered prices, familiar in many industries. The objection to them is not so much that these prices are too high when business demand is booming, but that they are frequently lowered only with a long lag, and grudgingly, when business slackens—thus again hindering the correction of any previous inflationary increases in the general price structure. And outright monopolies, of course, are likely to set prices which exploit the monopoly position in boom times, but which are not lowered much if at all in recession.

3. "Cost-push" factors

The so-called "cost-push" factors have been widely discussed, and are regarded by a good many students as being the primary cause of the creeping inflation of recent years. A different view of their nature and of the part they play will be presented in a moment. Some of them are genuine and important, however. The principal ones among them are as follows:

(*a*) *Union pressure*, for higher money wages and fringe benefits. So far as the increases in wages and benefits are matched by increases in productivity, of course, there is no cost-push. The evidence here is incomplete and even contradictory, naturally suggests different conclusions for different sectors of the economy, and has been hotly debated by both sides. What I have seen of it, however, suggests to me that in general, in most manufacturing, mining, construction, and retail trades, hourly money wage rates have risen somewhat more rapidly since 1949 than has productivity. This is especially likely to occur where unions seriously restrict the admission of new members. So far as wage rates have actually run ahead, there has obviously been a real upward push on costs, except to the limited extent that other factors of production voluntarily reduced their relative share of the national output. So far as they did not, prices were forced up. If aggregate monetary demand had remained unchanged, however, this rise in prices would have resulted in a decrease in the physical quantity of goods sold, unemployment, and a fall in prices. This did not happen on any substantial scale till the end of 1957, which means that aggregate monetary demand was expanding—as was also shown in earlier sections. How far the increase in monetary demand was itself caused by this cost-push is hard to say, but I doubt if it was a major factor.[4]

(*b*) *The lag of productivity increases in most service industries*, especially those providing personal services. These last typically use relatively little capital, and in most cases cannot make much use of labor-saving devices. Yet their wages, while as a rule lower than those in the unionized manufacturing industries, are strongly influenced by the latter and tend to move in similar directions, if more slowly. This provides a strong cost-push to the prices of the products. Again, however, if aggregate monetary demand were not also increasing the end result would be not rising prices, but falling output and unemployment. That this has not happened, at least until the end of 1957, is further proof that monetary demand was itself expanding.

(*c*) *Changes in the composition of the population.*—(1) The severe effect of the depression of the 1930's on the birthrate is just now beginning to be fully felt. Perhaps 6 or 7 million fewer babies were born in the 1930's than might normally have been expected, and the additions to the work force in the 1950's have been correspondingly smaller. This population gap has created an outright relative shortage of workers in the younger age groups, has made the work force grow much more slowly than it otherwise would, and has been an important factor in increasing the bargaining power of the unions. This genuine cost-push factor is only partly offset by the resulting stimulus to the introduction of labor-saving machinery. (2) Modern medicine has greatly increased the duration of the average life. Hence the proportion of older people in the population is higher than ever before. But older people spend less on new houses and consumer durables than the young, more on services—in which, as just remarked, productivity usually lags. Also, older people as a group contribute less than the young to current new output, and many of course contribute nothing: They must be supported. This population change too hence tends to push the unit costs of output upward.

(*d*) *The effects of business monopolies and quasi-monopolies.*—These effects, already mentioned, have been widely debated. Monopolistic practices obviously raise prices somewhat—that is what the monopoly is for, in large part. That they have had a major effect on prices at large, however, or have contributed much to the progressive inflation since 1946, seems to me doubtful. Their chief adverse effect here has probably been, rather, that they have hindered or prevented price decreases in periods of slack business—as remarked earlier.

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[4] The measurement of changes in productivity is in any event ambiguous in a dynamic economy. Few firms make a single product; products themselves change; and labor-saving improvements in production techniques raise the ratio of physical output to man-hours, without necessarily casting any light at all on the contribution of labor itself to that output.

(*e*) *To summarize*, there have obviously been a number of genuine "cost-push" factors at work. Of these the chief are union pressures, the growing relative importance of the service industries, and population changes.

I do not think, however, that the cost-push factors have been an important cause of the post-1946 inflation. First, some cost-push elements are almost always present, certainly in periods of generally stable prices and probably even in price recessions. Second, the prices of the things that one firm or individual sells in the market, whether physical goods or personal services, are costs to the firm or individual that buys them. Hence anything that results in increasing the prices of products also increases, ipso facto, the costs of the buyers. It is, in a sense, a vicious spiral. Third, therefore, a "cost-push" is not itself an independent factor forcing product prices up. We must look further for the explanation of "inflation." Fourth, this explanation must obviously lie in the expansion of aggregate monetary demand. If sellers try to put up their prices but monetary demand has not increased proportionately, either buyers will not pay the higher prices, and prices will fall back again; or they will pay the higher prices, but will buy smaller physical quantities. On a nationwide scale, the latter alternative means falling output and unemployment. From 1946 to the end of 1957, however, this did not happen more than temporarily and on a rather small degree. In general, that is, buyers have been both willing and able to pay the higher prices asked, and at the same time to buy the same or even larger physical quantities of products. This was true because, and only because, aggregate monetary demand had expanded. This was the root cause of the 1946–57 inflation.[5]

4. Summary: The causes of the post-1946 inflation and why they were not overcome

The principal factors that contributed to the post-1946 inflation fall thus into three main groups: Those operating to increase aggregate monetary demand, those operating to push up costs of production, and those operating to hinder or prevent downward adjustments of prices. Of these, the root causes of the inflation are to be found, I think, in the factors that have increased aggregate monetary demand. Downward inflexibilities may retard deflation, but they cannot themselves cause its opposite, inflation, and the cost-push factor cannot operate if the market for products—that is, monetary demand—is inadequate. Had aggregate monetary demand expanded only in rough proportion to the contemporary increases in physical output, we would have had no inflation; but it obviously expanded much more rapidly than that. Prices rose, depending on the measure used, somewhere between 50 and 70 percent or more.

This excessive expansion of monetary demand was not a simple process, easily understood. On the contrary, it was highly complex.

[5] The economists and others who have blamed "cost-push" factors as the principal source of the inflation have also usually assumed, tacitly or explicitly, that what we may call the "effective" money supply—money stock multiplied by its income velocity—is highly flexible. This is the assumption that either the size of the money stock itself or its velocity, or both, will always change in such fashion as to adjust to current market demands at current prices. But this obviously need not be so. In a country like ours, the central monetary authorities and the central government in combination can always, if they wish, restrain or reduce aggregate monetary demand and thus prevent inflation. They may think the price excessive, in terms of the possible precipitation of recession and unemployment, but that is a separate issue.

It was due to a number of different but in the main closely interconnected elements. The first was the inevitable adjustment within the United States after the war and wartime controls had ended. Two others "originated" outside of the United States. They were the response of our Federal Government and of our private economy to, first, the postwar reconstruction needs of the rest of the world; and second, after about 1949, to the ominously growing pressures of the cold war. These factors were basic. But others that were almost as important originated in the United States alone. They were principally the policies of the Treasury and the Federal Reserve to 1951; since about 1948 or 1949, the policies of Congress and the Executive with respect to taxation and nondefense spending; the spending programs of the State and local governments; and since 1951, the inability or the unwillingness of the Federal Reserve to impose more than (by hindsight) relatively mild restraints. Those last four factors we can blame on no one but ourselves.

This interpretation of our recent history thus places the chief responsibility for the excessive expansion of monetary demand in the last decade—that is, after completion of the postwar adjustments of 1946–48 [6]—on domestic and international factors that operated primarily at the governmental level. It seems to me beyond debate that had Congress and the Executive insisted on less nondefense spending of all types, both governmental and quasi-governmental; had they imposed higher rather than lower tax rates; and had the Federal Reserve enforced much greater monetary restraint [7]—had all this been done, the burden of increased defense spending could have been carried without any inflation at all. This is not to ignore the other factors working toward expansion in the purely private section of the economy. Technological advances and the consequent drive toward increased business investment, cost-push factors, the general exuberance of "prosperity," all contributed to the governmental factors and reinforced them, but were far smaller in sheer size and force. If they alone had been in operation we might instead have had, as in the middle and late 1920's, stable or even declining prices. They were certainly not, in themselves alone, the principal cause of the post-1946 or the post-1948 inflation.

It should also be emphasized that while combined congressional, Executive, and Federal Reserve action *could* have prevented any substantial inflation after 1948, no one of them could have done the job alone. Fiscal policy and monetary policy must work together, for either can wreck the other, as both European experience and our own amply show.

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[6] A substantial postwar price increase, of perhaps 20 to 25 percent, would have been inevitable even had the wartime controls been relaxed more gradually. The pressures of foreign and pentup domestic demand, and the tremendous volume of liquidity, were too great for any politically feasible combination of monetary and fiscal policy to overcome.

[7] The Federal Reserve did check the growth of the money supply (demand deposits plus currency) so that it increased only 26 percent from the end of the war to the end of 1957, whereas in that period the gross national product more than doubled in dollar terms. But a net contraction of some 10 percent would have been necessary to offset the rise in money velocity, to obtain the same increase in real output at constant prices. But the discount rate was not raised above 2 percent until mid-1955, nor above 3 percent until August 1957, when the boom was already over. If the object had really been to restrain an inflationary expansion, these rates can only be regarded as almost ludicrously low.

III. THE CAUSES AND CURE OF THE PRESENT RECESSION

1. *The causes*

The causes of the present recession, which may well turn into a major depression, are numerous and will doubtless be widely debated for a long time. The one thing that is unequivocally clear is that the recession cannot be blamed on either political party alone, or on other nations.

A recession *is* a decline in aggregate monetary demand. It is therefore tempting to assert that the present decline is simply an "inevitable" consequence of the inflationary overexpansion of monetary demand which has been going on most of the time since 1946, and which was examined at length in part II above. But this is too easy, and it really explains nothing. We need to know what kinds of things it was the demand for which fell off, and why the decline began in late 1957 rather than at some other time or not at all.

Especially since the mild recession of 1953–54, rapid expansion has been widespread through many parts of the American economy, both in monetary terms and in terms of physical output. The most conspicuous areas have been industrial plant and equipment, highways, other State and local governmental construction, housing, and consumer durable goods, especially automobiles. Yet a number of major areas, notably agriculture and the railroads, did not participate in the general expansion or even declined; housing, though at quite high levels even now, turned down after 1955; and some metal prices began to drop as early as the spring of 1956. The expansion, and "prosperity," were thus far from uniform through the economy—as is indeed almost always true even in periods of high boom.

Moreover, it is natural in free-market economies not only that expansion should proceed unevenly, but also that some sectors should at times move ahead too rapidly; that is, should increase their productive capacity beyond the current power of the market to absorb the products at prices that will cover costs and still leave a profit. When that happens on a moderate scale, inventories pile up, prices soften, the current output of finished goods falls, and a period of readjustment follows. The recessions of 1948–49 and 1953–54 were of this character: they were primarily "inventory recessions," did not last long or go very deep, and were soon followed by new periods of expansion. In both cases the recoveries began when inventories, especially of consumer goods, had fallen so low that dealers began to reorder. That brought the desired increases in output, and the recessions were over. The crucial factor was that in both cases the declines in personal income during the recessions were almost trivially small, so that there was a firm base on which to start the recovery.

The present recession looks to be of a different and more serious character. This is true chiefly because of the consequences, which are only now beginning to appear, of the enormous increases in business expenditure on plant and equipment which have been made in recent years, especially in 1956 and 1957. Their volume then was more than twice as high as the average volume for 1946–47, 10 years earlier, though total real physical output had risen only 43 and 50 percent and population hardly 18 percent. An excessive inventory of consumers' goods can be worked off relatively quickly, without doing much damage, but to work off an excessive supply of productive capacity, especially in the so-called basic industries, may take years. That is, it may take years for demand to catch up or for idle plant to rust away. But until it does catch up, part of the people who formerly operated the plants, and all of the people who built the additional plant and equipment itself, may be out of work. If that happens, what started out as a mild recession can swiftly turn into a major depression. It may well be true that another inventory recession was "about due" in 1957–58 (they seem to come about every 3 to 4 years), but that the onset of this one has also sparked the beginnings of a much larger and potentially much more serious decline in business investment. The drastic cutbacks in previous plans for expansion, which increasing numbers of firms are now reporting, have most ominous implications, and make it seem almost certain that just such a decline in business investment is already under way. This sounds like the 1929–32 collapse, not like the 1948–49 or 1953–54 recessions.

If all this is true, incidentally, both the cuts in defense spending in 1957, and the increase in the Federal Reserve discount rates of last August, will turn out to have been spectacularly badly timed (though I think they were at most a trigger-mechanism, not the primary causes of the initial downturn).

2. Identification of our current position

In order to decide what to do about combating the present downturn in activity, it is first necessary to make as accurate an estimate as possible not only of what has happened in the recent past, but also of what is now happening. The latter estimate determines judgments of how serious the current situation will become in the immediate future, before any corrective measures can take hold, and therefore of how powerful the necessary countermeasures themselves must be.

Identification of the current position, however, is difficult because there is almost always a lag, and often a pretty big one, in reporting current data. Some prices are reported weekly or even daily, but many production figures come in only monthly, and others still more slowly. Both the student and the statesman are therefore always behind the actual procession. When things are moving rapidly in the wrong direction, this reporting lag itself becomes serious, and must be allowed for.

I think nearly all of the current reports give bad news. There is no point in citing many specific figures, since they will be different by the time this is read. But steel output is down to below 50 percent of capacity, automobile output nearly as much (something like 80 percent of the first-quarter production of cars is still in inventory), car loadings are down 23 percent below last year and still declining, unemployment is at postwar highs, sales of consumer durables have begun to fall sharply, and the hoped-for seasonal spring return in activity never developed. Still worse are the growing reports that the confidence of consumers in any early recovery is beginning to falter as the unemployment totals rise. Worst of all is the increasing evidence, already referred to, that the plans of most business firms for plant and equipment expansion are being slashed back drastically, and not merely once but again and again as the situation gets worse.

The good signs are rather few. It is true that finished-goods inventories are in general falling or already low, but this merely provides a good platform for recovery if something else starts it.[8] Product prices are also holding up, and some are even rising a bit, which seems paradoxical in a recession, but the end effect may only be to delay the eventual fall of prices and thus delay the recovery. Consumer spending on so-called soft goods and services is up a little, but this is said to reflect merely a shift from purchasing durable goods, which is caused by the declines in income that have already taken place. The financial structure and the money and capital markets, however, show no sign of strain.

3. A summary judgment: The situation is becoming critical

I see nothing as yet to justify the frequent optimistic assurances that the bottom is in sight, and that business will turn up in the fall.

What seems to me especially ominous is the growing evidence of a general loss of confidence, both among businessmen and among consumers. The reason why this is so dangerous is that a general loss of confidence in the short-run future automatically produces conditions that vindicate the original pessimism. Businessmen spend less on replenishing inventories and on maintaining or expanding plants; they let workers go and pay out less as wages and salaries; consumers spend less because their incomes have fallen; and then businessmen have to cut back still farther because sales are down. It is a vicious downward spiral.

But will not the downward spiral cure itself "automatically" and fairly quickly, as some administration officials assert? Under the present circumstances, the answer is clearly "No." Businessmen will increase their current spending only if profit prospects improve, in consequence of a fall in costs with expected sales constant; or in consequence of an expected increase in actual sales themselves. But many costs are still notoriously inflexible, and sales are still falling. Consumers, on the other hand, will increase their purchases only if prices drop (with their own incomes constant); or if they expect their incomes to rise; or when their durable goods wear out. But again none of this is happening. In other words, no "automatic" increase in private spending can reasonably be expected in the near future; and the collapse in business investment is making the current situation steadily worse, not better. Only some powerful stimulus originating outside the private economic sector can bring any early improvement.

Moreover, to make things worse, even after a major decision to take corrective action is reached it requires a considerable time for the effects of the action to be felt. Meanwhile the general situation is likely to deteriorate still farther, and the job of curing it then gets still bigger and more expensive.

On all these grounds, I am gravely concerned, and I urge the committee to propose action on a major scale at the earliest opportunity. Every day that passes both increases the danger of disaster, and increases the cost of warding it off. I am unable to find any substantial body of facts that can justify the bland reassurances which the administration has been doling out, and I deplore the administra-

[8] The fall in manufacturers' inventories began in the latter part of 1957, but sales began to fall definitively after July 1, and are now falling substantially more rapidly than inventories (Department of Commerce, Business Statistics, April 4, 1958). This is extremely ominous.

tion's inertia. Its attitude has a horrid similarity to that of the administration in 1930.

4. Why reversing the business decline is crucially important.

There are two great reasons why the business decline must be stopped and reversed. One is obvious. A serious business decline, in a society like ours, brings falling personal incomes, serious unemployment, and in the end, grave human suffering. The scars of the depression of the 1930's are still fresh in the memories of most of the older generation of today. The apparent willingness of a leading official of the administration to accept a condition of fairly serious unemployment all through 1958 [9] seems to me at once inept and extraordinarily callous. It is not he who will be forced on to the unemployment benefit and relief rolls.

The second is even more important. A serious business decline here will drastically reduce our imports of goods and services from other countries. They fell by more than one-third in the short though sharp recession of 1937–38, and by 70 percent from 1929 to 1932. Any such collapse will have violently adverse effects not only on the economies of our trading partners but also on our international political position. This last is what is really grave about our own business decline. If we cannot buy from our allies in the cold war and from the so-called neutrals, they will in sheer self-defense turn to the Iron Curtain countries; the psychological and political consequences will be disastrous; and we can easily lose the cold war itself without ever firing a shot.

5. Remedies for the business decline: A combination of measures

The decline is a decline in aggregate spending, and what is required to cure it is a substantial and sustained increase in such spending—in aggregate monetary demands. That much is obvious. The practical problem is to select the measures or combination of measures which will produce a really substantial effect in the shortest possible time.

Three main types of measures have been proposed: Tax cuts, increased Government spending, and monetary policy. Each has notable merits, but each also has serious defects.

Tax cuts can be instituted quickly, but from the point of view of their effect on aggregate spending are "permissive" only. They create the possibility of increased spending, but cannot guarantee that it will take place. The beneficiary of the cut may merely use his increase in take-home pay or in after-tax profits to pay off debts, or to hoard against a rainier day. Also, the individual or firm with no current tax liability (and that includes all the unemployed) gets no benefits at all. Monetary policy is also permissive alone. Even at zero interest rates, businessmen will not borrow unless they see a prospect for profit. Finally, increased Government expenditure is ipso facto an increase in aggregate spending, but in most cases considerable time is required to get the necessary arrangements set up, and still more time before the full effects are felt. Meanwhile the business decline gets worse.[10]

[9] Secretary Anderson as reported in the New York Times, April 6, 1958.

[10] Note that the so-called automatic stabilizers, of which so much was made in other years, operate to slow down a decline in business, and perhaps to limit it, but of themselves alone are unlikely to start a recovery. Decreased tax liabilities do not encourage expansion, if income itself is falling still more; unemployment benefits and relief payments are usually smaller than the income previously earned; and so on.

As a practical matter, I think a combination of all three types of measures is essential. No one type alone will both do the job and do it quickly enough. A combination of selected measures, however, will enabe each to reinforce the others and will also have a spectacular effect on general confidence, and thus reduce the required strength of the measures themselves. I shall therefore list briefly the particular steps that seem to me most promising, and then consider how powerfully they must be applied. This last is most easily gaged by their probable combined effect on the Federal budget.

(*a*) *Tax cuts.*—If tax cuts are to be effective in stimulating spending they must be substantial, and with no strings attached at the time. That is, the duration of the cuts should not be specified in advance. To do so would throw away most of their psychological impact value. Not until recovery is well underway should the question of revoking the cuts be raised. I propose these steps:

(1) Personal income tax: (i) Cut the rate on the first $10,000 of income heavily, say; by 50 percent; (ii) implement this cut by immediately stopping all withholdings of taxes on the first $10,000 of income, leaving any tax due on this first $10,000 to be paid by the individual with his quarterly or annual payment of estimated tax.

(2) Corporate income tax: (i) Remove all restrictions on the rate at which business firms may charge off against income those expenses which are actually incurred for repair and replacement (this will provide a strong incentive to increase such expenditures); (ii) raise the level of business income at which the full rate applies to $50,000: (iii) cut all rates somewhat, say, by 10 percent.

(3) Excise taxes: cut heavily, by 50 or even 100 percent those taxes on products whose output it may be especially important to stimulate, such as automobiles, provided dealers or manufacturers can be prevented from absorbing any of the cut. This is a discriminatory proposal which may be hard to administer, but may be justified in the present emergency.

(*b*) *Monetary policy.*—The steps to increase monetary ease which have been taken to date are small at best. The Federal Reserve should: (i) Cut the discount rate heavily, perhaps to 1 percent; (ii) cut member-bank reserve requirements to the statutory minimums; (iii) buy both short- and long-term Government securities in the open market until the yield on long term drops to around 2½ percent, which seems to be roughly the historical minimum.

(*c*) *Increasing Government expenditures.*—This is the one sure way to bring about an increase in aggregate spending. The Federal Government, it is true, has already taken a few small steps. Defense and space programs have been somewhat expanded and speeded up; so has highway construction; and a new program of loans for community public works is now on the floor of the Senate. These total perhaps $5.6 billion; but by no possibility will that money all be spent in 1958. A new housing bill has also been enacted for some $1,850 millions, but this is chiefly for the purchase or guarantee of mortgages, not for direct spending; private enterprise must initiate each project.

All of this is good as far as it goes, but it is on a pretty small scale relative to the size of our gross national product, which in 1957 totaled $434 billions. Much more is needed. I suggest the following additional steps:

(1) Federal aid to the unemployed: Most State programs for paying unemployment benefits run for between 26 and 39 weeks, and then stop. In many individual cases, payments have already expired. Thereafter the unemployed person can only turn to local relief payments, at a still lower level. As a powerful antirecession measure, the Federal Government should pick up the burden when State aid stops, and should continue unemployment benefit payments until the recession emergency is over. This is a particularly effective way of stopping further contractions in aggregate spending, and can be started at once. Proposals to this effect are already in the congressional mill.

(2) Greatly increased aid to State and local governments for schools, hospitals, slum clearance, highways, and other projects of high social value. Such projects give relatively large employment in the urban areas and to the basic industries where unemployment is generally now most severe; the backlog of genuine need is enormous; and in many cases the necessary plans are already largely drawn: they would have been implemented long since had financing been available. The aid should take the form of both: (i) Direct Federal participation, up to 100 percent where local resources are currently inadequate; and (ii) the purchase of State and local government bonds, where debt limitations permit, at nominal interest rates, thus giving the Federal Government financial assets in return for its outlays.

(3) Greatly increased foreign aid, both loans and grants: This will give a powerful direct stimulus to many types of American business, will bring enormous international political gains, and will help offset the effects of the impending decline in American imports. Large additional programs can be put into action relatively rapidly.

(4) Increased defense spending: Both its merits as an anti-recession measure and its urgency for military reasons seem self-evident. The only defect is that in the present state of military technology, it is not likely to produce spectacular and early increases in employment per dollar spent.

(5) Increased appropriations for harbors, river improvement and the like: This is politically appealing, but as an anti-recession measure is at the bottom of the list. The resulting increases in employment usually appear only in limited areas far removed from the present centers of unemployment, and are not large per dollar spent.

(*d*) *Summary: How powerfully should the preferred measures listed above be applied?*—The best combination of measures is thus: (1) a heavy cut in personal income taxes on incomes below $10,000 and a smaller cut in corporate income taxes, plus abolition of the present restrictions on charges to business income for repair and replacement expenditures; (ii) a great easing of monetary policy; and (iii) increased or new Federal expenditure on unemployment benefits, on State and local projects of specified kinds, on foreign aid and on defense. I do not believe that any one of these three sets of measures will alone do the job, but the psychological impact and the direct effects of the three in combination will. Moreover, the greater the initial effect the sooner will recovery start, and therefore the shorter will be the period for which the measures must be continued. They will also be correspondingly less expensive.

This is powerful medicine. How strong the dose should be depends, first, on how great the present danger and need are judged to be, and second, on more technical considerations of how much action is required to overcome that danger. It is also necessary to keep in mind the question of how severe and lasting the after-effects in later years are likely to be.

(1) The present danger: I have argued above that the present danger is already very grave, and that if no adequate action is taken we may soon find ourselves plunged into disasters like those of 1929–32. Most serious citizens would agree, I think, that if that is really the prospect, no price is too high to avoid it. It is my honest conviction that that is in fact the present prospect.

(2) How much action? Limited and weak action is worse than useless. It breeds a temporary and false sense of security, and when the effects are past the basic situation is likely to be worse than ever. Major emergencies require major counter-blows.

If the decline in our gross national product which developed between the third and the fourth quarter of 1957 continues at the same rate (and it seems now to be falling more rather than less rapidly), by the end of 1958 it will stand at an annual rate some $40 billions below the 1957 peak—a fall of nearly 10 percent. This would be the most severe peacetime fall since 1929–32, and might raise our unemployment above 12 million. We should act at once, therefore, to offset the decreases in aggregate spending which are now taking place, chiefly in private spending, by steps to bring about other and at least equal increases in Government and private spending combined, that is, by increases in total spending at the rate of at least $35 to $40 billions a year. It may not actually be necessary to do all this, for if recovery begins and gets well under way we can decrease or stop the action taken, but we should start off with that goal, and at the earliest possible moment.

Specifically, I propose that we should begin by increasing Federal expenditures at the rate of as much as $15 billion to $20 billion a year, and institute the proposed tax cuts and easier monetary policies at once. It can then be expected that the direct and indirect effects of these measures will produce additional increases in private spending at the rate of at least another $20 billion a year or more; and that would do it.

If these steps proved inadequate after some months of trial, it would be necessary to make them stronger—to spend at a higher rate, and cut taxes further. The only alternative would be a collapse into the disasters of a 1930–32 type of depression. If they succeeded, however, and a firmly based recovery began, they could be gradually reduced and eventually ended.

(*e*) *The long-run cost: inflation?*—The effect of the proposed tax cuts on actual tax receipts is hard to estimate, because these receipts will fall in any event as business activity and incomes decline. The two factors together, however, might well produce a drop below 1957 levels of $10 billion to $15 billion—of which the tax cuts might be responsible for perhaps a half. This plus the proposed increases in expenditures would entail a Federal deficit running at the rate of perhaps $30 billion a year. This is a horrifying sum, at first glance. But it is less than 7 percent of our present gross national product, and it is only an annual rate, not necessarily a realized deficit. In any event, it would be a cheap price to pay for avoiding another great depression.

The deficit, whatever its size, will have to be covered by floating more Government bonds. That is easy enough—the Federal Reserve and the banking system can always insure their sale. It is argued by some, however, that the long-run effect will necessarily be inflationary, and that this is an even greater evil than depression. The latter assertion, I think, is simply not true. There is no economic catastrophe as bad as a major depression, and in the present world situation it would also bring us an incalculable international political disaster. As to the first assertion, it too need not be true. It is entirely up to Congress and the Federal Reserve. Between them, they have all the power required. After recovery has been effected and a new expansion is well underway, it is only necessary to enforce fiscal and monetary restraint: to cut nondefense expenditure, raise tax rates, tighten credit and thus establish a substantial budget surplus. Then there can and will be no inflation whatsoever.[11]

To put the matter still more simply, if your house is on fire it would obviously be stupid to limit the amount of water the firemen can use because you fear water-damage to the house itself. Without enough water, there may be no house left to worry about.

IV. LONGER RUN ECONOMIC GOALS, AND MEANS TO ACHIEVE THEM

1. *Goals*

Most people are fairly well agreed by now on the major goals at which general economic policy should aim. The goals are: (i) The maintenance of reasonably full employment, (ii) the maintenance of substantial price stability—that is, the avoidance of both inflation and deflation, more or less as defined in section I, above; and (iii) the maintenance of economic freedom. The meaning of the first two is clear enough, though precise technical definitions may differ somewhat, but the meaning of the last is less unequivocal. To avoid getting into philosophical disputes, we may take "economic freedom" to mean as much freedom for individuals and firms as is thought to be consistent with other goals the society may also have set, and to which it gives a higher priority—such as the protection of women and children in factories, the maintenance of competition, and the like.

The three major goals themselves, however, may also not be mutually consistent in all respects. In a given country, and with a given set of policies and control instruments, it may at times be impossible as a practical matter to achieve full employment without also incurring a measure of inflation (as in France at various times since 1946); or impossible to achieve price and exchange rate stability without also forcing serious unemployment (as in Great Britain in the 1920's). And it may be impossible to achieve both full employment and price stability simultaneously, without trenching rather heavily on economic freedom.

In the United States, our record in these respects over the last 30 years and even over the last 12—since the end of World War II—has not been very good. The depression of the 1930's was a major disaster. Even since 1946, we have had a 60 percent rise in consumer

[11] A government deficit incurred to bring aggregate spending back up to something like full-employment levels is not inflationary at the time it is incurred. Conversely (see a footnote in pt. II-1-e, above), even a balanced budget can be inflationary if government spending is increasing when employment is already high.

prices, two medium-sized recessions, and now, I fear, the beginnings of a real depression. Yet I think we can do a great deal better. I think we can combine the maintenance of high employment and price stability all or nearly all of the time, yet without making any substantial new inroads on economic freedom. To do this requires little that is novel. Rather, it requires chiefly only the intelligent and conscientious application of the knowledge and the instruments which we already possess. Few new principles or new apparatus are necessary. The argument is as follows.

2. Means to achieve the goals

The controls over the general level of operation of our economic system are of two sorts, which may be described respectively as automatic, and discretionary or optional. In a free-market economy, both are necessary.

(*a*) "*Automatic*" *controls.*—Of these the most important are the tax system and the social security system. They are "built in" by existing legislation, and operate without any further discretionary action by anyone. As business and incomes expand, tax liabilities increase, and exercise a restraining effect on further expansion. Social security payments also become larger. When business and incomes contract the opposite happens, and in addition the burden of unemployment is lightened, though not removed, by the payment of unemployment benefits. The defect of these automatic controls, however, is that in themselves they only exercise a braking effect, important though it may be. They alone can neither stop an overexpansion, nor start a recovery after a recession. For this, discretionary controls are also necessary.

(*b*) *Discretionary controls.*—Of these, the most frequently discussed are those exercised by the Federal Reserve in the form of monetary policy, and by the Treasury in the form of debt-management policy. By all odds the most important in the United States today, however, is the control which Congress and the President exercise, sometimes almost unconsciously, by varying the size of current Federal appropriations and expenditures, and by varying the coverage and rates of taxation. The average Congressman is likely to think of appropriation bills in terms of their effects on the economic interests or the political convictions of his constituency, not in terms of their effects on aggregate spending; and to think of taxation only as something that people dislike (except that tariffs are likely to be popular). Yet Federal taxation and expenditure are now by far the largest single independent or primary component of, and source of change in, aggregate monetary demand. They are independent, that is, in the sense that decisions about them do not necessarily depend on what some other group decides to spend or not spend.[12]

(*c*) *Specific proposals.*—To make the discretionary and quasi-discretionary controls work more effectively, I propose the following simple steps, all or most of which require legislation.

[12] State and local government financial operations are also extremely important, but it would be almost impossible to vary them deliberately in the aggregate with a view to influencing general economic conditions in advance—that is, to use them as a policy instrument.

(1) Amend the Employment Act of 1946 and the Federal Reserve Act to make price stability, appropriately defined, a major objective both of the Federal Government proper and of the Federal Reserve.

(2) Amend the Employment Act, or enact other legislation, to recognize formally the desirability from the point of view of the national interest of having substantial budget surpluses in times of general business expansion, and deficits in time of serious contraction. Deficits are not a road to perdition, if they are offset by equal or greater surpluses later. Congress must educate its own Members on both sides of this proposition, especially with reference to the need for decreased spending and for budget surpluses in times of general expansion.

(3) With respect to the Federal Reserve System, there are a number of measures which I think would substantially increase the effectiveness of its policy decisions, as follows: (i) Require all commercial banks, appropriately defined, to become members; (ii) place the Federal Deposit Insurance Corporation under the Federal Reserve, and abolish the national banking system as such (since the note-issue privilege was abolished it has ceased to have any real reason for existence); [13] (iii) revise the present reserve requirements, as the Federal Reserve itself has now proposed, to include vault cash; to arrange the assignment of particular banks to a particular reserve category on a less irrational basis than that now in force; to abolish the present discrimination against New York and Chicago; and to give the Federal Reserve more discretion in individual cases; (iv) reinstate permanent discretionary control by the Federal Reserve over consumer credit and real-estate financing; (v) authorize and instruct the Federal Reserve to conduct open-market operations in the long-term as well as the short-term markets, whenever the former fail to respond adequately to measures of monetary policy [14] (for this it may be necessary to increase the capital funds of the Federal Reserve banks).

(4) Create a National Economic Commission to coordinate, in the light of the goals outlined above, the policies and actions of the Federal Reserve, the Treasury, the Budget Bureau, and other independent or quasi-independent agencies of the Federal Government that have financial or fiscal power; and give the Commission the power to enforce its decisions on these agencies and departments. Multiple sovereignty in financial matters has become a luxury we can no longer afford.

(5) Give the Commission the power, with the consent of the President, to raise or lower any Federal tax rate by say 10 percent each way, as a countercyclical device.

(6) Finally, a more venturesome suggestion, I think the proposed National Economic Commission should be given a substantial standby fund, perhaps as large as $20 billion, to be used when needed, with the consent of the President, as an antirecession measure. This fund might be set up merely in the form of an authorization to the Treasury to sell bonds for the benefit of the Commission on its request. The Commission should be required to keep an adequate stockpile of

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[13] This will also reduce the number and expense of bank examinations.

[14] I am not impressed by the contention that this would increase the uncertainties and general misery of life for Government bond dealers. Even if it would, the price seems small relative to the probable gains.

plans and projects always ready for use. This would avoid the long delay in taking the first important antirecession measures, which special congressional action for such purposes necessarily entails.

(*d*) *The key: The will of Congress and the President.*—It cannot be emphasized too strongly, however, that all of these proposals are essentially no more than devices to help make our economic machinery run well, provided the will to make it run well is there in the first place. The Federal Government and its related agencies already have ample power to make it run well, but they have not always had the will, or perhaps have not always realized that they had the power. No man can legislate his own virtue, and the Congress cannot compel itself to do what it does not wish to do. The key to the achievement of the economic goals described above lies in the Congress and the President, and nowhere else. It is up to them.

UNIVERSITY OF ILLINOIS,
BUREAU OF ECONOMIC AND BUSINESS RESEARCH,
Urbana, April 17, 1958.

Hon. HARRY F. BYRD,
Committee on Finance, United States Senate, Washington D. C.

DEAR SENATOR BYRD: In accordance with your request of February 17, I am enclosing a statement entitled "What Should Be Done About the Recession."

Although complete answers to all your questions are not provided in this statement, all of them are at least partially dealt with. I trust you will find this a useful contribution to your "Investigation of the Financial Condition of the United States."

Sincerely yours,

V. LEWIS BASSIE, *Director.*

WHAT SHOULD BE DONE ABOUT THE RECESSION

The really critical question of the day concerns the causes of the current recession and what should be done about it. A general essay dealing with this problem in a comprehensive and orderly way seems preferable to providing answers to a series of discrete questions. Nevertheless, the relationship of the questions raised to the main theme is clear, and at least partial answers to all of them can be provided in an incidental manner, as indicated by the marginal numbers. It seems entirely appropriate to begin with an attempt to clarify the difficulty of terminology existing in discussions of inflation and deflation.

A certain amount of confusion arises from accepted definitions of inflation and deflation. A period of inflation is usually defined by the movement of prices; a period of deflation is usually defined by other measures of economic activity. This makes it possible for both to exist at the same time. In fact, insofar as prices tend to lag behind activity at cyclical downturns, both must be expected to prevail temporarily in such situations.

These definitions are arrived at negatively, by reference to the "evils" they involve: The evils of deflation are described in terms of unemployment and of losses of income from production, the evils of inflation in terms of the losses in value of purchasing power imposed on holders of fixed capital claims and others with fixed incomes. For this reason, the terms as they are ordinarily used are not direct antonyms, although many assume that they should be. Various definitions could be set up to eliminate this difficulty, but none will be attempted here.

BACKGROUND OF THE RECENT "INFLATION"

In the normal course of economic developments, the price level tends to be determined by the pace of overall activity. The broadest measures of activity, such as gross national product and national income, represent aggregate demand and aggregate cost; and these are the primary determinants of prices. However, the interactions are such that price changes may themselves become determining at times and induce changes in investment and in overall activity.

There are, in other words, periods of exceptional speculative activity when profits may be realized from the price movement and the inducement to borrow as a way of realizing such profits is strong. In such situations, prices are bid up more than would be justified by the underlying, "real" conditions of the economy; the pace of activity is fast enough seemingly to justify the price movement; and optimistic psychology feeds on both the price advance and the strength of "trends" in investment and output.

When such a movement occurs at the end of a long period of prosperity, it is usually accompanied by confidence that the boom will run on forever, This infectious attitude seemingly justifies for everyone the adoption of price policies designed to give each the most rapid improvement in his position. In recent years, labor viewed the economy as capable of providing greater security and leisure for workers; it pressed for wage increases large enough to give it all the gains of increasing productivity, not only in money but in real wages. Industry felt that its markets were strong enough to pass on all cost increases through the application of pricing formulas that would facilitate the financing of the new facilities it considered necessary. Each blamed the other for fueling the fires of inflation. Both were infected with the state of mind that denies restraint in a "new era" of optimistic fervor.

The movement began with recovery from the lows of the 1953–54 recession. The stock market led the way, roughly doubling from the fall of 1953 to the spring of 1956. Wage rates hesitated only briefly in the recession and moved into new high ground by the end of 1954. Consumers began to draw on available credit, which was more freely offered, and on "easier" terms. Housing starts first reflected the stimulus, and construction contracts moved to new highs in the latter part of 1954. Expenditures for consumer durable goods also showed firmness and began a strong upsurge to new highs at the end of that year. The spring and summer of 1955 recorded an unprecedented spurt in auto buying. This touched off in the fall of the year an unrestrained cycle in capacity expansion, which spread with some lag to steel and to other industries. This cyclical upsurge in fixed investment was encouraged by high profits and by the more rapid amortization of facilities permitted in the tax revision of 1954.

It was this boom in all forms of private investment that provided the real basis for the new advance in prices that got underway in the spring of 1956. It is more than a coincidence that the spreading wave of cost and price increases centered in the durable goods industries. In convincing themselves that prosperity was enduring enough to justify all-out expansion, businessmen also convinced themselves that the market was strong enough to pick up the tab. Their attitude toward wages and prices changed. Instead of asking, "How much of a wage increase can we grant without making necessary price increases that will upset the market?" they began to ask, "How much will we have to raise prices in order to grant the wage increases necessary to keep from getting shut down?" The strike in steel was not avoided, but its main effect was to reduce inventory holdings that might otherwise have had a restraining effect. This change in business attitudes in the early part of 1956 roughly coincided with the reversal of the steady decline in farm prices from the Korean war peak.

A minor contribution to the price advance, and to its lag behind activity, was made by the cost-of-living adjustments in wage contracts. The more widespread these escalator provisions become, the more unstable the price level will become, and the greater will be the speculative component in the business cycle. At the extreme, when all prices are subject to escalation, a high degree of instability might be engendered by temporary, exogenous price changes, such as changes in farm prices resulting from unusual weather.

CREDIT FACILITATED THE BOOM

Debt expansion placed a significant role in financing the boom. All forms of private debt—mortgage, long-term business, bank loans, and consumer installment credit—expended sharply through the postwar period, and, in most cases, the movement accelerated in 1954 or 1955. This use of credit facilitated the reaching of extreme heights during the boom, from which any reaction might be correspondingly severe. It also threatens in the current recession to aggravate the severity of the decline by diverting purchasing power from current expenditures to liquidation of debt.

State and local government programs were also facilitated by debt financing. During the mid-1950's, annual State and local security issues reached a level about four times the peak rate of the 1920's. Throughout the same period, State and local expenditures have moved up at a rate of $3 billion a year. The continuation of this movement into the current recession period represents a stabilizing force, though one of limited magnitude in a $440 billion economy. Moreover, the prospect that the advance cannot continue if declines in sales, incomes and property values adversely affect State and local revenues—and, more serious, that even the current rate of expenditures cannot be maintained under such conditions—has ominous implications with respect to the ultimate extent of the decline.

Federal Government debt, alone, did not rise substantially in the postwar period. Modest liquidation in the early years was reversed by the Korean outbreak, and, after the cutbacks in military expenditures in 1953, small budget surpluses were again realized. Cash surpluses were substantially larger. The gross debt rose to a new high only because of substantial accumulations in trust funds. There was, in other words, no significant contribution of deficit spending since the end of World War II to the boom or to the inflation experienced in its course through 1957.

This does not mean either that Federal expenditures played no role in the boom or that such expenditures financed by deficits can play no important role in the recession. They, like State and local expenditures, are playing a stabilizing role in the current recession. Unlike State and local, Federal expenditures may be expected to continue rising as the decline progresses. But it is unlikely that this one segment can produce a total sufficiently large to offset entirely the downward phase of a major business contraction. Nor, as is indicated below, should it be expected to do so.

The monetary-control policies of the Federal Reserve System had no important effects on the overall economy during this period. In the first flush of enthusiasm after the accord of 1951, monetary tightness was permitted to progress a little too far. This may have had some mildly depressing effects, particularly on residential construction, and, thus, contributed in a minor way to the recession of 1953–54. But it was not important in comparison with the other depressing influences at work at the time, and the prompt reversal of policy in the fall of 1953 corrected any such tendencies.

In the later period of "tight money," covering roughly the 2 years to its culmination in the fall of 1957, the "controls" contributed little to the results experienced. The impact of extraordinary demands for credit to finance the investment boom produced what was, by postdepression standards, an extreme stringency in money and capital markets. The bidding up of interest rates to new highs for a quarter century represented the operation of "natural" or "purely economic" forces.

Contrary to popular impressions, Federal Reserve policy was extremely cautious. All it did was hold Federal Reserve credit stable. It neither condoned the excessive borrowing and spending nor took away any of the resources available to those engaging in such activities. True, rediscount rates were raised in a series of steps, but in each case the market rate on Treasury bills had come up to the level established earlier before a new advance was made. A good case can be made that a more restrictive policy should have been adopted in the latter part of 1955, and pursued aggressively with the objective of cutting the top off the investment boom. It must be admitted, however, that such a policy would have encoutered strong opposition.

It follows as a corollary of this view that Federal Reserve policy is not significantly responsible for the current recession. Looking backward, it might be said that earlier easing would have been desirable, before the recession got underway in the fall of 1957. But this, too, would have encountered strong opposition. The first actions toward easier money were actually taken at a time when prices were still rising and the economic and business consensus was still optimistic.

NATURE OF THE POSTWAR INVESTMENT CYCLE

The recession was not brought on by resistance to price increases or by any conscious change in monetary or fiscal policy. Its direct and only important cause was the collapse of the investment boom. The suddenness of this collapse and the speed of the decline to date are due partly to the speculative elements that became so important in 1956. This is the typical conclusion of a long period of prosperity, as was noted by Wesley Mitchell a generation ago.

During recent years, evidence has been piling up that the postwar boom was approaching its culmination. Every major war has been followed by high prosperity, and every postwar boom has been followed by a severe depression. The recession now in progress is the early phase of that kind of major contraction.

The forces that produce these results are not accidental. The cycles in various components of private investment derive from a succession of imbalances on two levels: First, there are imbalances in the position of stocks—that is, stocks may be either excessive or deficient. Second, there are imbalances in the flows—that is, the rate of production may exceed or fall short of the current rate of consumption.

Postwar cycles are the most vicious kind of cycle. The economy inherits from the war imbalances on both these levels. Stocks and production are both too low at the end of the war. Business needs larger inventories. Backlogs of demand for consumers' durable goods are high, and people have large accumulations of liquid assets to make their demands effective. The stock of houses is inadequate in relation to the need for living quarters. Business rushes in to take advantage of this unusual opportunity. It needs new plant and equipment to do the job. All these deficiencies bring on the boom, and each phase of the cycle then follows as the logical consequence of that which preceded it.

To remedy the initial deficiency of stocks, production must be lifted above the level of current demand. This succeeds after the passage of an appropriate period of time; the deficiency is made up, bringing stocks to the desired level.

But note that the price paid for achieving this result has been the unbalancing of the flows. Production is running well above consumption and must be cut back to the level of demand to prevent excesses from appearing. But making this adjustment brings on the very excess it was intended to prevent. Stocks continue to advance until the excess of production is eliminated, but, by then, incomes and demand are lower, so that the existing stocks are excessive in relation to the new level of demand.

This excess has to be eliminated by unbalancing the flows in the opposite direction. That is, production has to be cut to a point below consumption to work off the excess, and activity is thus forced down into depression.

This mechanism works quite differently in the various segments, depending primarily upon differences in the time periods required by the processes of production and consumption. It is rather symetrical in the case of business inventories as such, because periods of production and consumption are short. It is long drawn out in the case of housing and productive facilities because the processes of production are long drawn out and the processes of consumption are even slower. Stocks of structures hardly ever decline. They just stop rising for a while.

There is one point in the fixed investment cycle that tends to make for extremely sharp changes. That is just after a downturn, when the two kinds of imbalance are working together. Today we are in such a situation. We have both excess capacity and a rate of new investment too high to be sustained. The excess capacity is not confined to industries like steel, where demand has declined; it has appeared in other industries whose demand has remained stable at high levels, because their capacity has expanded. Furthermore, the recent rate of new investment at $37 billion is far above the requirements for growth.

These imbalances are working together to depress new investment, and the decline will probably be both severe and long drawn out. Looking ahead, there can be no early adjustment. At the end of 1958, capacity will be higher and production lower. The imbalance of position that is helping to force the current decline will be worse at that time. It will tend to force a still larger decline in 1959.

Moreover, business inventories have been in much the same position in recent months. With the recent decline in sales—and this means sales in physical volume terms, not in current dollars—inventories are excessive and have to be liquidated. The rate of liquidation will tend to increase in irregular steps as long as sales recede. All forms of business investment will be driving the economy toward depression.

Can we hope that autos and housing will come to the rescue, as in 1949? This seems to be a futile hope. Those segments are governed by the same kind of cyclical forces, and their position has basically changed since 1949. There are no longer any backlogs of unfilled demand. On the contrary, both have been approaching the point of market saturation during the last 2 years.

It is evident from this that the current recession represents an unusual situation—the kind of conjuncture of deflationary forces that is encountered only in the downward phase of a major cycle. In considering remedial action, the first thing to be recognized is that the measures applied in unusual circumstances should not necessarily be the same as those adopted on other occasions. To apply measures that cannot succeed may merely discredit valid instruments of control whose use would suffice in situations to which they are appropriate.

LET PRICES TAKE CARE OF THEMSELVES

In these particular circumstances, the essential distinctions tend to be overlooked. There is a seeming identity between goals of stability and of growth; for the decline in employment and production has to be halted before growth can be resumed.

Considering these two objectives in more general terms, it might be said that the primary distinction between them lies in the time perspective: Over the long run, there is a strong desire for progress; in the short run, there should be sufficient stability to rule out interruptions to the steady gains by which progress is achieved. There could be no justification for any kind of stability that would prevent growth; but a temporary rate of growth so rapid that it must collapse into instability is also undesirable.

To add price stability as a third objective is to confuse the issues. There are situations in which rising prices cannot hold the implication that anti-inflationary action is needed. We are in one of those situations at the present time; action to halt the decline is called for despite the fact that prices continue high. Another such situation typically arises during recovery from the depths of depression; then, prices should be recovering long before unemployment has been reduced sufficiently to render further Government action to stimulate the economy unnecessary.

There are many lag elements in the Consumer Price Index. Rents, utility rates, and prices of many services do not adjust quickly to a change in conditions. Seasonal effects on food prices such as the unfavorable weather conditions of the last few months, hold few implications for stabilization policy. Differential price movements of this "uncontrolled" character might be either retarding or stimulating. Those of recent months call, if anything, for greater antirecessionary action, because the high prices for necessities drain consumer purchasing power from the industrial sectors of the economy in which unemployment appears.

Price changes should be considered symptomatic of underlying conditions rather than a basis for action in themselves. If there is a margin of resources available—and throughout the recent period of "inflation," unemployment continued at 4 percent—prices will be taken care of by the undirected responses of the economy. The increase over the past 2 years has been very moderate for the prevailing situation and holds no threat of continuing or all-out inflation. The most effective protection against inflation lies in the excess capacity and the surplus labor now looking for customers.

Furthermore, mere price stability dose not indicate a satisfactory state of affairs. Economic movements can get under way in either direction, and even get out of hand, before the price indexes show a definite response. The late 1920's comprised a period of exceptional price stability. Price stability also persisted throughout 1955; and finally we are now witnessing the false impression given by the divergent movements of recent months. Thinking we have achieved some kind of millenium when prices are stable may merely be a way of ignoring underlying conditions that will make prices move, and perhaps violently, at a future date.

From the longer term point of view, it seems clear that the economy can work well with prices, within limits, either rising or falling. Perhaps the minor stimulus obtained from gradually rising prices is to be preferred, since our resources and productivity are so high as to engender a tendency toward chronic unemployment. Nevertheless, the most satisfactory results are likely to be obtained in the absence of efforts consciously to steer prices in either direction.

As long as the economy shows a margin of unutilized productive resources, therefore, the only action needed on the price front is to insist on the maintenance of reasonably competitive conditions, including competition from abroad. Then prices may be permitted to take care of themselves; the essential freedom of individual prices to move will be preserved; and economic policy need not be contorted by endless wrangling over contentions arising from conflicts in stated objectives.

THE BASIC OBJECTIVE OF ECONOMIC POLICY

The real goal of all our efforts should be a system of control over economic fluctuations. Only if there is control can we be assured of both the progress implicit in the long-term goal of growth and the avoidance of wide cyclical swings implicit in the short-term goal of stabilization.

Unfortunately, the control mechanisms that have been developed to date do not appear to be fully adequate to the task. The lack of effectiveness of monetary policy for stopping recessions has been amply demonstrated. The difficulty here is that offering loans at lower interest rates cannot expand borrowing at a time when potential borrowers see no way to profit by the use of the funds. Once the reins are fully eased, pushing them out further doesn't necessarily make the old horse go faster; and dropping them entirely may have just the wrong effect. Other means of increasing the pace then have to be applied.

The most widely held view of how to go about this holds that the Federal Government has accepted the responsibility and now has to live up to it. The presumption is that any necessary adjustment can be made by suitable applications of the powers of its fiscal policy twins—tax reduction and increased expenditure. The former operates by leaving additional purchasing power in the hands of the public, the latter by stepping up activity in the specific areas to which the expenditure programs are directed. Both have the effect of increasing the deficit, and to the extent that the newly created debt is held by banks, of increasing the money supply.

Frequently overlooked is the fact that there are dangers in the use of these powers. The dangers inhere not only in the evils of inflation and deflation, but also in the changes that might be wrought in the social and political structure of the economy by intemperate action. It is hardly ever contemplated, for example, that the Government should take over the entire function of investing in capital goods; but to keep the economy completely stable might imply investing in such goods to an extent that private industry would never regain this function.

The effective use of any kind of controls requires knowledge, skill, and a sense of timing. The pilot of the airplane has controls adequate to make the plane do what he determines it should; but the novice may crash the plane by overcorrecting in a situation that calls for a delicate response. If his reactions are either panicky or delayed, he may never make a good pilot. Even if he qualifies for a license, there may still be circumstances in which it is unsafe for him to attempt a trip. Adverse weather conditions keep many flights grounded. There are certain analogous circumstances in the application of economic controls.

Just knowing when to act is important. The point is illustrated by the recent shift, in a period of about 6 months, from determined efforts to combat inflation to all-out seeking for means of stopping the recession. This veering about of attitudes and approach reflects not only the reversal in business but the limitations of economic know-how. It calls attention to the need for a policy determination as to suitable control points for compensatory action. The best of our stabilizing devices in other fields—thermostatic or mechanical—have limits of tolerance within which controls do not operate. Unless we can view the economic situation tranquilly within similar limits, action may increase rather than moderate instability.

Perhaps the best indicator of the need for action is unemployment. The first postwar decade indicated that unemployment may fluctuate over a fairly considerable range without changing the basic situation. During this period, the seasonally adjusted rate of unemployment varied within a range of 3 to 6 percent of the labor force. It is not unreasonable to regard this as an appropriate range of "no action" in unemployment policy. This should prevent intemperate action that could subsequently prove self-defeating. Some of the things that may be done to prevent a decline can only be done once; and if they are done at a time when unemployment is still moderate, part of the ammunition that might be used to compensate a much more serious setback will have been expended. Moves made in recent years to stimulate home buying on minimum terms and business investment on maximum writeoffs have precisely this unfortunate aspect at the present time.

When unemployment rises above 7 percent, as it has, there can be no serious doubt that it is time to get busy. Unless preparations are made for something still worse ahead, action will not be speedy enough to meet the need. Certainly by the time unemployment reaches 10 percent, measures of an all-out character should have been made operative; and as long as the rate remains above that level, efforts to bring it down must be unremitting. Nevertheless, reasonable care in the administration of stimulants is essential.

SOME FALLACIES ABOUT ECONOMIC CONTROL

The most dangerous fallacy in current thinking about economic control consists of the widely accepted notion that the Government can and should do whatever is necessary to reverse the decline quickly and bring activity back up to full employment levels. Looking at the available controls in quantitative terms does not suggest that there is any such easy solution. The quantities involved in the collapse of the investment boom are much larger than any Government action now contemplated. Following such a downturn, the major contractions have always been severe and long drawn out. Compensatory action on the scale now required might involve dangers of economic breakdown more serious than those posed by the current recession. The logical application of antirecession measures aims at mitigating the extreme fluctuations between business cycle peaks and troughs but not at maintaining "maximum levels" regardless of the consequences for existing economic and political institutions.

Another fallacious view of the problem consists in the idea that a deficit automatically results in recovery and inflation. This line of thinking overlooks the fact that a deficit may have no immediate effect of this kind and only result in additional stimulation and inflation at a later date when such effects are no longer wanted. A deficit per se tells little about the effects of Government policy on the economy. If it grows merely because receipts from established taxes are falling, it cannot be a positive force for recovery. Its effects have already been built into the multiplier, and all it can do is help moderate the decline. If a deficit resulted from decreases both in taxes at given rates and in expenditures, with the former falling faster, the net short-term effect would be deflationary rather than inflationary. In any situation, the effects of a deficit may be analyzed only by considering the specific types of program and tax changes responsible for the difference between expenditures and revenues.

A related misconception holds that a limited Government stimulus—say, a spending program or tax cut of $5 billion—will result in a new upswing. Actually, $5 billion is just $5 billion. A public works program of that amount will serve as a substitute for approximately the same amount of private construction; if anything, the secondary and subsequent effects will be less because it cannot be regarded as a component of long-term growth. An equivalent tax cut would be bound to produce an even smaller offset, since not all the funds left with the taxpayers will be spent. Neither of these actions could compensate for the projected $7 billion decline in business capital outlays from last year's third quarter high to the corresponding period of this year.

Another important fallacy is the analogy that compares the economy with an inefficient old pump. If the pump is primed with a little water it becomes operative, suggesting that a temporary stimulus will turn the economy up. This analogy, however, is entirely inappropriate. The forces that move the economy do not become inefficient during a decline. Business is making its usual vigorous response to the conditions that have been experienced, and activity will not come back up again until the underlying difficulties are corrected. There is nothing in our knowledge of economic processes to suggest that a temporary stimulus can produce any enduring change in the level of activity; it might set in motion cyclical swings in the private sector, but even these would probably soon "damp out." This applies equally to a tax reduction with a definite time limit and to a temporary speedup of expenditure programs for which the total outlay is fixed. To be effective in countering the recession, anything that is done should be done with a view to keeping it in effect as long as it may be needed.

Also erroneous is the assumption that maintaining the overall level of purchasing power in the hands of the public will solve the problem. This conception of the problem persists despite an economic commonplace which emphasizes the importance of the gap between purchasing power and purchases; current receipts may be "hoarded" in various ways, for example, by being used for debt reduction. But even if income and purchases were held stable at a high level, the result would not be stability in business investment at a high level. The latter requires growth in demand, not merely stability.

Finally, there is the fallacy that the economy operates on confidence and can be stimulated by optimistic predictions or by promises of future action. Most people are tough minded enough to make their own judgments about what is taking place. False predictions are quickly exposed and then an adverse reaction sets in. Promises not backed by deeds also result in disillusion. There are so many real and financial determinants of business that psychological states of mind ordinarily have little significance. Only in special situations does confidence become important and then by going to an extreme. We have just been through one of those periods at the peak of the boom, and no amount of idle talk can rekindle the excesses. Only recovery and growth into new high ground could do that. Facing facts and doing things can help promote recovery; but hoping that exhortation will get somebody else to do the job is unlikely to accomplish anything at all.

TAX CUTTING HAS LIMITED USEFULNESS

With these brief comments to clarify certain aspects of the situation, the potential value of tax reduction as a tool of economic policy may be considered. The economic stimulus to be obtained from any change in tax rates depends entirely upon the kind of change made. Since taxes come partly out of saving rather than spending, when they are not collected, the proceeds go partly into savings rather than expenditures. Reductions that increase the take-home pay of wage earners are likely to reappear in relatively high proportion in consumer purchases. Reductions that leave more income in the higher income brackets or in corporate accounts are also likely to produce some additional expenditures, but in relatively small proportion. These differences make it clear that if tax reductions are to be made for stimulating the economy, they should be confined to those best adapted to this end, and not just granted to all who would use the recession as an excuse for getting their taxes down.

It is often asserted that reducing high-bracket taxes will make additional savings available for investment, meaning expansion of real capital. This, however, is very improbable in a recession. The kind of "investment" most likely to be stimulated is investment in the bonds issued by the Government to finance the deficit. A high level of transfers could be effected in this way without any significant effect on activity.

One way to perceive the difficulty with any given total of tax reductions is to assume that tax rates will be left unchanged and an equivalent amount will be given away to those most likely to spend the funds received for goods and services. On this basis, the bulk of the funds would probably go to recipients whose position is such as to exclude them from tax liability, namely, to the unemployed. This line of reasoning leads to the conclusion that there is no tax cut that "best" satisfies both the objective of stimulating the economy and the Government's responsibility for the welfare of that segment of the population whose needs are most pressing.

A limited tax cut will not solve the problem despite the emphasis being placed on the role of such cuts in the recessions of 1949 and 1954. In both those situations, other factors were favorable, and there is no evidence that tax reductions made greater than normal contributions. The stimulating effect of any tax cut is bound to be less than the reduction in Government revenues except as it may tend to stimulate fears of inflation and a flight from the dollar. A modest tax cut of, say, $5 billion could hardly produce the latter response. If it were somewhat biased in favor of the lower income groups it would probably expand expenditures by $3 billion to $4 billion. If it had to be more generally distributed in order to command sufficient support to be enacted, the stimulus would be less.

A large, temporary reduction would produce the least effect of all. Experience indicates that "windfalls" are not spent to the same extent as regular income. A study of the veteran's insurance refunds indicated that the additional expenditures from such payments during the first year amounted to only half of the total received, even though they were very widely distributed, in comparatively moderate amounts. Additional evidence on this point is provided by the "permanent income hypothesis," which specifies that transitory components of income do not affect consumer expenditures to the same extent as the permanent components.

Perhaps the best argument for a tax cut is that once adopted it has almost immediate effects. What the economy needs at this point, however, is not just a quick stimulus, but a sustained effort on a continuing basis, making the best use of available resources.

Another argument in favor of tax cutting is that current tax rates are too high and exemptions too low, having been set in wartime and not subsequently modified to take account of inflation and other postwar changes in economic conditions. The existing rates, however, do not produce inordinate surpluses in prosperity years. They are apparently high enough to cover existing programs if personal and corporate incomes could be maintained near the peak rates. They provide little if any margin for expansion of antirecession expenditures. Furthermore, taxpayers have generally adjusted their activities to the existing rates, so that there is no reason to think that they have unduly depressing effect. Certainly, no such effect was noticeable in the recent boom. A good case can be made for setting rates that will produce a surplus in boom times and for keeping those rates stable through recessions, when reduced yields will result in deficits in any case.

Presumably any tax-rate reduction enacted at this time would result in aggravating the deficit that will have to be financed by borrowing. Since there are substantial leakages in tax cutting, this policy would add more to the problem of Government finance than it contributed to economic activity. It may, therefore, be concluded that tax reduction is the "weak sister" of the fiscal-policy team.

EXPENDITURES MUST BE ADJUSTED TO NEEDS

In considering increased expenditures as the alternative, it is evident that a variety of considerations other than economic effects must enter into program decisions. Some programs that meet needs unrelated to the position of the economy may have to be undertaken even though they will be unstabilizing, and at times such programs may have to be curtailed in a recession. It is impossible to deal with the ramifications of this subject here. Hence, except for specific comments in several instances, the noneconomic criteria for deciding programs are not considered.

Perhaps the one kind of expenditure that could be expanded sufficiently to provide a substantial offset to the recession consists of the military programs. The appeal of this "solution" is supported by the fact that we are engaged in an armaments race with the Russians. After the sputniks, several reports on national security were released recommending program increases designed to give us a preponderance of military power. However, this is also the one type of expenditure for which the best case can be made that programs should be determined independently of economic conditions. This case rests on grounds of moral principles, good Government planning, and international relations. Now that both sides are supplied with H-bombs, there can no longer be any "security" in military power. Decisions to wage all-out war have become, in effect, international suicide pacts.

If the armaments race should be given a push by the desire to avoid depression, the future of civilization may be endangered. The country pursuing this course would be on the road that Hitler took. It is hardly an agreeable experience to choose between war and depression. But a clear preference can readily be formulated: We may still live well if our income is somewhat reduced; we may not live at all if the forces of the atom are loosed upon us.

The kind of antirecession program commanding most attention since the 1930's consists of public works. These projects not only sustain activity by replacing private investment with public but create useful facilities to serve various community needs. The objection is sometimes made that public-works programs are slow and inflexible. However, slowness is relative to the timing of the need, that is, to the duration of the investment cycle. To the extent that this criticism is based on the "pump priming" concept, it misconceives the problem. The depression phase of the fixed investment cycle is long drawn out, and it is therefore appropriate to utilize a remedy that operates over equally long intervals. The main cause of delay up to this point seems to be reluctance to decide that the program is needed.

A related objection holds that since projects once started have to be completed, public-works programs cannot be curtailed quickly after the need has passed. This, again, is a "month to month" version of the problem which refuses to take the cycle seriously. The fact is that public-works budgets are subject to annual review. The may be curtailed far more readily than tax cuts could be rescinded; it is hardly ever expedient to raise taxes, even during a boom period, when restraint is desirable.

In attempting to meet specific depression needs, public-works programs rely upon a variant of the "trickle down" approach. In the case of tax cuts, the entire reliance is upon secondary and subsequent effects. Public works create a certain amount of direct employment but largely depend upon subsequent reactions to effect reemployment of other workers. In other words, the jobs they create do not necessarily meet the needs of the unemployed workers. Modern methods of construction do not require large numbers of workers. A major speedup of the highway program, for example, would put only a small fraction of the unemployed back to work. Moreover, projects have to be carried out on designated sites, often remote from the surplus labor.

It was mainly for these reasons that the work-relief program was adopted in the 1930's. Projects had to be "designed" to create the maximum number of jobs, requiring the appropriate skills, and this became a community function in order to insure that projects would be created in the localities where workers needed them. Even with the "inefficiencies" resulting from this approach, many of the accomplishments of a true public-works program were achieved.

In times of high unemployment, the Government is also called upon to make direct payments for the relief of hardship experienced by unemployed workers and their families. The welfare of the community demands that a minimum standard of subsistence be provided for those whose incomes are inadequate. Such direct relief payments go as far as possible in preventing diversions into saving, since the application of the means test confines payments to actual current need, but they are generally considered undesirable for reasons of a personal and social character.

Part of the subsistence problem is taken care of automatically by the social security programs. The old age program makes a contribution by providing retirement income for older workers who are removed from active duty, often involuntarily, at an earlier age than in fully prosperous circumstances. More important, the unemployment compensation program provides partial income over periods ranging up to a half year. Originally it was contemplated that this income should be about half of the worker's regular take-home pay, but rates of compensation have not been raised in line with increasing wage income, and in many cases reserves would not be sufficient for payments of that magnitude if the rates had been stepped up. Both of these programs provide income, not as a form of charity, but as a right earned in previous employment.

The deficiencies of unemployment compensation illustrate again the power of the desire to keep taxes low. It was this desire that led to the adoption of the various experience rating schemes that have kept benefits and reserves at a minimum. Efforts are now being made to put the program on a basis more nearly adequate to the need for income, by making Federal funds available to extend the period of payment. However, any limited payment period, even one longer than now proposed, will leave the basic difficulty. After the initial upsurge in unemployment, benefits dwindle, and the power of the program to counter further recession is lost. Furthermore, there is considerable doubt that any program should confer benefits as a matter of right over an indefinite period. The application of the means test in relief derives from its ability to conserve resources; transfers beyond actual needs are not desirable.

HOW MUCH SHOULD THE GOVERNMENT DO?

What emerges from this brief review of alternatives is that none of the measures available to Government for compensating economic fluctuations is wholly free of objectionable features, and these make each the subject of controversy. This no doubt accounts in part for delays and indecision in moving to head off a decline during its early stages. Nevertheless, it seems clear that the Government can do much and that it should use its powers as effectively as possible to minimize depression difficulties and promote recovery. This generally accepted view, which was incorporated in the Employment Act of 1946, is founded upon international as well as domestic considerations.

Agreement on these principles does not mean, however, that efforts to reduce unemployment and promote recovery can or should be expanded without limit. To attempt unrestricted compensatory action would merely endanger the system with another kind of instability.

Even if a more effective system of controls had already been established, situations might still be encountered from time to time in which the controls proved inadequate. To fall back on an electrical analogy, the economy may be regarded as placing a highly variable demand on the Government powerhouse. At times the capacity of the generators may be exceeded, so that the circuit breakers are tripped. The Government then finds itself in the predicament of being unable to "pick up the load." The only way to avoid futility in endless attempts to reset the circuit breakers is to restrict the demand for power. By cutting off part of the load, limiting it to capacity, power can be rationed and utilized effectively for the best advantage of the system as a whole.

In the major contractions following great postwar booms precisely such a situation develops in the economy. Although it may be unfortunate that the recession cannot then be quickly ended, it is no council of despair to suggest that the Government should observe appropriate limits on the use of its countercyclical powers. The cyclical forces will work in later phases for recovery as well as they do now for recession. In the course of time they would bring about a resumption of growth even without Government action. Since the time would be too long and the depression too deep, the Government should act. But its action should neither inhibit the natural forces of recovery nor engender a kind of recovery that cannot be sustained.

To use control mechanisms violently will not necessarily result in control but may set up oscillations that are completely destructive of stability. It is not difficult to illustrate this point by setting up models of the multiplier-accelerator type. If compensatory Government action is assumed to fill in for declines in private investment with a lag of two calendar quarters, any kind of cyclical misbehavior can result. Explosive cycles can readily be portrayed by relatively moderate adjustments of the postulated coefficients. If the oscillations should, on even a single occasion, run to the extremes of all-out inflation and deep depression, the misguided attempts at stabilization would tend to discredit valid controls that could in less extraordinary circumstances be made to work effectively.

Study of cyclical models brings out two main points: First, an oscillatory system of this kind can only be stabilized by looking ahead. There is no simple "after the fact" formula—such as filling in for declines in private investment or maintaining consumer purchasing power—that can accomplish this result. It is necessary to anticipate fluctuations in the private sectors and compensate them as they occur.

Second, control cannot be established in a major depression period. In such a period, Government has to use its resources on a rather massive scale just to meet pressing immediate needs, and interim curtailments in the early stages of recovery, like that of 1937, will result in disconcerting setbacks. After all forms of private investment have progressed during the boom beyond the needs of long-term growth, it is too late to hope that activity can be maintained. The resumption of stable growth must then wait until the excesses are liquidated. But if restraint can be applied during prosperity to hold private investment within a reasonable range above the rate required for growth, the actual rate may in the course of time merge into the required rate because the latter will be slowly advancing. Thus, it is in approaching the peak of prosperity that control must eventually be established.

WIDE LATITUDE WITHIN THE LIMITS OF RESOURCES

Another way of looking at this problem is in terms of the size of the Federal deficit. Deficits are implicit, of course, in any of the alternative lines of action that might be undertaken. Moderate deficits may be assumed to have no effects beyond those resulting from the programs in which they originated. This would almost certainly be true of deficits up to $10 billion a year, and probably also of somewhat higher deficits. Perhaps $20 billion deficits could be taken in stride for a while if they were expected to be temporary and actual reductions were not too long delayed. But somewhere along the line, the breakaway would be violent.

If it should turn out that deficits of $50 billion were required to hold the economy at the full employment level, incurring them would not result in stability. It would merely replace one kind of instability with another. The situation would tend to fly off into all-out inflation, with Government credit failing in the flight from money, and then collapse into panic when the inflationary boomlet lost its artificial support.

Barring such extreme developments, the management of the public debt poses no major obstacle to effective action. In one sense, the problem of debt management is no longer significant. It reaches an acute phase in periods of high activity, when conflict between monetary restraints and the desire for low charges on the public debt develops. Now monetary policy must work with Government finance to help ease the depression.

One fortunate factor in the current situation is the adequacy of the monetary system to insure against the kind of financial panic that in times past has resulted in banking insolvency. It is, in fact, difficult to separate in past declines the contributions of real and financial factors to the pressure for liquidation. At the moment only the real factors are involved and the outcome should provide a test of their relative importance in comparison with the financial factors. No amount of financial security, however, could be adequate to provide stabilization of the economy against the other causes of variation. On the monetary front we should be concerned only that financial security be not undermined by efforts to overuse monetary devices in an attempt to remedy economic illness for which they are inappropriate.

In summary, it is suggested that the Government act on various fronts to halt the recession as quickly as possible. In doing so, it should be willing to incur deficits—moderate deficits over a period of a decade, if necessary, and substantial deficits during particular years within that period. There could be no objection to moderate tax cuts, as, for example, by raising exemptions somewhat; but on the whole, tax cutting offers less promise of achieving the desired results than expansion of expenditure programs. The objects of expenditure should be selected in such a way as to use financial resources efficiently and avoid interferences with the recovery of private spending. It should be recognized, however, that by the nature of the situation, recovery may not come quickly despite everything that is undertaken. The shortcomings of the specific measures adopted must not be permitted, in other words, to lead to the abandonment of sound principles of government operation. If extreme fiscal adventures are entered upon in the pursuit of apparent prosperity, the consequence may be failure to achieve stability, ultimate breakdown, and the defeat of efforts to establish effective controls. The Government, though playing a role of substantial magnitude, must be patient with partial results until a point is reached at which control can be established.

NATIONAL BUREAU OF ECONOMIC RESEARCH, INC.,
New York, N. Y., February 19, 1958.

The Honorable HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: I have your kind invitation of February 17 to contribute to the investigation by the Senate Finance Committee of the financial condition of the United States.

The economic and financial questions to which your committee is addressing itself are vital to the future of America. The best contribution that I can presently make to your committee's deliberations is contained in a series of lectures that I recently gave at Fordham University on the subject of "Prosperity Without Inflation." I am sending you a copy with this letter in the hope that it may prove suggestive to the committee. You will find specially interesting, I think, the last lecture of my little volume.

With best wishes and personal regards, I am,

Sincerely yours,

ARTHUR F. BURNS.

Enclosure.

CHAPTER FOUR: PUBLIC POLICIES FOR COPING WITH INFLATION

The economic future of America depends largely on what we make of our opportunities. They have never been better than at present. Research and development programs, which only a decade or two ago were conducted on a piecemeal basis, have become a highly systematic and rapidly expanding effort in which private industry, the universities, and the Government are actively joined. This effort is opening up economic opportunities in numberless directions through a constant flow of new products, new materials, and new processes. Our population is increasing at a rate of 3 million per year, or about 3 times as fast as during the 1930's. A progressive shift from low paid and unskilled occupations to better paid and more interesting work is taking place in myriad industries. Inequalities of income such as ruled in earlier periods of our history have been dramatically lessened. Our growing national income is being shared widely and mass markets for consumer products now match our capacity for mass production. The American people are more eager than ever to improve their level of living and are willing to work hard to earn the incomes that may enable them to live as they feel they should. The broad trend of political thought in our country is also favorable to economic growth. Governmental policies are mindful of the need to encourage private enterprise, innovation, and investment, while they remain responsive to the humanitarian impulses of our age. All these domestic factors, as well as the economic revival of Western Europe and other parts of the free world, are improving the long-run prospect of growing markets for the workshops of our economy.

We may, therefore, reasonably expect that our economy will continue to grow rapidly. Setbacks in economic activity will undoubtedly occur from time to time. There will be declines as well as rises also in the price level. But if my analysis in the preceding pages is not too wide of the mark, the broad trend of the consumer price level seems likely to be gradually upward across the decades unless we learn how to manage our economic affairs better than we yet have. As far as the immediate future is concerned, the threat of inflation has definitely abated. But the problems of inflation will return to haunt us. There is no time to be lost in considering, realistically, the ways and means of checking the threat of creeping inflation. For if we continue to tolerate the upward trend of prices, the lives of millions of our people will surely be blighted and the strength of our entire economy may be damaged.

I

As we look to the long future, there are choices before us. Not one path but many may advance us toward the goal of reasonable stability of the consumer price level. We could reduce Government expenditures or restrain their expansion in times of great economic exuberance. We could raise taxes. We could restrain the expansion of credit. We could modify the arrangements under which wages are set. We could alter the price-making process. We could reduce tariffs and abandon or modify other governmental devices for supporting prices. We could work harder and produce more. We could remove or reduce artificial obstacles to higher productivity. And, in principle, we could do any of these things or some combination of them in a great variety of ways.

In practice, our choices are more limited. Some methods of seeking general price stability—such as the allocation of credit or wage and price fixing—are ruled out by our traditions of freedom except under conditions of grave national emergency. Other policies, which would stress the expansion of supply rather than the restraint of demand, may prove very helpful in the long run but quite ineffective in the short run. That is a serious limitation if the advances that occur in the consumer price level during cyclical expansions of economic activity tend to be partly or largely irreversible. Still other methods, such as an increase of taxes, could hardly serve as a useful prescription at a time when the budget is already balanced. Some day in the distant future, it is possible that Americans will be willing to tax themselves at higher rates just to enable the Government to accumulate a sizable surplus and thereby ease inflationary pressures. The time for such a policy has not yet arrived.

Realism requires that we recognize also that governmental policies for restraining inflation—whether they assume a monetary, fiscal, or regulatory character—usually have the quality of austerity. It requires an act of the imagination and some objectivity to understand that, when the economy is already working at or close to its practical capacity, unrestricted credit expansion or liberal Government spending would result in a scramble for resources and a cumulative bidding up of prices. The manufacturer who seeks to expand his activities will not always accept with quiet understanding the need to put up with a smaller loan than he requested from his bank. Nor will the homebuilder or merchant or consumer. When a policy of credit restraint is being pursued by the monetary authorities, many firms or individuals who feel that their opportunities are being restricted will naturally blame the Government for their failure to accomplish all that they had planned. And so it will be also if the Government reduces its expenditures, since there is no way of doing this without reducing the sales of some businesses or forcing some men and women to look for new jobs.

Clearly, governmental policies for checking inflation cannot be expected to be as popular as policies for reducing unemployment. However, popular enthusiasm for a policy is also not a prerequisite for its adoption. It is sufficient if the policy can gain broad support and if it is viewed as an economic or moral necessity. Public sentiment has been moving in the direction of acceptance of anti-inflationary programs at a time of general exuberance. It is likely to continue to do so, provided people retain confidence in the Nation's ability to prevent serious economic slumps. The broad masses of wage earners, as they look to the future of their families, have most to gain from stopping the creeping advance of the price level and increasing numbers among them know this. But they are not likely to support the austere policies that are required to contain inflation at one time, if they fear for the security of their jobs or for their opportunities of advancement at a later time. Nor will many businessmen support anti-inflationary policies in such circumstances.

It would be a grave mistake to assume that the increasing concern of people over the upward climb of the price level justifies or requires half measures in dealing with the problem of recession. Very many of those who today are worried about the cost of living will be worried still more about their jobs if unemployment should spread. If, therefore, we wish to create a climate of opinion that will support effective policies at times when the stability of the dollar is threatened, we can ill afford anything that at any time revives fear of a business depression. This means, as we look to the long future, that, whenever the economy shows signs of faltering, the Government must honor by its actions the broad principles of combating recession which served us so well during the decline of 1953–54. It means, since no two recessions are alike, that the scale of governmental measures, their precise sequence, and the manner of their coordination must be skillfully adapted to the peculiarities of the individual case. And it also means that it would be wise not to lose time in extending recent efforts to strengthen the resistance of our economy to such recessional tendencies as may develop from time to time.

Several steps in this direction can be usefully taken. One is to amend the Highway Act of 1956 so as to permit some flexibility of this tremendous program in the light of economic conditions. Another is to extend the carryback of business losses for tax purposes beyond 2 years, which is the limit under present law. A third is to extend the principle of deposit insurance to the share accounts of credit unions, which are growing very rapidly althought they are still small in relation to deposits in commercial or savings banks. A fourth, and perhaps the most constructive immediate step, would be to improve our unemployment-insurance programs. Unemployment insurance is the Nation's first line of defense against depression. When business activity falls off, the payment of insurance benefits promptly rises and, thus, offsets in part the decline of incomes from productive employment. Although unemployment insurance cannot, of itself, prevent a decline of aggregate economic activity, it can significantly check the rate of decline and thereby make it easier for both private and public policies to be adjusted in a calm atmosphere. Despite the substantial reforms that have been made in our unemployment-insurance system during the past 3 or 4 years, there is considerable room for further improvement. About 12 million of the Nation's wage earners are as yet entirely unprotected, and in numerous States both weekly benefits and their maximum duration still fall short of the level that the President has repeatedly recommended.

As we move to strengthen the Nation's defenses against depression, we should also move—and we could then do so with an enhanced basis for hope of achieving permanent results—to strengthen our defenses against the threat of creeping inflation. What we need more than anything else at this juncture of our great experiment in the management of prosperity is a national declaration of purpose with regard to the level of prices that could have a moral force such as the Employment Act already exercises with regard to our levels of production and employment. This can be simply accomplished by including reasonable stability of the consumer price level among the objectives of the Employment Act which "it is the continuing policy and responsibility of the Federal Government to use all practicable means" to promote. It has been said that such an amendment of the act is unnecessary, since it already covers the objective of general price stability by implication. I would agree to this interpretation of the law. Nevertheless, I believe that it would be a highly constructive step if the Congress stated explicitly what the act appears to some of its interpreters to state implicitly. One of the main factors in the inflation that we have had since the end of World War II is that many consumers, businessmen, and trade-union leaders expected prices to rise and, therefore, acted in ways that helped to bring about this result. A declaration by the Congress that it is the continuing policy of the Federal Government to promote reasonable stability of the consumer price level, as well as "maximum employment, production, and purchasing power," could go a considerable distance in dissipating the widespread belief that we are living in an age of inflation and that our Government, despite official assertions and even actions to the contrary, is likely to pursue an inflationary course over the long run.

It is sometimes argued that a mere declaration of purpose concerning the stability of the dollar would be futile in the absence of some specification of how this objective is to be realized. That is a possible result, but I am inclined toward greater optimism. The language of the Employment Act, as it stands, is extremely general. The act does not specify how the Government should "promote maximum employment, production, and purchasing power," beyond observing that it is to proceed "in a manner calculated to foster * * * free competitive enterprise and the general welfare." Yet the general language of the act has not led to inaction or frustration. On the contrary, it has in practice proved a source of strength, for it has allowed Government officials the utmost freedom in devising means to fit particular and unforeseeable circumstances. The force of the act derives entirely from its affirmation of basic policy, and this would continue to be true if the act were amended.

Broadening of the act, so as to include reasonable price stability among its objectives, would tend to make it a constant reference point for public and private actions that bear on the level of prices. One of the likely consequences of the suggested amendment would be a greater emphasis in the President's annual economic report on the outlook for prices and on how reasonable stability of the price level is to be sought. The reports of the Joint Economic Committee of the Congress would naturally move in a similar direction. Policies the promote stability of the price level would, therefore, tend to gain in prestige and to exercise increasing power over the thoughts and actions of both Government officials and private citizens.

I recognize, of course, that movements of the consumer price level and of the physical volume of economic activity may diverge for a time and that Government officials may occasionally be uncertain whether to give greater heed to the one or to the other. It is easy to exaggerate the trouble that this difficulty, which inheres in the economic process, will cause in practice. What Government officials do now is to shape economic policy in the light of emerging trends in production, employment, and prices, as well as the many factors that impinge on the movements of these magnitudes. They recognize the tendency of consumer prices to lag behind wholesale prices and industrial activity and they allow as they best can for this lag. They recognize that full employment in a practical sense is a zone rather than a point or line, and that the same must apply to a stable price level. They pursue policies that will help to maintain the employed percentage of the labor force as well as the consumer price level within a neighborhood that allows for minor movements in the one and the other. They do not seek perfection in terms of any single yardstick, but a good all-round performance. The suggested amendment of the Employment Act would change these attitudes and procedures only to the extent of leading to somewhat greater vigilance with respect to price developments.

If this proposed amendment had been in effect 5 years ago, I am morally certain that the measures that were taken to check the recession of 1953-54 would have been no less prompt or extensive. On the other hand, I believe that stronger anti-inflationary policies would have been adopted in 1955—which was the critical time to check the newly gathered forces of inflation. It is because I expect that the proposed amendment would strengthen efforts to deal with inflation, while it would in no way reduce zeal in checking recessions, that I regard the explicit inclusion of reasonable stability of the consumer price level among the objectives of the Employment Act as a wise and progressive step at this time.

II

The precise governmental policies that will need to be applied in later periods of vigorous expansion cannot be usefully delineated in advance. It seems clear, however, that fiscal policies will need to occupy a more prominent place in an anti-inflationary program than they have received of late. The forces that make for high governmental expenditures are and will remain powerful. There is little likelihood that the sums needed for our national defense will soon diminish. On the contrary, we may well be spending appreciably more in coming of itself suffice. Many other measures and reforms will be necessary. In view of the constant pressure to add new governmental programs, better machinery than now exists will need to be devised for review and reappraisal of existing programs. The planning of public works, which has been pushed vigorously in recent years to serve the Nation at a time of possible depression, will need to be enlarged to deal with the stretching out of going projects at a time of inflationary pressure. All new programs will need to be brought together in the budget message, so that their cost—not only in the coming year but in each of several succeeding years—may be readily grasped. Most important of all, the accounting and budgeting techniques of the Government will need to be reformed so that they may better serve the purpose of controlling expenditures. At the present time, governmental expenditures can go a very considerable distance either above or below the sums that are budgeted because the accounting methods, particularly of the Department of Defense, make close managerial control impossible.

III

Although it will be necessary to lean heavily on fiscal policy in our quest for reasonable stability of the consumer price level in the future, it would be unwise to neglect monetary policy. The importance of checking the growth of credit at a time of advancing prosperity, whether or not excesses spill over into consumer markets, must never be minimized. With all its limitations, monetary policy can also make—and in fact recently has made—a useful contribution to curbing the advance of consumer prices. This contribution can be greater in the future if we learn how to deal with the obstacles presented to an effective monetary policy by our economic and political environment.

It would be unrealistic to hope that credit restraints will be greeted with great popular enthusiasm in any future that need concern us. However, something can surely be done to improve the political climate for carrying out such a policy when economic conditions require it. As we have noticed, there appears to be some basis in experience for the criticism that at a time of general credit restraint the economic opportunities of smaller businesses are restricted more severely than the opportunities of large farms. To the extent that this problem exists, we should deal with it by opening a safety door for small businesses, not by abandoning or weakening general credit controls. One way of proceeding would be to enlarge the operations of the Small Business Administration when general credit restraints are being exercised. Such a solution may be very useful as a stopgap, but as a permanent policy it is objectionable for two reasons. In the first place, it is doubtful whether the public interest will be well served by having the Government get deeper into the banking business. Second, the activities of the Small Business Administration could grow large and be pursued in a manner which seriously interfered with the policies of the Federal Reserve System. I believe that a more constructive way of attending to the difficulties of the small business community at a time of generally tight credit would be to draw on the powers and facilities of the Federal Reserve System itself.

Thus, when the Federal Reserve authorities embark on a policy of credit restraint, they might simultaneously take steps to prevent undue restraint of small business enterprises. They could do this under existing law in at least two ways. First, they could favor at the discount window those banks which were attending with special solicitude to the requirements of their smaller customers. Second, they could breathe life into section 13b of the Federal Reserve Act, which has been allowed to become virtually dormant in recent years. Under this section of the law, the Federal Reserve banks have the power to extend credit directly to a sound business that is unable to meet its needs through regular commercial channels. The law limits loans to established businesses, to the provision of working capital, and to a period not exceeding 5 years. It would be desirable to lift these restrictions by an amendment. But even under existing law, much could be done at a time of credit stringency to relieve the financial difficulties of small businesses. In view of their intimate contacts with local financial institutions, the Federal Reserve banks should be able to refer many of the loan applicants to commercial banks or to development corporations that could accommodate them in whole or in part. It seems unlikely that the Federal Reserve banks would need to assume very many of the loans themselves. To the extent that they did, they could intensify somewhat their general controls so as to approximate the overall restriction that they took as their practical goal. In this manner the Federal Reserve authorities would be attending constructively to the special problems of the small business community and at the same time helping to create a political environment that would be more salutary for their operations.

The financial handicaps of the home-building industry at a time of credit shortage require a different attack. Here the difficulty stems largely from the unrealistic maxima that are imposed by law or regulation on the interest rates of governmentally underwritten mortgages. There is no way of getting private capital to flow abundantly into such mortgages when it can earn more in other investments. Efforts by the Congress to protect the ceilings on interest rates by regulating discounts only aggravate the problem. Unhappily, there are political obstacles to a solution that fully respects market forces, and governmental adjustments of interest rates are apt to come much too slowly. However, experience even in this area indicates that progress is not impossible. What we need to do is to practice greater foresight and to make a determined effort at reform of our housing laws, so that artificial interest rates cease working as a selective control to the disadvantage of the home-building industry when credit conditions are tight. Unless such a reform is carried out, there is always a danger that general credit controls may be weakened by the political unrest that distraught home builders can stir up when they find their markets slipping while other industries are booming.

The political environment for flexible monetary policies might also be improved by removing or lifting statutory ceilings on the interest rates that can be paid by some of our local governments. It would surely be desirable to develop ways of broadening the market for the securities of local governments, particularly of the smaller municipalities and school districts, so that they may have better opportunities to borrow at reasonable interest rates. Some experimentation along these lines has been under way and needs encouragement. One contribution that the Federal Government might make is to revise the tax laws so as to permit investment companies to pass on to their stockholders the tax-exempt status of the income derived from local securities.

Another and more important problem that requires attention in the interest of improving the political and administrative basis of Federal Reserve policy is the large short-term debt of the Federal Government. The Treasury's need to refinance substantial blocks of securities every few weeks or months unavoidably hampers the Federal Reserve authorities in pursuing a firm and consistent policy. This difficulty will remain serious until a substantial part of the Treasury's short-term debt is funded. Whatever may be said in favor of a cyclically flexible policy of debt management, it has not worked out well in practice. If it has proved difficult to carry out funding operations in a period of economic boom such as we have recently experienced, it is practically sure to seem still harder to do this when the Nation's business turns sluggish. Since the ideal time for funding, from a business cycle standpoint, is likely to elude us in the future as it has in the past, it may be best to revise our methods of managing the public debt and to try out a policy of putting out small blocks of medium- or long-term issues at fairly regular and frequent intervals.

If systematic efforts to soften the uneven impact of general credit controls and to lengthen the outstanding maturities of our public debt are attended by success, the Federal Reserve authorities will gain a greater sense of freedom in conducting the Nation's monetary policies. There is a serious question, however, whether the economic power of the Federal Reserve System—that is, its ability to restrain the expansion of credit with reasonable promptness and yet without shock—may not have been eroded in some degree by the narrowing of the economic base on which its policies impinge. Our financial system has become far more complex than it was at the time Federal Reserve Act was framed or during the 1920's. Commercial banks, which once dominated the entire financial system, have shrunk in importance. We have today not one banking system but several, each subject to different regulations, different taxes, and different modes of supervision. By controlling the reserves of commercial banks, the Federal Reserve System can still exercise close control over the growth of bank assets and of the money supply. But the Federal Reserve authorities have little influence, at least in the short run, over the volume of credit extended by other financial intermediaries or over the creation of money substitutes. Indeed, there is reason to believe that these activities may for a time be stimulated by a policy of general credit restraint.

Various ways have been suggested of reconstructing our financial machinery so as to enhance the effectiveness of monetary policy. One suggestion is to require various financial intermediaries to hold reserves against their labilities on a basis similar to the requirements imposed on commercial banks. Another suggestion is to free commercial banks from some of the regulations that may have impeded their growth—in particular, to restore their power to pay interest, if they so choose, on demand deposits. A third suggestion is to give the President or the Federal Reserve Board standby authority to regulate the terms of consumer installment credit and perhaps also the terms of conventional housing mortgages. It is interesting to speculate about these and other possibilities; but it would clearly be undesirable to tinker with the delicate machinery of finance, on which the workings of the entire economy so largely depend, until a comprehensive study of our financial system and of the basis of monetary policy has been carried out by men of wide knowledge and experience. With all of its shortcomings, the financial system that we have evolved is wonderfully efficient, and it would be unwise to change it in any important respect until the implications of the proposed change have been thoroughly studied and are well understood. Since the Congress has taken a negative attitude toward the proposal for a National Monetary and Financial Commission, it is fortunate that a citizens' commission is now being privately organized to assume responsibility for a thorough and objective reexamination of our financial system and of our tools of monetary policy.

IV

It is hardly necessary to argue further that our monetary and fiscal policies both should and can become a more effective weapon against inflationary pressures than they have been in the recent past. Just as we have done better in combating inflation in the last few years than in the early postwar period, so it seems reasonable to expect that effort, persistence, and imagination will bring more striking success in the future. There is room for doubt, however, whether the threat of creeping inflation can be adequately met within the framework of business-cycle policy alone. The smaller the burden that is imposed by our complex of laws and the course of events on flexible monetary and fiscal policies, the better are the chances that they will approximate what we expect of them. That is why I have put so much stress on the need for a declaration by the Congress that it is the continuing policy of the Federal Government to promote reasonable stability of the consumer price level, as well as maximum employment, production, and incomes. Such a declaration of policy may be expected to have an influence that is incomparably greater than exhortation by high officials, for it would put private groups as well as public officials on notice that the Government is determined to find a way to reasonable stability of the price level.

We must not blink the fact that big corporations and big trade unions have made a difference in the workings of our price system. The rivalries of the business world are nowadays as keen or keener than ever. Competition with respect to quality of products and the services associated with them has increased. However, less stress is being placed by many of our larger businesses on price competition. Meanwhile, the growth of nationwide trade unions has introduced elements of monopoly in many of our labor markets. It has also fostered active rivalry among trade union leaders in pressing for higher wages and more liberal fringe benefits, often with little regard to what is happening to the Nation's overall industrial productivity. Employers, on their part, have often been willing to concede what is demanded by trade unions, partly because of a feeling of helplessness, partly because of the comforting thought that their competitors would have to foot the same bill, and partly because they have reckoned that any increase in labor costs per unit of output could be passed on to their customers. These practices of trade unions and business managements are not likely to be changed quickly. We must, however, keep in mind that the threat of creeping inflation is a long-range problem, and that the best solution—all factors considered—is likely to be one which evolves with a minimum of social and economic disturbance.

Although I believe that inclusion of reasonable stability of the price level among the objectives of the Employment Act would help to reshape the wage policies of our trade unions and both the wage and price policies of business firms, it would be desirable for the Government to go further at this time. Business monopoly is prohibited by law, and the enforcement of our antitrust laws has of late been very vigorous. Trade unions, however, enjoy immunities under the law that are denied other groups or individuals. Our antitrust laws need strengthening in their application to the business world, as the President and many leaders in the Congress have repeatedly pointed out. The least that we can do with regard to trade unions is to subject their finances, as well as the election of their officials, to standards defined by law. Such legislation would of itself have no effect on what happens at the bargaining table; but it should help to remind the leaders of our trade unions that unless they practice greater restraint and foresight, the Government may need to take drastic steps to curb their power to push up costs and prices.

It is not too much to hope that the suggested amendment of the Employment Act, besides stimulating private groups to reexamine their policies, would foster a reappraisal of the effects of many of our public policies on industrial productivity and competition. Our tariffs, import quotas, agricultural price supports, stockpiles, and multiform subsidies—all require a new look. So, too, do our policies with regard to education, research, taxes, patents, and depreciation, on which the Nation's productivity so largely depends in the long run. And so do the featherbedding practices that are sanctioned by labor agreements to the detriment of costs and productivity. Needless to say, reasonable stability of the consumer price level can never be more than one objective of governmental policy among others. Nothing can compare in importance with a strong national defense. A high and expanding level of employment, a prosperous agriculture, conservation of natural resources, the vitality of small businesses, expanding homeownership, and decent neighborhoods for our children—these also are central objectives of national policy. The pursuit of these and other objectives that Americans hold dear is bound at times to release forces that tend to drive prices higher. But once we make reasonable stability of the price level one of the key objectives of the Nation's economic policy, and do this so plainly that there can be no mistaking the fact, it seems likely that public officials will become more enterprising in seeking ways and means of offsetting or containing the price-raising forces that some governmental policies—whether with regard to agriculture, foreign trade, trade unions, or other areas of national interest—unavoidably release.

V

There are several reasons why a broad approach to the problem of inflation, such as I have tried to suggest, carries a greater promise of success than concentration on any particular tool of policy. One is that none of our tools is as yet sufficiently dependable by itself. Another is that there are always limits to the extent to which any specific policy, whether it be credit restraint or anything else, can be wisely pushed in practice. Furthermore, unless the goal of stabilizing the price level is simultaneously pursued by our leading governmental agencies, there is always the danger that one agency or another will be left to carry the burden of resisting inflation while the rest take an independent course, with the probable result that any inflation that may be underway is intensified.

The basis for effective planning and coordination of the economic policies of the Federal Government was laid by the Employment Act, which established a Council of Economic Advisers within the Executive Office of the President. Two major defects that soon became evident in the Council's operations were corrected in 1953. The first stemmed from the fact that under the law the three Council members not only had identical intellectual responsibilities which is as it should be, but also had identical administrative powers, which can lead to confusion. This difficulty was eliminated by a reorganization plan which delegated to the Chairman of the Council the responsibility for administering its affairs and for reporting to the President on its work. At the time of this reorganization, the President also established an Advisory Board on Economic Growth and Stability under the chairmanship of the Chairman of the Council. This Board was designed to overcome another difficulty in the Council's operations—namely, the want of regular governmental machinery whereby the economic thinking and planning of the Council could be brought continuously to bear on the work of the executive departments and agencies or whereby their economic plans could be brought continuously to bear on the work of the Council. To advance further an informed and systematic approach to governmental economic policies, the President later assigned a large role to the Council in Cabinet discussions of economic matters.

As a result of these devices, and other procedures that have developed from them, very considerable strides have been taken toward the improvement of economic policymaking within the Government. Both the means and the experience now exist for another major advance in the machinery of formulating and integrating the economic policies of our farflung government. This can be simply and effectively accomplished by lengthening the arm of the Advisory Board on Economic Growth and Stability. The Board now meets weekly. It includes representatives, usually at the Under Secretary level, of 6 Departments (State, Treasury, Commerce, Labor, Agriculture, and Health, Education, and Welfare) and 4 agencies (Federal Reserve Board, Bureau of the Budget, Council of Economic Advisers, and the White House Office). The Board might continue to function as it now does, except that its deliberations would be preparatory to periodic—say, monthly or semimonthly—meetings at the highest level of our Government. These climatic meetings of the Board would be conducted with the President in the chair and with the heads of the departments and agencies represented on the Board, as well as their deputies, in full attendance. Through this simple transformation of a device of government that has already been tested and found useful, a consultative body would come into existence which would carry a weight in decisions on basic economic policies that would be fully comparable to that of the National Security Council in its sphere. Any such change in the status of the Advisory Board lies entirely within the President's discretion. I need only add that if the President saw fit to elevate the role of this Board, none of the responsibilities of the participating officials or agencies under existing law would require modification.

The Secretary of the Treasury has recently announced that informal meetings are to be held from time to time with the President, which will bring together the Chairman of the Federal Reserve Board, the Chairman of the Council of Economic Advisers, the special assistant to the President concerned with economic matters, and the Secretary of the Treasury. I hope that this development, which rightly recognizes the importance of the Federal Reserve System in the economic scheme of government, will soon lead to the larger and more formal Board that I think is required to cope with our major and changing economic problems. The Nation needs greater assurance than it now has that our Government is equipped to deal on a consistent basis with the threat of inflation. It likewise needs assurance that the Government or one of its central organs will not become so engrossed in the long-run problem of creeping inflation that any immediate problem of recession is neglected. Needless to say, the reconstruction of the Board of Economic Growth and Stability, along the lines that I have sketched, will not of itself prevent mistakes in economic policymaking. It will, however, provide a maximum of opportunity for balanced judgment and it will facilitate the early correction of governmental policies that are found wanting.

Reasonably full employment and a reasonably stable price level are not incompatible. We have often come close to this ideal in the past, and we have done so again recently during the years from 1952 to 1955. The matters that I have stressed in these pages—explicit recognition of reasonable price stability among the objectives of the Employment Act, improvement in the practical workings of monetary and fiscal policies, the reduction of monopolistic practices, and better organization of economic policymaking—will not be attained without great and continuing effort. But if I am right in thinking that these measures will significantly improve our chances of maintaining a reasonably stable consumer price level as well as reasonably full employment over a long span of years, the effort is surely worth making.

NATIONAL PLANNING ASSOCIATION,
Washington, D. C., April 18, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: You asked me on February 17th to answer a number of questions by April 1. This deadline was extended by members of your staff and I am submitting to you my answers today. I have answered most, but not all, of the questions and combined in a few cases my answer to several questions. I hope that you find this material of some value for your purposes.

Cordially yours,

GERHARD COLM.

Enclosure.

ANSWERS TO QUESTIONS OF SENATE COMMITTEE ON FINANCE BY DR. GERHARD COLM [1]

1. DEFINITION OF DEFLATION AND INFLATION

I propose to call deflation and inflation conditions of economic disequilibrium in which there is a general contraction or expansion of purchasing power. The contraction or expansion may originate in one sector but thereafter spread to other sectors of the economy. This implies a change in the supply of money and/or a change in the velocity of circulation of money.

DEFLATION AND INFLATION NOT MERELY CHANGES IN PRICE LEVEL

Deflation and inflation are most commonly defined as decreases or increases in the general price level. Indeed deflation and inflation as defined above are usually but not always associated with price declines and price increases. The price changes per se, however, are not the essence of the phenomena which I would call deflation and inflation. Price declines and price rises may take place for reasons which have no relationship to deflation or inflation; and there can be deflation and inflation without price changes. During the boom period 1926–29, for example, consumer prices were falling whereas during the current recession prices have been rising in spite of the economic slack. Then, too, we have "suppressed" inflation when Government price controls prevent a price rise in spite of the creation of excess purchasing power (e. g. during World War II). We can also have deflation as defined above when business price policy prevents or slows down price declines in spite of a contraction in purchasing power.

[1] Chief economist, National Planning Association.
The views expressed are those of the author and not necessarily those of the National Planning Association. Manuel Helzner has assisted me in the preparation of the answers.

Price changes which in the meaning of the proposed economic definition would not be inflation or deflation may be illustrated by the following examples:

Assume a country had an excellent harvest; food supply increases and food prices drop. The drop in food prices stimulates consumption so that the market is cleared of the large harvest. Farmers sell and consumers buy a larger quantity at lower prices. In this case, the initial disequilibrium between supply and demand resulted from a physical event rather than from a monetary change. The drop in food prices helped to restore the equilibrium between supply and demand. Even if the drop in food prices should cause a drop in the general price level, I would not regard this situation as a case of deflation.

The reverse would be true in case of a poor harvest and a consequent price rise. If the price rise results directly in a curtailment of consumption again no monetary injection of purchasing power is required and the price rise serves as an equilbrating force. Farmers would sell and consumers buy a lower quantity at higher prices. What we observe is a remedial and not a pathological process.

Assume, however, that in the last example the price rise does not result directly in a curtailment of consumption but that many income receivers succeed in increasing their incomes. Then prices will rise still further until the consumption of those income does not keep up with rising prices is curtailed sufficiently to equate supply and demand at the higher price. This price spiral, however, would require an injection of money or increased velocity of circulation of money to finance transactions on a higher price and cost level. The inflation process in this instance is pathological because the initial price rise does not directly fulfill the remedial functions of equilibrating supply and demand. (See also answer to question 16.)

In the modern economy severe demand inflation has been typically the result of war finance. However, milder forms of demand inflation can also be caused by large increases in investments or consumer spending. Conversely, deflation is typically caused by contracting Government finance or a contraction in private credit-financed purchases. If, for example, in case of a curtailment in Government activities (e. g. curtailment in armament expenditures) the price of labor or steel, etc., would drop and stimulate the use of labor and steel in private use, the price drop again would simply play an equilibrating role. If, however, these prices fail to drop or if the price drop fails to stimulate a compensating increase in the private use of these materials, the drop in Government activities would result in unemployment and curtailment in production; private incomes and private spending would fall. Instead of a compensatory increase in private activities we experience then a cumulative destruction of purchasing power—a process, which we call demand deflation.

It is an important fact that in the modern economy the price elasticity of demand for basic factors of production is relatively low. Demand for many basic industrial commodities does not respond readily or significantly to moderate changes in price (within the limits of substitution). For this reason fluctuations often occur in employment and production rather than in prices in response to changes in demand.

To summarize, deflation and inflation are processes which involve either the excessive destruction or excessive[8] creation of purchasing power. They are processes which result from the failure to restore equilibrium through the direct working of the price mechanism. Therefore, they are pathological processes. As deflation and inflation are not just decreases or increases in the price level, it is not paradoxical if it is observed that at times we have had inflation without price rise and deflation without price declines or even with creeping price rises.

DEMAND INFLATION AND COST INFLATION

With respect to inflation a distinction has recently been made between a demand-pull inflation and a cost-push inflation. Although this distinction has often been presented in considerable oversimplification, there is a good deal of validity in it and it has important consequences for policy measures.

Inflation always involves cumulative processes which require the injection of additional purchasing power (additional money created by credit or an increase in the velocity of circulation). The inflationary process however may originate either through excessive demands being generated by government, business, or consumers, or through increases in the price of materials or labor. Both types of inflation are typically intertwined. If inflation is sparked by excessive demand, increases in the prices of labor and material will rise and lift the whole income and cost structure of the economy. If the primary increase should take place in the prices of labor and material, the injection of additional credit would be needed to make transactions at the higher cost level possible.

The term "cost push" inflation has often been interpreted as suggesting that price rises typically originate in excessive wage increases (that is, in excess of productivity gains). This is, however, not the only possibility. It may be that some business firms are able to charge higher prices in spite of slack demand and that wage increases merely keep up with the price rise. Gardiner Means speaks of this situation as "administered" inflation—that is inflation resulting from "administered" price or wage determination. I fear, however, that some people will think that an "administered" inflation is an inflation brought about by action of the Government administration, which would be a complete misunderstanding. Also the term "excess capacity" inflation has been proposed in order to indicate that this kind of inflation may occur even when there is no excess demand. The disadvantage of this term is that we may have the same causal factors at work even when there is no excess capacity in which case both types of inflation processes—cost and demand pressures—may be operative at the same time.

The relationship between demand and cost inflation may extend over a period of time. Assume a demand inflation results in high prices in period "t1." Assume further that in period "t2" excess demand has disappeared. However, in some industries increases in wage rates to compensate for the price rise will take place only in this period "t2." This increase in wage rates in some industries starts a wave of wage-rate increases not directly related to demand inflation. Thus, the aftermath of demand inflation may become the begin-

[8] "Excessive" is meant in relation to the potential production.

ning of a cost inflation. The "inflation" of the year 1957 may show some similarity with the "t2" period of our example. This example demonstrates that it is not meaningful to ask whether wage increases or price rises are responsible for inflation. They are interlocked.

People trained in classical economic theory may deny that a cost or excess capacity inflation is possible. For them it is difficult to understand why prices should be raised except in response to an increase in demand. Even a monopolist who presumably always charges what "the traffic will bear" cannot expect to gain by a price rise except when consumers are willing to pay more for the same quantity of products. The theory of "administered" prices is based on the belief that the producers for a variety of reasons normally do not charge the very maximum price which the traffic will bear. Therefore, they have a margin for price rise which they can use at a time which appears opportune to them. A producer may have been satisfied with a price well below the "peril point" of substitution as long as profits made possible a satisfactory level of dividend distribution and adequate internal accrual of funds for replacement, modernization, and expansion of plant and equipment. If, however, gross profits become unsatisfactory because of a rise in costs (e. g., wage rates) or a contraction of sales, the producer may be inclined to push his prices more nearly to the limit of what the traffic will bear. A rise in wage rates and prices in industries in such a situation may be advantageous from the aspect of that particular group of producers, but it may be undesirable from the aspect of the economy as a whole. This may help explain why prices do not drop so readily in a period of recession.

DEMAND AND COST DEFLATION

Is there a condition of cost deflation corresponding to the condition of cost inflation which we have discussed above? We could imagine, for example, a situation in which demand is adequate or even excessive but in which because of technological advances there is some unemployment and a downward pressure on wage rates. If the reduction in wage rates merely stimulates a more labor intensive type of production it would be of the remedial nature which we would not call deflation. More likely, the wage reduction may become general thereby resulting in more and quicker curtailment of mass purchasing power than is added to mass purchasing power by the hiring stimulated through the wage reduction. In this case a general deflation may ensure, originating by reduction in the price of one cost factor, namely, labor.

2. POLICIES TO AVOID INFLATION AND DEFLATION

A. Policies to avoid inflation

(*a*) *Demand inflation.*—In case of demand inflation there are logically two remedies, namely, either to step up supplies or to curtail demand. Obviously the positive measure of promoting an increase in production has advantages over the restrictive policies of curbing demand. An economy usually has some production reserves which can be mobilized. However, such measures as working overtime, offering full time or part-time jobs to the retired (e. g., by modification of provisions in the social-security laws), facilitating work of women and similar measures not only add to total production but also add to incomes and consumer demand. Thus only a fraction of the increase in total production can actually be regarded as an antiinflationary measure. Also a lowering of import duties would increase the supply of goods and would serve as an antiinflationary measure.

In appraising the contribution which increasing supply can make to remedy a situation of excessive demand, it is important not only to evaluate the conditions of supply and demand as they exist at the moment but to protect them over the period of time during which countermeasures could become effective. One should not forget in such appraisals that we are living in an economy in which potential production is increasing year after year by 3 to 4 percent or about $15 billion. Of course, the other side of the coin should not be forgotten either; namely, that, if production increases by these amounts, the income and demand of the producers will also rise.

In case of excessive demand it will first have to be examined what kind of demand has been increased and may be regarded as the cause of inflation. If it is, for example, a demand for greater national security, it may be assumed that the increase is taking place for compelling reasons of foreign policy. Then increases in other demand categories (e. g., other Government programs, business investment, consumer demand) may have to be limited or resource utilization may have to be expanded. If the increase in demand is of a nature of lesser national urgency (e. g., speculative demand for consumers or business as in the period of scare buying in the second half of 1950), then it would be most desirable to curb that particular kind of demand by countermeasures.

Policies available for curtailing demand include credit policy, tax policy, sometimes persuasion, and, in extreme situations, direct controls.

The anti-inflationary policies to be recommended will depend in each case on the reason for the creation of excess demand. A war, or a business investment boom, or a consumer buying spree call for very different policies. These policies will include different combinations and doses of the same ingredients mentioned above. There is general agreement on the ingredients but room for controversy about the combinations to be used in each situation.

(*b*) *Cost inflation.*—In contrast to the case of demand inflation there is disagreement as to whether or not there exists such a phenomenon as cost inflation and if it exists how it can be avoided or counteracted.

The orthodox view is that if cost inflation exists it does not require any other countermeasures than the old-fashioned demand inflation. As pointed out in response to question 1, cost inflation requires an injection of money in order to become effective. Representatives of the orthodox view, therefore, conclude that to avoid cost inflation the creation of the credit needed to finance transactions at the higher cost level should be prevented. There is some logic to this argument. If in the light of cost and price rises credit expansion is denied by the monetary authorities, then business activity will contract and if the policy is pursued drastically enough prices will eventually come down. We got a relatively mild dose of that medicine in 1957. It contributed to the recession but not enough to bring prices down. A restrictive credit policy which is an appropriate policy in case of demand inflation can effectively counteract a cost inflation only if it is drastic enough to cause a severe recession. However, the use of that policy in such a situation is not compatible with a policy designed to promote "maximum employment and production." We must, therefore, seek other more suitable policy devices to restrain cost inflation.

The various economic reports of the President and many other policy statements have employed persuasion; they have appealed to business and labor to refrain from wage and price increases which would force the price level up. Persuasion can be effective if it is backed up by a strong public opinion. It has not been, however, effective or not effective enough in the present instance. Many proposals have been made for Government measures which would help to restrain excessive price and wage increases. None of these proposals, however, has found serious legislative consideration.

I do not pretend to know the answer to this problem. In spite of all the research done on prices, wages, and productivity in relation to the general price level and the level of employment, production, and economic growth, more facts and a better understanding of these facts are needed as guide for policy decisions. Nevertheless, better facts will often be forthcoming only when some operational use requires that they be developed. Therefore, it would appear desirable that on an experimental basis procedures should be evaluated and initiated for implementing the price stabilization objective of the Employment Act. The following two interrelated proposals may deserve consideration:

1. There should be an annual conference in which representatives of business and labor, with the aid of research economists, discuss general lines of such price and wage policy which would give support to high and rising employment and production without causing inflation or deflation. Statements which could be formulated regarding a desirable general price and wage policy would be used as guidance for price and wage determination in individual industries. Regardless of whether or not agreement on price and wage policies can be reached between business and labor, the results of such a discussion should be informative for public opinion and actually may lead at least to a clearer understanding of the areas of disagreement. A better informed public opinion in itself will exert a restraining influence on price and wage policy. Actually both business and labor, for a variety of reasons cannot disregard for long the judgment of public opinion.

2. Consideration should be given to the creation of a special Government commisison on prices and wage policy. The following specific proposal is meant only as an illustration of the kind of procedure which might be considered.

The commission would be authorized to undertake an examination of a select number of industries in which producers would be obliged to inform the commission of contemplated price increases and new collective bargaining agreements a short period before they become effective. The designation of those major industries would be made by the President in consultation with the Council of Economic Advisers and other Government officials. The commission in studying the proposed changes in prices or wage rates (and related benefits) would report the results of its factual investigation to the President. The

Council of Economic Advisers would then review these reports for the President who would be authorized to suspend the effective date of the change in prices and wages for a specified period of time (e. g., 60 days) if such changes were deemed to be contrary to the public interest. During this time the previous prices and wages would continue. After the end of the period the producers have the right to proceed with the price or wage change if no modification has been worked out in the meantime. A procedure similar to this is already in operation as regards the activities of the NLRB in the matter of labor-management disputes. Adoption of this relatively mild procedure might have a wholesome effect because it will put the parties on notice that the Government is seriously concerned with the task of price stabilization. This might greatly increase the chances of a success in a voluntary effort.

B. Policies to avoid deflation

The policies designed to avoid deflation are to a large extent simply the reverse of the policies designed to combat inflation, particularly demand inflation. In discussing present policies in response to a later question I will deal with policies to avoid demand deflation. Here I will add only a brief comment on cost deflation.

Why should a cost deflation be avoided? According to classical economic thinking nothing can be wrong if costs and then also prices drop. Classical economics regards a drop in costs and prices merely as a remedial process. If unemployment is prevalent, wage rates and prices drop and real purchasing power will rise; demand, production, and employment will increase as a result. In reality it is more likely that a general curtailment of wage rates will result in a drop of incomes in excess of the rise in real purchasing power which would follow from the drop in prices. This would lead to a further curtailment of employment. A general drop in prices to the extent that it would follow from a curtailment of wage rates may even have a depressing effect because it would discourage inventory holding. Therefore, a general cost and price deflation would not be desirable.

A reduction in prices of specific products may be beneficial and result in increasing sales of these commodities. This, however, differs from a cost and price decline spreading through the economy as a whole.

A SPECIAL NOTE ON A LEGISLATIVE PROPOSAL

As this question specifically calls for suggestions about legislative proposals, I would like to add a comment on the proposed amendment to the Employment Act which would specifically identify price stabilization as an objective of equal importance as "maximum employment and production". In my opinion no such amendment is needed. The Employment Act specifically calls for "maximum purchasing power" which implies price stabilization and has been interpreted this way from 1947 to 1958. This interpretation is reflected in the President's Economic Report and in statements by the Joint Economic Committee during the whole period. Price stabilization considerations have at times received even more attention in these reports than employment and production problems.

The amendment would not only be unnecessary; it would, moreover, be undesirable. It would suggest a change in the legislative mandate, and might be interpreted as saying that, from now on, the high-employment objective should be pursued only to the extent that it is compatible with the objectives of price stabilization. People who believe that prices can be stabilized only if there is some substantial permanent unemployment may claim that the amendment sanctions their view. While this is probably not the intent of those who propose the amendment, it would be open to this kind of interpretation.

What is needed, in my view, is not a new declaration of the objective of price stabilization, but a legislative backing of an effort by business and labor to effectuate price stabilization. A proposal toward that end has been made above.

3. MONETARY-CONTROL POLICIES OF THE FEDERAL RESERVE SYSTEM, 1942 TO 1957

Monetary policies in peacetime have the objective—

(*a*) of supplying the economy with the money needed for sustained economic growth;

(*b*) of helping to channel credit in such a manner that various private and public sectors of the economy grow in balanced proportion, and that speculative excesses are prevented, as far as possible;

(*c*) of contributing to a price policy which supports economic growth and maintains the purchasing power of the dollar;

(*d*) of cooperating with the Treasury in the management of the public debt.

In emergency periods, the objective of aiding in financing Government operations (e. g., for war) may become so dominant that monetary policies must be used to restrict growth in other public and private sectors of the economy. Demand for other than war purposes was restricted by direct controls and prices were kept within limits by price controls. This was the situation from 1942 to 1946, when the problem of financing the war had higher priority than preventing current or future price inflation.

In the early postwar period, backlog demand of business, consumers, State and local government, and foreigners was so large that no particular stimulus for economic growth was needed. The main objectives of monetary policy in that situation were limiting the pressures for inflation arising from excessive demand and cooperating in the Government's debt management. With regard to the latter objective, the wartime policy of financing the Government's debt at low interest rates was the main policy objective until the so-called Federal Reserve-Treasury accord of March 1951.

With the end of World War II, the problem facing monetary policymakers was: Is it preferable to give first priority to higher interest rates as an anti-inflationary restrictive credit policy or to a policy of holding down the interest rate on Government securities in order to prevent a sharp rise in interest charges on the public debt? The decision to maintain Government long-term interest rates at a low level was based, in large measure, on the ground that a restrictive monetary policy could have made only a relatively small contribution to price stabilization, but would have cost a great deal in terms of much higher interest charges on the Government's war debt. This policy of pegging the price of long-term Government securities was continued from 1946 to the beginning of 1951. While the policy did prevent a substantial rise in budget expenditures for interest charges, it also had the effect of paralyzing monetary policy as an anti-inflation device.

Other considerations, probably, contributed to the continuation of that policy as well. The experiences of the great depression had somewhat diminished the belief in the importance of credit policy as an effective economic stabilization policy device. Also, some economists believed that the early postwar inflation was only a short-run phenomenon and that low interest rates would be needed in the long run as a stimulus to development. Therefore, it was regarded unwise to permit a steep rise in long-term interest rates if there soon would be a need to lower them again. Finally, Government security holdings constituted such a large segment of the asset holdings of most financial institutions that a steep rise in interest rates and, hence, a steep drop in Government security prices would have had serious implications for the financial soundness of these institutions.

In retrospect, some of these arguments still appear justified; others were exaggerated.

For reasons which were not foreseeable at the end of World War II, the period of dominant inflationary pressure lasted longer than was anticipated. As a result, it was unwise to cripple monetary policy by the rigid pegging policy. It probably remains true, however, that in these first postwar years a truly restrictive credit policy would have forced up interest rates and budget charges on the national debt so much that the cost for a limited gain in price stability would have been very high. This evaluation takes into account that at war's end the banks were so liquid (holdings of short-term securities) that none of the conventional credit policies really could have prevented a considerable postwar inflation.

The Council of Economic Advisers in 1951 suggested, in an answer to a questionnaire from the Joint Committee on the Economic Report, that, in lieu of a pegged market, a "stable" market which permits some fluctuations would have been preferable. (See Joint Committee on the Economic Report: Monetary Policy and the Management of the Public Debt, pt. 2, p. 882 ff.) It would certainly have been undesirable to continue the rigid policy indefinitely. Basically, I believe that the policy adopted under the March 1951 accord of Treasury and Federal Reserve was an improvement compared with the previous policy of rigid "pegging."

There were times during the period from 1951 to 1957 when the low-interest-rate principle of the previous period was substituted by a bias in favor of high interest rates. A restrictive credit policy probably contributed to the recession of 1953, when a sharp curtailment in defense expenditures should have called for simultaneous policies stimulating expansion in other Government and nongovernment outlays. Such a policy of credit ease was adopted only after the recession had actually developed. The switch, however, may have been too drastic as an inflationary boom followed in 1955 and 1956. The monetary authorities applied the credit brakes again, but probably did not take them off promptly enough when indications appeared early in 1957 that economic expansion was falling short of the growth potential and that a downturn in business investments was in the making. Credit restrictions were actually relaxed early in 1958, when the recession was well underway and business in general no longer responded well to ample credit at easier terms. (This should not suggest that the credit policy of 1958 was without effect—it probably had an effect on such areas as housing and local-government undertakings.)

4. FACTORS CONTRIBUTING TO THE DECLINE IN THE VALUE OF THE DOLLAR (CONSUMER PRICE INDEX FROM AUGUST 1956 TO SEPTEMBER 1957)

This was a period during which production capacity was gradually rising and no indications of an excess demand existed. Therefore, this period cannot be characterized as a period of demand inflation.

I would mention the following factors which may have contributed to the price rise:

1. There was some demand inflation in the years 1955–56, due to the high and rising rate of business investment (general price indexes did not fully reflect this inflation because of the simultaneous decline in farm prices). Demand inflation, as was pointed out in response to question 1, affects the cost structure in some instances quickly, in other instances with considerable delay (e. g., in the wages of some industries, in the rates of regulated public utilities). These rising costs, which originated in the inflation of 1955 and 1956, exerted an influence on prices in 1957 even though the conditions of demand inflation had actually disappeared. One might say that the aftereffects of the demand inflation of one period contributed to a cost inflation in the following period.

2. The wage-rate increases in 1957 exceeded productivity gains. In part, they were designed to compensate for price rises of the past; in part, they led to price rises in 1958 or were taken by business as an occasion to increase prices.

This, I would explain the price rise of 1957, in part, as a delayed aftermath of the preceding demand inflation; in part, as a cost inflation resulting from the rise in administered prices and increase in wage rates in excess of productivity gains.

6a. RELATIVE IMPORTANCE OF—

1. PRICE STABILITY
2. STABILITY OF PRODUCTION, DEMAND, AND EMPLOYMENT
3. ECONOMIC GROWTH IN PRODUCTION, DEMAND, AND EMPLOYMENT

1. Economic growth is, in my opinion, the most comprehensive economic objective. In an economy with a rising labor force and rising output per man-hour, the basic choice is between an increase in production and an increase in leisure. Under present national and international conditions, it seems to me that increased leisure has lower priority than increased production. This does not exclude some shortening in the workweek, particularly through longer paid vacations, opportunities for advanced training, and similar arrangements.

2. Stability of production, demand, and employment is desirable to the extent that growth should not be accomplished by fits and starts but, as far as possible, by sustained expansion. Nevertheless, in an

economy of substantial growth, certain sectors will at times grow faster than other sectors. Also, some sectors of the economy may actually be contracting while others are expanding. Such fluctuations have to be accepted. Widespread and prolonged contractions (recessions or depressions) or excessively rapid expansion (inflation) are undesirable. Thus, for example, when business investments slow down or decline, public investments should be accelerated or consumption promoted, if economic growth is to be maintained.

3. Price stability is desirable because a general downward movement in prices usually has a depressing effect and hinders economic growth. A general increase in prices leads to a change in the distribution of income—to the detriment of receivers of relatively fixed incomes (e. g., pension receivers). Also, a substantial general increase in prices, if continued over a period of time, leads to speculative movements and malallocation of resources. Therefore, price stability may be regarded as a corollary objective of economic growth, if understood as balanced economic growth, which means growth in proper proportion to the various elements of growth.

6b. TRENDS SINCE WORLD WAR II IN RELATION TO THESE THREE OBJECTIVES

At the end of World War II, most economists expected a period of postwar inflation (substantial backlog demand financed by ample funds before civilian production could get back in full swing) followed, possibly, by the threat of another depression. This appraisal of the economic outlook—which assumed an expected lasting demobilization of the Armed Forces—formed the background for the consideration of the full-employment bill of 1945. Broadly speaking, this concern with inflation and depression still dominated economic thinking until the outbreak of the Korean war.

During the period 1947 to 1952, the executive branch of the Government, under the leadership of the Council of Economic Advisers, while primarily concerned with anti-inflation programs, nevertheless, prepared plans for antirecession programs, should their use become necessary.

Beginning with the year 1951, it seems to me, the emphasis of economic policy shifted from economic fluctuations to economic growth. There was a growing realization that the United States probably would need to support large national security projects for a long time. During the preceding years many nondefense programs (e. g. school and hospital construction, development of natural resources) were held down on the ground that we could catch up with those programs as soon as the period of the postwar inflation was over. With the advent of hostilities in Korea it became clear that these nondefense programs could not possibly be postponed until some other demand pressures had subsided. The need to proceed on the most urgent nondefense programs had become pressing even while national security programs were still high and possibly rising. As a result, greater emphasis came to be placed on the increase in total production, and there was less concern with the threat of depression.

Some economists have gone so far as to express their belief that all emphasis should be on economic growth, that we need no longer be concerned with serious instability in production and employment, and that some continued rise of prices had to be accepted as an unavoidable consequence of economic growth.

The economic policy of the administration in 1957 and 1958 has given at least equal consideration to the concern for current and future increases in prices as to the concern for current recession and unemployment. Monetary policy has been eased only reluctantly and piecemeal; expenditure programs even for such high priority objectives as national defense and education have been increased only within narrow limits, and tax reduction has been postponed.

It is difficult to judge whether the antirecession program up to now has been limited primarily because the economic advisers expect an early upturn in business conditions or because they fear that any larger size program, while halting and reversing the recession, may bring us back into inflation. It can only be guessed that a combination of these two factors explains the limited character of the current antirecession program. So long as prices are rising, Government decisionmakers may feel that no broad policy of credit or fiscal expansion is called for; if prices move sidewise, a policy of waiting and caution might be adopted. Thus, the fear of inflation may have led to a reluctancy to pursue a policy designed first to prevent, and then to stop, the recession, and to promote the resumption of economic growth.

If the threat of rising prices is fought exclusively with a restrictive credit and fiscal policy, then we cannot be certain that we can achieve the objective of sustained economic growth. The specific proposal for price and wage policies submitted in response to question 2 is intended to bring together and to reconcile at the same time the objectives of economic growth and price stability. It is my conviction that one of the most important tasks of economic policy is to devise methods by which the objectives mentioned in this question can be reconciled.

7. THE EFFECT ON THE ECONOMY OF CURRENT FEDERAL, STATE, AND LOCAL GOVERNMENT SPENDING

In 1957, total expenditures of Governments in the United States amounted to $114.1 billion, or about 26 percent of all production of goods and services (GNP). Of this, $86.6 billion, or 20 percent of GNP, was spent directly by the Governments for goods and services; $27.5 billion, or 6 percent of GNP, were transfer, interest, and subsidy payments to individuals and business, and reflected in their spending for goods and services. The size of Government has been rising both in absolute and relative terms as the following table shows.

Government expenditures, fiscal years 1939–57

[Billions of dollars except where rated as percent]

	1939	1950	1953	1957
Expenditures of—				
Federal Government	7.8	38.6	74.7	75.4
For goods and services	5.1	22.1	59.5	50.5
For transfers, etc	2.7	16.5	15.2	24.9
State and local government	9.6	22.6	27.1	38.7
For goods and services	8.2	19.9	24.9	36.0
For transfers, etc	1.4	2.7	2.2	2.7
Government total for goods and services:				
In billions of dollars	13.3	42.0	84.4	86.6
In percent of gross national product	15	15	23	20
Government total for transfers, etc.:				
In billions of dollars	4.2	19.2	17.5	27.5
In percent of gross national product	5	7	5	6
Gross national product	91.1	285.1	363.2	434.4

NOTE.—Details may not add to totals due to rounding.
Source: Economic Report of the President, January 1958. Survey of Current Business, July 1957. Survey of Current Business, 1954 National Income Supplement.

This very large and rising amount of Government spending is of great significance for the current economic development. This is one of the several factors which makes a downward spiraling depression of the 1930–33 variety very unlikely.

The large military demand, on the other hand, absorbs about 10 percent of the gross national product which otherwise could be devoted to productive purposes. Not only is manpower in the most productive age groups being taken out of the productive process, but especially a large number of scientists and engineers are allocating their energies to the defense effort.

The effect of this absorption should, however, not be exaggerated. Total production in the United States is so enormous and has increased so much over the years that the rise in Government expenditures (e. g. compared with 1939) has taken place at the same time as consumer expenditures and business investments have increased. A significant restriction in expenditure programs, however, has taken place with respect to nondefense Government expenditures for such purposes as schools, hospitals, resource development, urban redevelopment, and so forth. These programs, too, have risen in dollar terms, but not in proportion to total production and certainly not in relation to the needs of a rising population.

It might well be that the coming phase of development will see both an absolute and a percentage rise of these nondefense programs. If, however, a very substantial increase in national security expenditures should become necessary, some of the improvements in these nondefense programs may have to be postponed in spite of their great need and urgency.

8. THE EFFECT ON THE ECONOMY OF CURRENT FEDERAL, STATE, AND LOCAL TAXATION

The aggregate tax burden in the United States—Federal, State, and local—is heavy, amounting to approximately 25 percent of national income in 1957 in contrast with 11 percent in 1929 and 17 percent in 1939. Taxes affect the economy in two basically different ways. First, taxes affect the flow of funds. If used for financing the purchase of goods and services for public purposes, taxes transfer funds from the private to the public sector of the economy. Thus, an increase in taxes, as a general rule, reduces the share of private consumption or investment in the economy as a whole. (Whether the share of consumption or investment is reduced depends on the kind and incidence of the specific taxes.) If, however, the Government spends tax funds for making transfer payments (e. g. benefits to veterans), no reduction in aggregate private spending takes place but rather a shift in spending power from taxpayers to benefit receivers. These examples are concerned with the effects of taxes on the flow of funds and on spending throughout the economy.

Second, taxes have an effect on the attitudes and the economic behavior of people. Taxes influence incentives and thus affect the decisions of individuals and corporations. To appraise the effect of taxes on incentives and economic decisions is much more difficult than to estimate the effect of taxes on the flow of funds. Looking at the last decade, there is little evidence that the tax burden has had a generally harmful effect on work incentives. In spite of a few examples of film stars who were not interested in making more than a few pictures or of some participants in prize contests who because of tax considerations were satisfied to stop playing the game short of the final payoff, there is no evidence that individual income tax rates, in general, have discouraged productive efforts. Nor is there evidence that the high corporate tax rates have significantly reduced the willingness of corporations or curtailed the availability of funds to invest in new plant and equipment particularly for the larger corporation. Rather, part of the corporate taxes have more than likely entered the cost and price structure with the possible result that profits after taxes are not much lower than they would be with lower corporate taxes.

Nevertheless, individual tax rates, particularly in the upper income brackets are so heavy that tax provisions become an important influence in making decisions.. Taxpayers in the higher income brackets try to arrange their investments in such a mannar that part of their income is received in the form of tax-exempt income (State and local securities) or in form of income subject to lower tax rates (e. g., long-term capital gains).

Businessmen are conscious of the fact that outlays for research and development may be treated as business expenses and need not be treated as capital outlays. This fact has encouraged many firms to spend more on research and development programs than they would do without that tax incentive. Other influences of the tax system on business management have induced less constructive results, such as the incentive of profitable corporations to acquire deficit corporations. In some instances, such tax provisions have been the motivation for increasing business mergers.

The tax system as a whole has probably not impeded but more likely has added incentives for economic growth. In other respects tax-benefit considerations were decisive enough to lead to less desirable results. However, the latter, in general, have not been of overwhelming importance. (For a discussion of Federal, State, and local tax relationships, see answer to question 10b).

9. FISCAL POLICY AND MONETARY AND CREDIT POLICY

It is generally recognized that a budget surplus tends to have a deflationary effect and a budget deficit an inflationary effect. Nevertheless, three qualifications to that simple statement are needed.

1. An appraisal of the economic impact of the Government's budget should include not only the expenditures and taxes incorporated in what has been called the administrative budget but also those in the consolidated cash budget. The latter includes such items as the benefit payments and tax receipts of the social-security trust accounts and the income and expenditures transactions of other trust funds. Also, in appraising the effect of Government policy there should be considered the effects of debt guaranties, insurance, and other programs which are reflected in private credit transactions but are, in part, actually attributable to measures of public policy.

2. A budget deficit or surplus which results from a change in economic conditions (i. e., the automatic increase in taxes resulting from an increase in production and incomes, or the automatic decline in taxes resulting from a drop in production and incomes) does not have the same economic effect as a budget deficit which results from a deliberate increase in expenditures or a deliberate cut in tax rates. The former may help to mitigate an inflationary or deflationary movement; the latter, however, would be more effective in reversing such movements.

3. The inflationary or deflationary effect of a budget deficit or surplus respectively also depends on the debt management and monetary policy which are used. A budget deficit financed by the issue of savings bonds, for example, has a less inflationary effect than if financed by the issue of short-term bills placed with the banking system, particularly if the central bank provides the member banks at the same time with additional reserves so that they can buy the bills without reducing their liquidity. Conversely, a budget surplus has a limited deflationary effect if used for redemption of bonds in the hands of investors who are likely to use the funds immediately for other investments (e. g. mortgages). A budget surplus if used for the redemption of bank-held debts, exerts its strongest deflationary influence if the central bank at the same time increases reserve requirements so that the redemption does not increase the liquidity of the banks. This example demonstrates that fiscal and credit policies are most effective as devices to combat inflation or deflation if they are used in combination.

Fiscal policy and monetary and credit policy are devices of the same character insofar as both may effect the flow of funds and private spending. Nevertheless, in some situations the predominant use of the one or the other device is more effective.

In a situation of demand inflation (see answer to qeustion 1) a restrictive credit policy may be effective in curtailing demand for investments, particularly in housing and local government outlays. As far as business is concerned, however, the effect is uneven because smaller businesses which depend more on credit are affected more severely than the larger firms which usually finance a sizable portion of their investments out of their own internal funds. In answer to question 2, it was pointed out that neither fiscal nor credit measures are effective policy devices for countering a cost inflation.

A policy of credit relaxation is particularly effective when private demand begins to slacken but before a general economic downturn has set in. However, once a recession is underway the easy money policy will have an effect only in specific cases—business investments and consumer purchases in general are heavily influenced by market expectations and employment prospects rather than by the availability or terms of financing. Therefore, in a recessionary period greater reliance should be placed on fiscal measures, specifically on an increase in expenditure programs and/or a reduction in tax rates. Nevertheless, fiscal antirecession measures can be most effective if supported by an appropriate monetary policy.

10b. ADEQUACY OR INADEQUACY OF THE UNITED STATES FISCAL SYSTEM

If we look at current trends in Federal, State, and local government taxation in contrast to trends in Federal, State, and local expenditures a serious problem becomes apparent.

The Federal Government largely relies upon the most productive kinds of taxes, particularly the individual and corporate income taxes which have a tendency to increase at least in proportion to the increase in total production and income. State and local governments finance the largest portion of their expenditures by sales, real estate, and other property taxes, which are regressive in character and respond to rising production, and incomes, in general, only with a time lag. Greater reliance by State and local governments on income taxes is limited because if significant State or local differences in tax rates occur, taxpayers may choose residences where taxes are lower.

If we assume that expenditures for national security need not be increased substantially during the next decade, we can expect that the greatest future growth in Government activities will be in those functions (particularly education, health, development of water resources, urban redevelopment) which traditionally have been State and local responsibilities. Under the existing fiscal system two alternatives would be readily available, namely either an increase in State and local taxes, or Federal grants-in-aid on a much enlarged basis. Neither of these alternatives appears very desirable. An increase in the State and local sales and property taxes with a relative decline in the importance of Federal income taxes would make the tax system as a whole more regressive. A larger use of the grants-in-aid program for specified purposes would magnify the problems of establishing and enforcing standards of performance. It would appear desirable to explore other possibilities, such as a Federal income tax with shares going to the States. Also the question of borrowing by State and local governments needs reexamination. Such borrowing is at present heavily subsidized by the Federal Government through the tax exemption of interest on State and local bonds. Much can be said in favor of Federal support for State and local borrowing, but the tax-exemption provision may be questioned as the best way of doing it. It is my impression that recent committees set up to examine the Federal, State, local fiscal system of the United States have made significant contributions to our knowledge of the basic facts, but have not come to grips with some of the immediate problems which are likely to attain dimensions in the future.

11. INFLATION, FULL EMPLOYMENT, AND UNEMPLOYMENT

As discussed in response to question 1, rising prices and unemployment can at times exist side by side. Such a price rise, however, is not likely to be of the character which we called demand inflation.

The price rise in 1957 may in part be explained as a delayed action arising from the inflationary situation of the years 1955 and 1956. A demand inflation in an earlier period sets in motion forces which may make for a cost inflation in a subsequent period.

I do not agree with those who suggest that we should accept a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals.

A small continuing price rise if accepted as a part of general economic policy may easily develop into a larger price rise. A continuing larger price rise is undesirable both on economic and social grounds. This should not lead to the conclusion, however, that in order to avoid a future price rise the Government should not pursue a vigorous policy designed to halt and reverse the recession and to promote balanced economic growth. The objectives of promoting balanced economic growth and price stability come into conflict only if rising prices, originating on the cost side of production, are combated by a restrictive credit and fiscal policy. One of the most important economic tasks before the country is to initiate private and public policies which are designed to limit price fluctuations without interfering with, but rather support, policies designed to promote economic growth.

13 AND 17. CAUSES OF THE RECESSION, AND THE ANTI-RECESSION PROGRAM

CAUSES OF THE PRESENT RECESSION

1. The present recession is primarily the result of an increase in productive capacity which exceeded the increase in active demand in recent years. During most of the last decade, but particularly in the years 1955 and 1956, very large increases in productive capacity took place. At the same time price rises limited the increase in active demand. This discrepancy laid the ground for a decline in business investments which is characteristic of the present recession.

2. In addition to this basic cause, there were a number of contributing factors, such as the curtailment in defense contracts in the second part of the calendar year 1957; the decline in exports due to dollar shortages in foreign countries; the continuation of a restrictive credit policy through most of 1957 even though excess capacity began to make itself felt earier in that year.

3. Furthermore, there were secondary factors aggravating the recession. Once sales did not rise, business began to cut back inventories; consumers became concerned with the job outlook and became more reluctant to buy durable goods, particularly on installment. Also, the expectation of a price decline probably induced some consumers to postpone purchases. In recent months, the recession has been reflected in a decline in personal increases (not fully offset by rising transfer payments), which had a depressing effect in addition to the psychological effects.

THE PRESENT OUTLOOK (BEGINNING APRIL 1958) AND THE NEED FOR AN ENLARGED PROGRAM

Several of the factors making for the recession have in recent months been reversed, particularly the cutback in defense contracts and the restrictive credit policy. The reversal of credit policy coming at a time when the recession was well under way, has contributed to lower interest rates and has facilitated Government finance operations but has not resulted in any significant increase in business borrowing. Credit policy measures create a potential supply of credit but in themselves do not assure that business will actually use the additional credit made available. The decline in manufacturers' inventories is still continuing although at a reduced rate. In relation to the current rate of sales, inventories are not low, in spite of the reduction which has taken place. All in all, the pace of the decline in economic activities appears to have slowed down but indications of an upturn and a resumption of economic expansion are not yet assured.

Do the measures adopted by the Government or most likely to be adopted in the next few weeks promise to bring about such an upturn? These measures include a moderate increase in defense work, the step-up in the highway program, the facilitation of housing credit and, the supplements to unemployment insurance benefits. These measures may bring about an increase in Government expenditures of about $3 billion in the fiscal year 1959 and, in addition, may increase private residential housing outlays by about $1 to $1.5 billion. It seems reasonable to expect that these measures will suffice to bring the downswing to a halt. There is a real question, however, as to whether or not these measures will be adequate to turn the tide and to restore a satisfactory rate of economic growth.

Federal Government tax revenues could fall $5 billion short of the fiscal 1959 budget (of January 1958), assuming that the economy will continue through the fiscal year 1959 at the level of production of the first quarter of the year 1958. Thus a deficit of about $8 billion could be expected for the 1959 fiscal year.

A deficit which is largely the result of shrinking revenue is only of limited effectiveness as an antirecession force. Broadly speaking, it helps to mitigate a downswing but does not assure the initiation of the upswing. The increase in defense work, in road building and residential construction, however, should make for some additional activity. We do not know to what extent this increase in Government expenditure programs is likely to stimulate private activities (i. e. consumption and business investments). Nor are we assured that this additional activity will do more than check a further decline. Thus, under the programs as they are now formulated there is a distinct possibility, if not probability, that with some ups and downs the economy may move sidewise at the present relatively low level for some time to come.

In such a situation those responsible for the government's economic policy must decide whether it is more prudent to run the risk of doing too much or the risk of doing too little. If we do too much we might have to adopt anti-inflationary measures at a future time. If we do too little we are wasting productive resources through idleness and we are bearing a heavy cost in human frustrations, lost opportunities, and damage to our international good will and prestige.

It has been suggested that a bolder antirecession program would be fiscally irresponsible if undertaken in the face of an expected large budget deficit. A large recession deficit must indeed be expected for the next fiscal year and possibly for several years if effective antirecession measures are not adopted. At the present time, the choice is not between budget deficits and a balanced budget but between a recession deficit and an antirecession deficit. An increase in expenditures in excess of those now adopted and a reduction in taxation are likely to increase economic activities and thereby lead to increasing tax yields. These effects of an antirecession program will develop over time. With a greatly enlarged antirecession program the deficit in the next fiscal year may be somewhat larger than it would be otherwise. Over 2 or 3 years, however, the aggregate deficit and the increase in the national debt resulting from a prolonged recession is likely to be substantially larger than the deficit and the increase in the national debt resulting from an antirecession program. (If a bold program had been adopted, say, in January 1958, a deficit for the fiscal year 1959 might possibly have been avoided altogether.)

A budget deficit and raise in the national debt resulting from a recession is a liability with no assets to show on the other side of the ledger. An antirecession deficit creates very important assets—reduced frustration from unemployment, much needed schools, hospitals, and roads, consumer welfare, added capacity to produce, and a greatly enhanced international position.

ELEMENTS IN AN ENLARGED ANTIRECESSION PROGRAM

Proposals have been made for expanding a number of expenditure programs which need to be expanded anyway. Besides the field of national security, there are programs in the field of education, including school construction, school equipment, and higher salaries in order to attract a higher quality teaching staff. Larger programs are also needed in health, conservation and development of water resources, and urban redevelopment. In most of these fields arrangements must be worked out with the State and local governments. These programs can be fully justified on their own merit as well as on the ground of promoting sustained economic growth. But even with prompt legislative intitiation it will take some time before these programs can make a substantial contribution.

Tax reduction as an antirecession device can take effect more quickly. The exact amount of needed tax reduction, however, should depend on the increase in expenditures which appear likely during the next few fiscal years. Tax reductions which (a) add to consumers' disposable income and (b) support price reductions will exert an immediate impact. A reduction in the personal income tax, with emphasis on taxpayers in the lower income brackets is particularly effective for increasing consumer income and encouraging consumer expenditures. From the point of view of both the immediate impact and the longer run strengthening of the tax system, consideration should be given to the proposal for splitting the present first $2,000 income tax bracket and lowering the tax rate of the first $1,000 taxable income. A reduction from the present 20 percent to 16 percent on the first $1,000 taxable income, for example, would reduce tax revenues by about $2.8 billion (although part of the reduction may be offset by rising tax yields as production and incomes increase). While this tax reduction would emphasize reduction in lower bracket incomes, nevertheless, 60 percent of the benefit from the rate changes would accrue to taxpayers with more than $5,000 incomes. An increase in exemptions by $100 would have a similar impact on the economy. However, the latter measure would take about 4 million taxpayers off the tax rolls. In the present international situation of uncertainty, much can be said in favor of leaving the tax base as broad as possible.

The elimination of some excise taxes could be recommended as a tax measure which would facilitate price reduction and thereby stimulate private consumption. Consideration should be given to a reduction in excise taxes amounting to perhaps between $2½ and $4½ billion. The National Planning Association has specifically recommended elimination of excises on transportation and communication, and on a variety of miscellaneous products, excluding taxes on alcohol and tobacco, a few regulatory excise taxes, and excluding those tax sources which are largely allocated to the highway trust fund. The National Planning Association's proposal to eliminate these miscellaneous excise taxes would cause a loss in revenue of about $4.5 billion—again not counting the offset in other revenues which would follow from an increase in sales of these commodities. (A copy of the NPA statements on Cost of Unemployment and Priorities in Tax Reduction as an Anti-Recession Measure is attached.)

In summary, brief comments should be made regarding what fiscal measures can and cannot achieve. As was pointed out above, the basic cause of the recession probably lies in the fact that the increase in productive capacity has temporarily exceeded the increase in active demand. This explains primarily the downswing in business investments in plant and equipment and the depressed conditions in the tool and machine industries. Other contributing factors are the low level of activity in the automobile and certain export industries.

In general antirecession measures cannot be pinpointed so as to directly lift activities in industries particularly hit by the recession. Some speedup in placement of orders for automotive equipment by Government agencies or for school buses could be initiated as has already been done with military vehicles. But these can only be minor aspects of an antirecession program. The objective of an antirecession program for the general economy is to lift the level of activities in a widely dispersed number of industries and services and thereby make the solution of the particular problems of specific industries more feasible. No fiscal policy can (or should) immunize a specific industry from the effects of a miscalculation. Fiscal measures can stimulate private business investments by promoting a growing demand in the economy in general and thereby restore the markets which will again make investment in plant and equipment promising. Private business investments can be stimulated by such measures as corporate tax reduction only if the prospect for expanding markets make business expansion attractive. For this reason, the fiscal measures which have been recommended are suitable primarily for counteracting the secondary effects of the recession; namely, the general decline in consumer buying and business confidence. They cannot (and should not) relieve business management of the job of making adjustments in their investments, production, and pricing policies.

16 ESCALATOR PROVISIONS IN WAGE AND OTHER CONTRACTS

Escalator clauses provide for an adjustment of wage rates or other payments usually in response to changes in the consumer price index. Sometimes they are related to productivity increases. Some contracts provide for an annual increase in wage rates so that labor shares in the benefit derived from technological and managerial advances. Productivity-related wage increases are meant to result in higher real wages, as distinct from increases which merely offset price increases. In the face of rising prices, however, productivity increases which do not provide for wage adjustments based on price increases would not accomplish their purpose.

Productivity increases have much to recommend them as a feature in wage contracts. They provide an element of flexibility for agreements extending over a number of years; they permit management to do a better long-range planning job; and they function as a spur to induce constant improvements. This assumes, however, that the automatic productivity increases are of a realistic magnitude and not of a magnitude which the firm can only pay by raising the prices for its product. To the extent that automatic productivity increases in wage contracts are desirable the use of the escalator clause is probably unavoidable.

There is still another argument against a wholesale condemnation of escalator clauses. Business management can protect their firms (and management incomes to a considerable extent) by their pricing policies. Private investors, particularly in the high income brackets, can obtain some measure of protection against price rises by investing in selected securities. In this situation it would be difficult to maintain that labor groups should not seek protection against price rises if they are in a position legally to do so.

And yet, with these arguments in mind, a realistic approach to the problem would also examine what the consequences of widespread escalation are for economic and fiscal policy.

Widespread escalation may weaken the resistance to price inflation on the part of those who are protected by escalation; and at the same time it deprives price inflation of the function which it used to have in emergency periods (particularly during wars). A price rise resulting from an extraordinary increase in some demand factor (e. g., as result of a large Government war program) has the function of curtailing some types of demand and of helping to restore equilibrium between demand and supply at a somewhat higher price level. If the demand of some part of the population is protected against the effect of the price rise through automatic wage increases, a greater price rise will ensue and will hit with enlarged impact upon those receivers of relatively fixed incomes who do not enjoy any protection against the price rise.

In a situation of demand inflation, therefore, it is preferable both from an economic and a social aspect to curtail demand by tax and other financial measures where the impact at least in a broad way can be distributed in a manner compatible with social justice, rather than to rely on the price spiral which results in the least justifiable distribution of the burden. The existence of escalator clauses is a strong argument for all unprotected groups of the population to demand the use of tax and other financial measures for curtailing demand, when necessary.

In this connection, it is an oversimplification to talk about the interest of labor in contrast to the interests of fixed income receivers. In this respect labor is not a unified group. Only some unions will succeed in obtaining escalator provisions and even where they are obtained they may not all be uniform and usually become effective only with a considerable timelag. A majority of labor is more likely hurt by price rises and have an interest in an economic and fiscal policy designed to keep price changes within narrow limits. Thus, in summary, in our economic and social system there seems to be no justification for preventing one group—namely, labor—from seeking protection against price rises. However, the spreading of escalator clauses makes general price changes as an equilibrating force less effective and therefore strengthens the reasons for pursuing a general policy of price stablization.

UNIVERSITY OF CALIFORNIA,
DEPARTMENT OF ECONOMICS,
Berkeley, Calif.

Mrs. ELIZABETH B. SPRINGER,
Chief Clerk, Senate Committee on Finance,
Washington, D. C.

DEAR MADAM: Please find enclosed my response to the questions sent me on February 17.

Very truly yours,

HOWARD S. ELLIS.

RESPONSES TO THE QUESTIONS OF THE SENATE COMMITTEE ON FINANCE (SENATOR HARRY F. BYRD, CHAIRMAN) BY HOWARD S. ELLIS, PROFESSOR OF ECONOMICS, UNIVERSITY OF CALIFORNIA, BERKELEY, CALIF.

1. I would define inflation as a general rise in prices, and deflation as a general fall of prices.

2. I do not believe that the economy of the United States could completely avoid inflation and deflation except by so much direct control as to jeopardize the free-enterprise system. Economic progress in a free-enterprise system engenders waves, and we must accept some fluctuations up and down as the price of progress and freedom. But we need to accept neither chronic inflation nor chronic underemployment, nor do we need to experience disastrous periods of boom and bust as the price of progress and freedom. It is my conviction that, for the most part, excessive fluctuations and undesirable secular developments in prices and employment can be avoided by wise and vigorous use of fiscal and monetary controls.

For the effective use of fiscal and monetary controls, we need two changes in our laws and practices. The first is the ending of the virtual exemption of labor unions from antitrust laws. (See answers to questions 9, 10, 11, and 15). The second is the establishment of some sort of coordinating authority or council to secure unified policy among the Federal Reserve, Treasury, and the various Federal lending or credit-guaranteeing agencies. A mild measure, which would be enough if all goes well, would be a sort of interdepartmental advisory committee in the field of domestic finance, somewhat after the pattern of the National Advisory Council in the international finance field. I would be in favor of trying this measure before resorting to suggestions which have been made for a supreme monetary authority. We can probably make do with existing institutions with a little more attention to coordinating Federal lending and credit-guaranteeing activities with Federal Reserve policy. The Federal Reserve and Treasury seem to have established a practical modus vivendi since the accord of March 1951. The moral responsibility of securing effective general coordination lies, in the last analysis, with the administration. But a special coordinating committee or council would, probably, be useful.

3. Prior to the accord of March 1951, the Federal Reserve System was too much dominated by the objective of maintaining the prices of Government securities to be able to exercise effective monetary control. Of course, during the war years, monetary control was (and probably had to be) superseded by direct controls, such as price ceilings, rationing, and production priorities. The war was too little financed by taxation, and part of the postwar inflation could scarcely have been avoided in view of the large increase in demand deposits and currency already produced by wartime deficits in the budget. But in the postwar period the inflation was intensified unnecessarily by unjunstified fears of higher interest rates and of a freer market for Government securities. Federal Reserve support of Government security prices unnecessarily expanded the credit base through open-market purchases and the creation of commercial-bank reserves. Prior to the accord, the Federal Reserve had taken some steps toward restoring monetary control, but they were much too mild.

Since the accord of March 1951, Federal Reserve policy has on the whole, been very ably and correctly conducted. It has been flexible and, until recently, rewarded with a fairly high degree of stability of prices, production, and employment. In retrospect, monetary policy should have been somewhat more restrictive during 1955, 1956, and the first half of 1957, but there were other factors in the inflation of those years, and Federal Reserve policy was not seriously lax.

4. The factors contributing to the rise of prices from August 1956 through September 1957 were partly monetary and partly nonmonetary.

On the monetary side was the extensive expansion of loans by commercial banks. The course of these funds was the sale of securities by banks to private persons and nonfinancial firms, and, more ultimately, the high liquidity of these persons and firms which was a leftover from wartime money creation and the postwar years. Loans expanded while demand deposits scarcely increased. Thus, in one sense, the Federal Reserve could say that there had been no increase of money. But the sale of securities by the banks and the making of loans transferred deposits from the idle or relatively inactive to the quite active category, and velocity (as measured by debits to account) rose substantially from 1955 to mid-1957. Federal Reserve policy should have been still more restrictive in order to offset the increase of velocity.

On the other hand, fiscal policy—in the form of a higher budgetary surplus—should also have been stiffer during these months.

Another factor, perhaps second to none other, was the wage increases which, fairly clearly during 1955, 1956, and 1957, exceeded increases of productivity and, hence, were inflationary.

5. Although there are other aspects of debt management, the two most important are (1) the height and structure of interest rates, and (2) the division of debt into short term and long term. The higher are the coupon rates on Government securities, the more attractive they are to lenders in comparison with corporate securities, mortgages, and other forms of lending. Thus, higher interest rates are a brake on inflation by restricting private investment. Mortgage and other types of long-term borrowing, particularly speculative and consumer borrowing, are less sensitive. Higher coupon rates also have a tendency to restrict consumption, but this is a milder influence.

Short-dated securities, being highly liquid from the angle of the owner, do not inhibit spending as much as longer maturities. In the situation in which short-term rates are lower than long-term rates (and this is normal), there is a correct proportion of short-term (cheap) and long-term (expensive) debt to achieve the needed degree of restraint upon investment, consumption, and inflation. Interest is the necessary cost of limiting the potential inflationary influence of public liquidity resulting from holdings of Government securities. The public must be persuaded to continue to hold the securities.

6 (a). All three of the objectives are important for the economic policy of the United States; all three have, in my judgment, quite correctly, been so designated in the Employment Act of 1946.

If we were talking of the objectives of monetary policy, it would suffice to mention the first two objectives only. And, indeed, for monetary policy, I would make price stability the primary objective. Stability in production is chiefly obtained by monetary policy by means of its contribution to price stability. And the primary and, perhaps, exclusive contribution which monetary policy can make to economic growth is the securing of price and output stability. This combination is the best setting for avoiding speculative wastes and the wastes of idle plant and manpower. Monetary policy does not—and should not—include the direct control of the use of capital, and, therefore, if monetary policy makes a contribution to progress, it does so by affording an auspicious setting for the efficient operation of the price system and private enterprise.

6 (b). The United States economy has fared well, with respect to all these objectives, since World War II, when compared to most countries. Its least impressive record has been made with respect to price stability. Our largest amount of inflation came between 1945 and 1948, chiefly in consequence of wartime finance. But the record of 1955–57 was not good. (Please see answer 4.)

7. I have no criticism of the general character or present level of Government spending. If unemployment increases much over its present level, Government spending should be increased.

8. In view of present levels of unemployment, I would favor reductions in Federal income taxes, of rapidly increasing magnitude, if unemployment shows a tendency to increase.

9. Under fiscal policy, I would include the magnitude and specific composition of revenue and expenditures, the way deficits are financed (by borrowing or by money issue), and the way surpluses are used, and the management of the public debt. Under monetary policy, I would include all measures directed toward controlling the amount of money in the economy. It is obvious that monetary and fiscal policies overlap in my definitions and in fact.

To control inflation, Government receipts should be increased and expenditures decreased; taxes which discourage expenditure, particularly consumption expenditure, should be increased; coupon rates on Government securities should be raised; short-term debt should be funded into long-term debt; and the lending and debt-guaranteeing activities of the Federal lending agencies should be curtailed.

To control inflation through monetary channels, the Federal Reserve should raise its rate of discount, increase reserve requirements for the commercial banks, and sell securities on the open market.

Through the combined effects of fiscal and monetary policies it should be possible to control effectively the volume of demand deposits and currency in circulation. It is not possible for fiscal and monetary measures to control the velocity of circulation of money, since this is determined by private spending decisions. But if the volume of money is stabilized, this will operate powerfully toward stabilizing private spending decisions, and hence velocity and prices.

10 (a). Except for inflation induced by monopoly pricing (see question 11), the monetary system of the United States seems to me generally adequate to cope with inflation, if properly supported by appropriate fiscal measures. Nevertheless the monetary system would be strengthened by the founding of a coordinating council to assure that Treasury, Federal Reserve, and Federal lending agency policies are mutually consistent. A recent study of the National Bureau of Economic Research has found that the magnitude of Federal agency loans and loan guaranties approaches the magnitude of compensatory budget changes, and that, over the two decades since the lending agencies came into prominence in the thirties, the size of these loans and guaranties has as frequently changed in a direction opposed to Federal Reserve policy as conformably to it.[1] Thus the coordination of all Federal monetary activities is a matter of first rate importance.

Two other reforms are long overdue, though the Federal Reserve and the commercial banking system have been able to function despite these shortcomings. One major reform would be the requirement that all commercial banks, whether or not they are member banks of the Federal Reserve System, should be subject to the reserve requirements of the Federal Reserve. Another reform is an overhauling and simplification of the reserve requirements. Differential requirements as among central reserve, reserve city, and country banks are no longer significant; other improvements are probably needed. Detailed reforms can be worked out in consultation with officers of the Federal Reserve. These two reforms would tighten up the operation of the monetary system and afforded a more equitable distribution of the financial burden of maintaining reserves.

10 (b). I shall not attempt an answer to this question since I do not consider myself a qualified expert in public finance.

11 (a). In my judgment, the main explanation of the existence of this paradoxical phenomenon is monopoly wages and monopoly profits. Monetary policy and fiscal policy may somewhat restrain the inflationary force of monopoly but in the final analysis is incapable of dealing with it. In my own judgment, wage advances secured by monopoly labor organizations in excess of increases of productivity chiefly account for the inflation of the years 1955–57. But it is also true that monopoly profits are a fertile background for wage demands, since employers can yield and still retain adequate profits. Thus, industrial monopoly also contributes to inflation. The inflation problem will not ultimately be licked unless public policy can cope with monopoly restriction of entry and of output by both labor and industry.

11 (b). No only is a gradual inflationary trend neither necessary nor desirable in the attempt to achieve full employment; it is a serious

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[1] J. Saulnier, Harold G. Hallcrow, and Neil H. Jacoby, Federal Lending: Its Growth and Impact, National Bureau of Economic Research, New York, 1957.

obstacle to achieving it. Any such policy, as soon as it was really thought to be settled policy, would result in inflation which would be much more than gradual. Rational action will discount the future inflation into the present and cause (as it has in South American Republics practicing chronic inflation) a rapid acceleration of the process. This inevitably leads to speculative excesses, misdirected production, pathological boom conditions, and the inevitable aftermath of recession and unemployment.

12. In general, if either private or public debt does not grow more rapidly than gross national product it does not seem dangerous to the stability or vitality of the economy. However, there are particular categories of private debt which can be dangerous. I refer to installment credit, the growth of which, I believe, has been excessive, and which helps to account for overexpansion in the automobile and some other consumer durable industries in 1956 and 1957. Also this excessive volume of installment debt now overhangs the consumer markets and will have to be worked down before there can be a revival of consumer demand.

13. This, of course, is a question of anyone's judgment. In my own, tax reduction should begin if unemployment exceeds 4 or 4.5 million and public works should be considerably increased at the level of 6 or 7 million.

14. Negligibly. Budgetary deficits since World War II have not been sufficient to account for inflation.

15. Please see my answer to question 11.

16. No. In general, they exacerbate the problem.

17. The causes of the present recession are partly monetary (please see questions 10 and 11) and partly nonmonetary. On the side of real factors there has been the growth of capacity and output in consumer durables, including automobiles, at a somewhat too rapid rate prior to mid-1957. The same may have been true of residential construction. A contributing cause to the downturn was the reduction of defense orders in the middle of last year. I agree with what is a rather general view that we reached the end in 1957 of a long-term investment boom, and that it may take longer than in 1953–54 to overcome maladjustments and oversupplies. As for remedies, I have already replied in previous answers.

NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS,
New York, N. Y., March 31, 1958.

The Honorable HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: In reply to your letter of February 17, attached are my views on the 17 questions that you have posed. You will note the views expressed are the author's and do not represent, necessarily, those of the National Association of Mutual Savings Banks or the Association's individual members.

If I can be of further help to you, please let me know.

Sincerely yours,

GROVER W. ENSLEY,
Executive Vice President.

Attachment.

REPLIES TO QUESTIONS OF THE SENATE FINANCE COMMITTEE BY GROVER W. ENSLEY, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS, NEW YORK 17, N. Y.[1]

1. Give a definition, in your own words, of deflation and inflation.

Inflation means a general increase in prices of goods and services, while deflation means a general decrease in prices. This definition is broad in scope; in practice, the terms are often confined to substantial and persistent trends, and the definition also takes no account of the intecedent forces at work. Nevertheless, the definition of inflation and deflation is a good deal easier than their measurement. Which price movements should be measured? Our economic history is replete with instances in which consumer prices moved at different rates and, indeed, in opposite directions from wholesale prices. In the postwar period, an index which attempts to measure the price movements of all goods and services produced, i. e., the gross national product, implicit price deflators, has risen every year without exception. During the same period, however, the Consumer Price Index rose nine times, fell once, and remained virtually unchanged twice. The Wholesale Price Index rose in 7 years, fell in 3 years, and remained substantially stable in 2 years. Measurement of general price movements, i. e., inflation and deflation, is also complicated by the fact that the specific articles the prices of which are included in the indexes, do not remain unchanged from year to year. Automobiles are a frequently cited illustration. While the price indexes attempt to make adjustments for changes in the product, there, nevertheless, remains considerable uncertainty about the significance of price measurements where product changes are frequent and significant.

2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws

[1] The views expressed are the author's, and do not necessarily represent those of the National Association of Mutual Savings Banks or the association's individual members.

should be changed or new laws are required, then make specific suggestions.

In general, the control of inflation or deflation depends primarily on the proper exercise of public policies, particularly monetary and fiscal policies. Those invested with responsibility for formulating and executing public policies must be alert to changing economic conditions and adjust policies in line with such changes rather than merely on the basis of some arbitrary rules. Thus, during a period of economic expansion, fiscal, and monetary restraints should be applied with such vigor as may be needed to keep the expansion of total spending in line with the increasing availability of goods and services. This very well may require keeping taxes at rates high enough to provide substantial budget surpluses and restraints on expansion of the supply of money and credit. By the same token, in a period of recession it well may be necessary to increase the availability of credit at reduced rates of interest and to reduce tax rates and, therefore, tax revenues relative to Government spending. If the objective is to moderate fluctuations in the rates at which the economy's productive capacity is used and in the general price level, Government surpluses and deficits well may be required. They should not be eschewed on the basis of false and inappropriate analogies to private households or businesses.

On the whole, therefore, avoiding inflation or deflation depends on the alertness and responsiveness of public policies. This does not mean that such policies must be changed in response to every minor change in economic conditions. Flexibility in public policies should provide for some tolerance of minor fluctuations, up and down, in unemployment and prices.

The argument has been offered with increasing frequency in the past few years that general fiscal and monetary controls are inadequate to prevent inflation because of the control which some business and labor groups can exert over prices and wages even in the face of changing demand conditions. There is little evidence as yet to support the contention that such power, in fact, exists or is exercised effectively. If this contention can be supported, however, antitrust policy should be carefully reappraised to determine how this power can be eliminated or reduced without sacrificing basic institutions of a free, private-enterprise economy.

3. Comment generally on the monetary-control policies of the Federal Reserve System as exercised within the following years: 1942 to 1957. (You may wish to divide the period into two parts, 1942–50, prior to the accord, and 1951–57.)

Prior to the March 1951 "accord," Federal Reserve monetary and credit policies were based partly on fear that removal of the peg of Federal bond prices might have serious economic consequences and partly on accommodating Treasury debt management. As a result, monetary-control policies were of limited usefulness as instruments for economic and price-level stabilization. For example, during the high-employment postwar years prior to 1951, fiscal policy efforts to restrain total demand to noninflationary levels could have been expected to result in increasing liquidity pressures and a rising interest-rate structure. Efforts by the Federal Reserve to prevent any significant increase in Treasury financing costs, however, necessarily involved making additional reserves and funds available in the money market for support of Treasury bond prices. The desired pressure on credit availability and costs to restrain total expenditures to noninflationary levels, therefore, was weakened rather than enhanced by the Federal Reserve's credit policies.

Following the "accord," the Federal Reserve System exercised considerably greater freedom to adjust its policies to meet economic stabilization requirements. Through its self-imposed strictures to conduct open-market operations solely in Treasury bills, its limited use of its power over reserve requirements, and its extensive use of rediscount-rate changes, the Federal Reserve has sought to restrict its discretionary authority over the money supply to relatively modest changes at the margin, i. e., "to lean against the wind." Some experts in monetary policy believe that the monetary authorities have, on the whole, been too cautious, too much inclined to defer action until its need has been clearly established. Others, particularly those who feel that monetary policy ought to play a relatively minor role, at best, secondary to fiscal policy, in economic stabilization believe that the Federal Reserve has been excessively restrictive in its general policy position and, on the whole, unduly concerned with the prospects of inflation.

4. Beginning in August 1956, there was an increase in the Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

The statement that the decline in the value of the dollar between August 1956 and September 1957 was caused by the continuous increase in the Consumer Price Index should be qualified along the lines suggested in response to question No. 1, above. Considerable reservations attach to measuring the value of our money in terms merely of consumer prices. While, admittedly, this is the relevant index from the consumer's viewpoint, it is not necessarily so relevant from the point of view of the producer. As noted above, divergence in the movement of various indexes is not an extraordinary phenomenon in our economy. Rising capital-goods prices or rising industrial raw-material prices well may bespeak inflation, from a number of relevant viewpoints, even if the Consumer Price Index is at the same time stable or even falling.

In very general terms, the rise in consumer prices in August 1956–September 1957 (and in subsequent months, as a matter of fact) may be attributed to the fact that, at the close of 1955, the economy was operating at, or very nearly at, full capacity. Further expansion of production to meet additional demands of business, Government, and consumers necessarily was limited by increases in productive capacity. Preventing a rise in prices of a wide range of goods and services, therefore, required limitations on the expansion of total spending.

Moreover, the rapid rate of expansion of economic activity in 1955 had inevitably resulted in bottlenecks in several important lines, in the sense that quick and substantial increases in the resources required to meet anticipated demands could come only by bidding them away from other uses. Rising costs of resources would show up in rising prices of final products, unless total demand were limited sufficiently to mitigate the incentives for bidding up resource prices and, therefore, production costs. In retrospect, therefore, it appears that a somewhat larger increase in tax revenues relative to Government expenditures and/or somewhat greater restraint on the expansion of credit would have been advisable in 1955 and early 1956.

5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

I infer this question refers to management of the debt now in existence, rather than to policies determining levels of expenditures and receipts which will affect the amount of debt. In this context, debt management is concerned primarily with problems of maturity and yields of Federal obligations. From a parochial viewpoint, the objective of debt management is as for as practicable, to minimize the cost to the Treasury of maintaining any given volume of debt. If this objective were ruling, changes in the Federal debt would be guided very largely by estimates of the effective yields which would have to be paid on any specified volume of various types and maturities of debt instruments.

Whether following such a guide would necessarily be in the best interests of economic stability, however, is doubtful. Minimizing the interest charges on any given volume of Federal debt well might involve demands upon the money markets which would impair the financing prospects of private and State and local government borrowers. Such demands might be regarded as at least as important to the Nation's economic progress as those of the Federal Government. Avoiding disruptive changes in the money markets, therefore, must also be an important consideration in Federal debt management.

On a somewhat broader level, debt management must recognize that the total demand for and supply of loanable funds in the money markets reflect a wide variety of financial requirements. Different groups of lenders may seek different objectives in their investments, while the demands of various groups of borrowers also must be expected to differ. The interaction of the sum of these varying supply and demand factors determines, in effect, the structure of total public and private debt in terms of volume, interest rates, maturities, etc. The total money market, therefore, may be viewed as consisting of a number of compartments. Ideally, changes in the conditions in any one compartment quickly would affect those in other compartments. In fact, however, this interaction may be slow or sluggish, so that the consequence of any prospective change in Federal debt management for overall credit conditions may be difficult to discern in advance. Imperfect knowledge may result in debt-management actions which significantly change the relative advantages enjoyed by different groups of borrowers and lenders.

At the present time, the Treasury faces the need to refinance about $41 billion of maturing obligations, apart from bills, before the end of fiscal 1959. In addition, continuation of present economic and budgetary trends might add some $4 billion to $5 billion to the Treasury's total financing requirements during the last quarter of fiscal 1958 through fiscal 1959. These demands can, to some extent, be met through the decrease in business demands for funds, which is one of the major aspects of the current recession. Thus, in the fourth quarter of 1957, business loans fell by $0.2 billion in contrast with fourth-quarter increase of more than $1.5 billion in 1955, 1956, and 1957. Apart from this shift in loans from private business to Government, however, some net additional demand for credit is to be expected. So long as these demands coincide with continuation of recession conditions, expansion of bank reserves should be provided to minimize upward pressure on interest rates and diversion of credit away from non-Federal borrowers. On the other hand, should these increasing demands coincide with strong economic recovery trends, some restraint on credit expansion will be required if inflationary forces incipient in such expansionary circumstances (see No. 4, above, and No. 12, below) are to be held in check. Some rise in interest rates and decrease in availability of credit, at least relative to what might be anticipated if recessionary tendencies predominate, would be expected.

6. (a) Discuss in their relationship to one another and, according to your judgment of their relative importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand, and employment.
3. Economic growth in production, demand, and employment.

(b) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

(a) These objectives have been considered in detail and on a continuing basis in the studies of the Joint Economic Committee and its subcommittees. (Cf. Monetary, Credit, and Fiscal Policies, Subcommittee on Monetary, Credit, and Fiscal Policies, 81st Cong., 2d sess.; Monetary Policy and Management of the Public Debt, Subcommittee on General Credit Control and Debt Management, 82d Cong., 2d sess.; Federal Tax Policy for Economic Growth and Stability, papers submitted by panelists appearing before the Subcommittee on Tax Policy, 84th Cong., 1st sess.; Federal Expenditure Policy for Economic Growth and Stability, papers submitted by panelists appearing before the Subcommittee on Fiscal Policy, 85th Cong., 1st sess.; and hearings on 1957 Economic Report of the President, 85th Cong., 1st sess.)

One of the most significant considerations emerging from these inquiries, I believe, is that no one of these objectives can be considered in isolation from the others. Public economic policy, therefore, is not called upon to rank one objective, in any absolute sense, ahead of or behind any other. The priorities to be determined, rather, refer to the extent to which gains in achieving any one objective should be put ahead of gains with respect to any other objective. Such priorities must be expected to change quite frequently in a dynamic environment. It seems clear, for example, that most policymakers were persuaded in 1956 and 1957 that increasing restraints on inflationary pressures were well worth sacrificing some of the expansion of production that, otherwise, might have been achieved. On the other hand, one can visualize circumstances in which a faster rate of growth in productive capacity might be regarded as sufficiently compelling to warrant somewhat less concern with price-level stability. At the beginning of World War II, for example, the need to expand, quickly, capacity for producing certain strategic products was generally regarded as sufficiently great to tolerate the upward price pressures which the resulting bottlenecks produced. In addition, the adverse effects on the desired expansion of the labor force which were anticipated in any effort to offset increases in some prices by decreases in others through the use of general fiscal restraints were regarded as sufficiently serious as to warrant tolerating some (preferably modest) buildup of inflationary pressures.

No hard-and-fast rule, therefore, can be offered for determining the relative importance of various economic-policy objectives.

(*b*) With the benefit of hindsight, it now appears that inadequate emphasis was given to price-level stabilization in 1955 and 1956. The current recession, apparently, has weakened the inflationary impetus which developed during 1955, 1956, and the first several months of 1957, particularly if adjustment is made for the effect on food prices of normal seasonal movements and the exceptionally hard winter. Since changes in the Consumer Price Index typically lag several months behind broad changes in levels of economic activity, it well may be that consumer prices will be moving downward as the economy begins recovery. In the interests of price-level stability for the long run, public policy should seek to keep the pace of expansion of total demand within proportions consistent with avoiding further bottleneck pressures on resources, production costs, and, consequently, prices.

In this connection, it should be noted that the economic-policy objective of stability in the rate of use of our human and material productive capacity does not preclude some fluctuation in unemployment rates. Such fluctuations, of course, must be kept within bounds which are tolerable to the American people. It is clear that, if no fluctuations in employment rates were tolerated, general fiscal and monetary policies would hold little hope for stabilizing the general level of prices.

7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

Many of the numerous questions and issues concerning the impact of present Federal spending programs on the economy were explored intensively by the Fiscal Policy Subcommittee of the Joint Economic Committee in its study in the fall of 1957 of Federal expenditure policy for economic growth and stability. The papers submitted by panelists appearing before the subcommittee, the subcommittee hearings, and the subcommittee report provide a wealth of information and analysis concerning the relationship of Federal expenditure policies to the Nation's economic development. The general policy guides offered by the subcommittee in its report warrant careful consideration. A copy of this report is appended hereto.

It is clear from this study that no simple generalization about the effects of Federal expenditures on the economy can be offered. Increases in Federal expenditures, by adding to total demand, stimulate economic activity just as any other category of spending. Similarly, Federal expenditures take up resources and, therefore, limit their availability to other sectors of the economy. One cannot say whether the net effect of these stimuli and limitations will be "good" or "bad" except in terms of one's own judgments concerning the "right" composition of the total product of the economy. No absolute standards are available, therefore, upon which to base general evaluations of total Federal spending or major components thereof. Essentially the same observations may be made with respect to State and local government outlays.

Each of us is free to assert that Government spending is too high (or too low) and to try to persuade others of the correctness of our viewpoint. The assertion may be directed primarily against waste and inefficiency (see answer to 10 (*b*)), although on the whole, it is extremely difficult for anyone to demonstrate the extent of such waste without a more intensive investigation of specific spending programs than most of us can undertake. But, apart from this, the assertion that Government spending is too high (or too low) merely reflects the individual's feeling that some other mix of the total product of the economy would more closely conform to his own preferences.

8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

For the most extended and one of the best studies of the economic effects of Federal taxation, let me commend to the committee's attention the study, Federal tax policy for economic growth and stability, undertaken in 1955 by the Subcommittee on Tax Policy of the Joint Economic Committee. The compendium of papers submitted by panelists appearing before the subcommittee in this study presents careful and well-balanced analyses of all the major features of the Federal tax system with respect to their economic effects. The subcommittee's report, Senate Report No. 1310, 84th Congress, 2d session, offers important guides for formulating tax policies consistent with steady growth of a free-enterprise economy. A copy of the report is attached herewith.

In the current situation, the subcommittee's recommendation that the level of tax revenues should be related to the level of Government expenditures by the need for full utilization of expanding productive resources is particularly topical. Following this principle would call for reduction of taxes relative to Government outlays if the basic sources of the current recession are thought to be not merely temporary and minor adjustments.

It has been very widely maintained, that present levels of tax rates are too high for the economy's long-run growth requirements if the rate of increase in Federal Government expenditures is confined to that of the post-Korean war years. For example, the Joint Economic Committee staff's projections of the Nation's economic growth to 1965 assumed reductions in Federal tax rates sufficient to reduce combined Federal, State, and local revenues 15 to 20 percent below the hypothetical yield that could be expected from present rates at income levels estimated for 1965 (Potential Economic Growth of the United States During the Next Decade, materials prepared for the Joint Committee on the Economic Report by the committee staff, 83d Cong., 2d sess.). The basic policy problem during the past 2 or 3 years according to this view has not been whether but when taxes should be reduced. During 1955, 1956, and most of 1957, the strength of inflationary pressures appeared so strong as to preclude tax reduction relative to Government outlays unless the Nation was prepared to accept much more rigorous monetary restraints than were actually imposed. The present indications of abatement of inflationary forces during the current recession suggests that this is the appropriate time for tax reductions unless significant increases in Government outlays are anticipated.

9. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy, and then

relate them, one to the other. Please discuss these policies stating how they may be used in restrain inflationary trends and otherwise aid in preserving a stable economy.

Fiscal policy is concerned with management of the Government's receipts and expenditures (and consequently debt or surplus) while monetary and credit policy is concerned with the supply of money and credit, in relation to the demands therefor. Both seek to achieve certain objectives. The two sets of policies most obviously come together in connection with debt management. The extent and basic character of debt-management problems depend primarily on the receipts and expenditures results of the Government's budget, but these problems have obvious consequences for monetary policy (see No. 5, above). The immediate objectives of the two sets of policies may, of course, differ markedly, but in the present setting, their broad objectives are the same: contributing to the steady browth of the economy without price-level instability.

Fiscal policy, in addition, has long been concerned with the overall impact of Government spending, taxing, and borrowing activities on the distribution of income and wealth. Without passing judgment on the appropriateness of this concern, it is evident that fiscal policy cannot ignore whatever may be the wishes of the American people in this respect. Thus, fiscal measures which well might contribute to achieving the economic stabilization and growth objectives of public economic policies will, nevertheless, be regarded as unacceptable if they significantly conflict with the wishes of most Americans regarding the distribution of expenditure benefits and tax burdens.

One of the most provocative suggestions concerning the use and relationship of fiscal and monetary policies to achieve the Nation's economic objectives has been set forth succinctly by Prof. Paul Samuelson, in Federal Tax Policy for Economic Growth and Stability (papers submitted by panelists appearing before the Subcommittee on Tax Policy, Joint Economic Committee, November 1955, pp. 229–234). Professor Samuelson points out that given the expenditure by the Federal Government, the restraints on total spending necessary to prevent inflation may be provided either by monetary or tax measures. These measures may be combined in alternative ways to satisfy alternative desires with respect to the influences on levels of investment and consumption, and income and wealth distribution. As an example, the monetary authorities may provide relatively "easy" money, and as a consequence, a relatively low structure of interest rates, as a means of encouraging investment while those responsible for fiscal policies provide a relatively progressive tax structure at rates high enough to produce the budget surplus necessary to restrict total demand to noninflationary levels. Alternative combinations to meet alternative priorities among objectives similarly are feasible.

While public policymakers seldom, if ever, discuss these matters in such explicit terms, it is clear that fiscal and monetary policies in fact do reflect the type of combination Professor Samuelson discusses. Since the Revenue Act of 1954, for example, one may conclude that tax policies have sought, more than in the preceding postwar years, to encourage investment while monetary policies, until November 1957, were increasingly relied upon to check the expansion of total demand and, therefore, to restrain inflationary pressures.

Relying on hindsight, some maintain that a more restrictive tax policy and a less restrictive monetary policy might have proved more effective in moderating excessively expansionary forces in 1955 and 1956, and consequently in curbing inflationary forces. Others might well argue that since an even higher priority should have been placed on encouraging expansion of the Nation's production facilities, tax and monetary measures should have been more closely oriented to encouraging a higher overall rate of savings and somewhat lower levels of consumption. In any case, it is evident that alternative sets of priorities among objectives call for different combinations of fiscal and monetary policies.

Given the desired "mix" of objectives, the overall restrictiveness of any combination of fiscal and monetary policies should be related to aggregate supply and demand conditions and consequent pressures on stability of resource use and of the price level. For example, a prospective expansion of total demand at a faster rate than the expansion of productive capacity generally will call for increasing fiscal and monetary restraints. If relatively easy credit conditions are desired, relatively greater stringency will have to be provided by the net budget operations of the Government. On the other hand, if a smaller budget surplus (or larger deficit) is to be accepted, greater restraint will have to be exerted on the expansion of the lending power of the commercial banking system and other financial institutions.

10. (*a*) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank credits.) Also please furnish your ideas for the correction of any inadequacies that you feel now exists in our monetary system.

(*b*) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

(*a*) The broadness of this question precludes a concise reply. A number of factors, including the rise of new institutions like pension funds and the rapid growth of sales finance companies, suggest the desirability of a full-dress study of our monetary system. Last year when the President proposed formation of a National Monetary Commission he further emphasized its value in seeking an answer to the question: Are savings adequate for long-run growth? A number of alternative proposals have been offered concerning the appropriate vehicle for such a study. Without discussing the relative merits of any of these proposals, I would point out that since the Constitution explicitly invests responsibility for control over the Nation's monetary system in the Congress, any inquiry should reflect this responsibility and facilitate, to the greatest possible extent, congressional action on such recommendations and findings as may be produced.

This study by the Committee on Finance already has helped to point up some of the major issues in monetary policy emerging from the post-Korean war experience. Major insights into the strength and limitations of monetary policy were provided by the Joint Economic Committee studies: Monetary, Credit, and Fiscal Policies by the Subcommittee on Monetary, Credit, and Fiscal Policies, 81st Congress, 2d session, and Monetary Policy and the Management of the Public Debt, Subcommittee on General Credit Control and Debt Management, 82d Congress, 2d session. Further inquiry in this area should fully exploit these past contributions.

(*b*) In general, the reports of the Joint Economic Committee's Tax Policy Subcommittee (on Federal Tax Policy for Economic Growth and Stability) and Fiscal Policy Subcommittee (on Federal Expenditure Policy for Economic Growth and Stability), taken together, provide a valuable set of standards for evaluating Federal fiscal policies and practices. Referring to these criteria, I believe considerable improvements can be made in a number of Federal expenditure and tax programs to conform them more closely with basic principles of economy in government.

11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy.

(*b*) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

(*a*) For a long time past, many economists and others concerned with public economic policy assumed that economic stability, in the sense of limited fluctuations in the rate of resource use, and price-level stability were equivalent. During much of the postwar period this assumption coincided closely with observable developments. Since 1955, however, it has been apparent that some divergence between the two is quite possible.

The principal explanation of this divergence lies, I believe, in the strength of restraints within the private sector of the economy on the free movement of resources. A dynamic economy, in which mass production of industrial products is a major type of activity, will necessarily experience some unemployment, usually called "frictional," as people move from one job to another, even where overt restraints on such mobility is at a minimum. Similarly, in a dynamic environment, some idleness of production facilities is to be expected, since these, too, will be shifted among alternative uses. Such shifts cannot, of course, be made instantaneously, so that any periodic measure of labor force and capacity use is almost certain to show some unemployment. The more dynamic the economy, i. e., the more frequent and the greater the changes in technology, demands, methods of production, the larger will be unemployment of this type. Moreover, bottleneck situations are likely to arise with considerable frequency, exerting upward pressures on the prices of productive resources. If efforts are made to reduce unemployment substantially in this type of situation, these upward price pressures will be strengthened. Thus, even in a highly competitive, substantially free-market economy, some unemployment and upward pressure on prices are likely to exist side by side. If the Nation is willing to accept some fluctuation in rates of employment, a system of fiscal and monetary policies which keeps expansion of demand in line with expansion of capacity will provide substantial price-level stability in an economic setting free from overt constraints on the movement of resources.

If, however, significant monopoly elements are present in product and resource markets and if public policy does not rigorously limit the exercise of monopoly power, the problems of simultaneous stabilization of the price level and of rates of resource use are likely to be more severe. Under these circumstances, the relative price changes required to induce a change in resource use in response to changes in demand or supply conditions are likely to be reflected in general price movements. Curbing a general price rise under these conditions will require more rigorous restraints of total demand than would be necessary in a free-market situation, with a consequently greater impact on the rate of resource use. Considering the lag in the response of prices to changes in demand conditions, therefore, one might well expect to observe rising prices and flagging rates of employment and capacity utilization at the top of a boom and in the early stages of a downturn.

(b) As indicated above (in the last paragraph of my response to question No. 2) if the situation described in the preceding paragraph in fact prevails, it seems to me that it calls not for passive acceptance of continued erosion of the value of the dollar but for vigorous public action to minimize the source of creeping inflationary pressures. If such action cannot or will not be taken, those responsible for formulating public policies will have to determine the Nation's relative priorities with respect to price-level stability as compared with stability in employment and capacity use. I submit that, since inflation cannot of itself increase the volume of real resources available under the conditions described, one must be hesitant in proposing a policy of continuing mild inflation as a solution to the problem posed. If such a policy were adopted, it is problematical that inflation could long be kept mild. The expectation of continuing erosion of the dollar's value as a deliberate policy result might well destroy present thrift patterns and increase the difficulty of providing the real savings needed to finance expansion of productive capacity.

12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy.

The growth of private debt, per se, has no necessary implications for the stability of the economy. Since, it must be remembered, debt is the basis of our money supply, the relevant consideration is the rate of its increase relative to the total real saving of the economy (assuming no change in preferences concerning the composition of liquid assets). It is possible, therefore, that debt will not increase rapidly enough, just as it is possible that it will increase too rapidly for economic stability.

Regardless of the specific form of the legal contract, a debt is created when one economic entity acquires the use of some resources or current product from another on the promise of making some sort of payment for its use. At full-employment levels of incomes it is obvious that the resources or products proposed to be acquired in this manner cannot exceed the amount of such resources or products the use of which others are willing to forego at the current payment rate. In other words, at any given rate of payment, an additional dollar of debt-financed spending must be matched by an additional dollar of real savings (again assuming no change in preferences concerning the composition of liquid assets). It is this relationship which was the basis of monetary action during the recent boom to restrict the creation of new debt through bank lending while at the same time encouraging higher levels of real savings. In the absence of such restrictions, the growth of debt financed expenditures in excess of real current savings will produce a greater increase in total demand than can be met at existing prices with available productive capacity. The result is inflation.

On the other hand, if starting with a full-employment stable price level situation, the growth in debt-financed demand is less than current real savings, total demand will not be adequate to make full use of available human and material productive capacity. Either employment will be curtailed or prices will fall or both.

As indicated above, public-policy devices can influence both the savings and debt-creating decisions of individuals, businesses, and governmental bodies, made in free markets. In fact, it is virtually impossible to think of any public policy which would not exert some influence on these decisions. In view of the Nation's long-run growth prospects, a particularly heavy responsibility is placed on public policies to provide those influences which will match the growth of debt with a level of real savings adequate to minimize economic and price-level instability.

With the benefit of hindsight, again, it is possible that public policies did not provide sufficiently rigorous restraints to achieve this result in 1955 and in 1956. The rate of expansion of consumer debt in 1955 and of business debt in 1956, despite the restraints imposed by the Federal Reserve, incidentally, is one of the factors which have led to demands for a thorough investigation of our monetary institutions and policies.

13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy.

As my previous replies indicate, I do not believe that any specific volume of unemployment, production, or consumer demand should necessarily be regarded as calling for expansionary action by the Federal Government. Any such point designated as appropriate at any one time for any given set of conditions is more likely than not to be inappropriate at another time. Flexibility in public policies, based on alertness to major changes in economic conditions, is essential to achieving our major economic objections. These policies should not be circumscribed by any fixed rules.

14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

In the 12 calendar years 1946–57, cash receipts of the Federal Government exceeded cash payments in 6 years, were less than payments in 5 years and were equal in 1 year. For the full period, cash receipts exceeded cash payments by $11.3 billion. The total cash deficit in the deficit years 1949 and 1952–55 amounted to $10.8 billion. In current prices, total gross national product for these 12 calendar years aggregated $3,880 billion. Deficits, therefore, represented less than 0.3 percent of income over the entire period. The deficits, per se, therefore, hardly represent a major factor in the postwar inflation.

More to the point is the question whether in view of the postwar demands upon the economy the net cash surplus for these 12 years was large enough or alternatively whether monetary policy was restrictive enough to provide the total real savings which were required to prevent inflation. On the whole, the answer, I believe, is "No." For the future, therefore, we would do well to be less concerned about whether there is a surplus or a deficit and more concerned about whether the amount of that surplus or deficit in relation to increases or decreases in total demand is large enough to provide reasonable stability in the price level and in resource use.

15. Can full employment goals be attained while maintaining a dollar that has relative stable purchasing power?

My answers to previous questions set forth my conviction that full employment and price-level stability are compatible objectives of public policies. These objectives will not be automatically realized. Their realization will require continuing alertness and flexibility in public policies.

16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

If public policies are appropriately directed to economic stabilization, the present system and extent of escalator provisions in wage contracts may be regarded as relatively insignificant. If, on the other hand, public policy accepts continuing inflation, these provisions may be expected to enhance inflationary pressures.

17. List and briefly discuss what you consider the causes of the present recession, and what should be done to terminate it.

No simple or categorical listing of factors categorically or satisfactorily explain recessionary movements in an economy as large and as complicated as that of the United States. I shall confine my list and discussion to some factors which I believe contributed to the recession, without attempting to evaluate their relative importance.

One factor is the current decline in plant and equipment outlays. According to the most recent Commerce Department-SEC survey (Friday, March 14, 1958), business reduced capital outlays from the $37¾ billion seasonally adjusted annual rate in the third quarter of 1957 to a fourth quarter adjusted annual rate of $36¼ billion. These outlays are expected to fall to seasonally adjusted annual rates of $34 billion in the first quarter of 1958 and to $32½ billion in the second quarter. Since the expected total for 1958 is $32 billion, further declines in the third and last quarters of the year are expected. If these expectations are confirmed, the fourth quarter seasonally adjusted annual rate of about $30 billion will be 20 percent below the third quarter 1957 peak.

The reasons for this decline cannot be definitively specified. One very general explanation is that the 40-percent increase in plant and equipment expenditures in 1955–57 added more to the Nation's productive capacity than to effective demand. The result was a falling rate of plant and equipment utilization which signaled a reduction in the rate of further additions to capacity.

Another factor often cited is the cutback in placement of defense contracts during the third quarter of 1957. These cutbacks, it is averred, had adverse effects on contractors' expectations about the volume of future defense demands as well as, more immediately, on their activity in securing materials and supplies and labor force use.

Disappointing automobile sales are also identified as a contributing factor in the current decline. Whether this is properly attributable to poor consumer acceptance of style and engineering changes, to price increases, or to a falling rate of increase in the first half of 1957 in personal disposable income is difficult to ascertain.

The income and employment effects of these developments were reflected in the very modest increase in sales in 1957 (as a whole) over 1956, and in the downturn in manufacturing sales during the latter part of the year. Reductions in new orders and inventory liquidation contributed to the downturn in total economic activity and employment since the third quarter of 1957. The decline in net foreign investment during the year also added to recessionary pressures.

Action to terminate the recession must depend on the most careful appraisal possible of the strength and likely duration of recessionary factors. On the whole, the prospective continuation of the decline in plant and equipment outlay suggests that even if further reduction in gross national product is arrested in the near future, some stimulus will be needed to provide an expansion of total demand adequate to provide job opportunities for the recently unemployed and for expected additions to the labor force.

One of the first actions to be taken is substantial easing of monetary restraints. As the Joint Economic Committee stated in its report on the January 1958 Economic Report of the President (H. Rept. No. 1409, 85th Cong., 2d sess., February 27, 1958), "monetary action should be used without hesitation and in such degree as the situation requires if, as a flexible instrument of public policy, it is to make its contribution to recovery. From the testimony presented at the hearings we find no reason why the monetary authority should under today's conditions hold back in supplying additional reserves to the monetary system. It is well recognized that such monetary action may not succeed in reversing the present economic downturn but the absence of such further action might perpetuate monetary stringency and lack of liquidity for consumers, business and Government."

If such action proves inadequate, tax reduction would be called for. The character of this reduction and its magnitude should depend on prospects concerning Federal Government expenditures. Indeed if such expenditures are expected to increase significantly tax reduction may not be warranted.

Increases (or decreases) in Federal expenditures at this time should be determined primarily on the basis of considerations other than that of economic stabilization. For example, whether defense outlays should be increased should be determined on the basis of the requirements "growing out of our own accomplishments and those of a potential aggressor"—to quote the Fiscal Policy Subcommittee of the Joint Economic Committee (op. cit., p. 4)—rather than on the basis of the effect of such increases on total levels of economic activity. Of course, the fact of an increasing amount of idle resources serves to reduce the real cost of various Federal spending programs, so that some acceleration of or increase in Federal expenditures will be in the interests of economy in Government.

In any case, it should be recognized that the larger the increase in Government outlays, the less need be the reduction in tax rates to achieve full employment. As a corollary, reductions in Federal expenditures at this time will require larger tax reductions than would otherwise be consistent with attaining high levels of employment.

HARVARD UNIVERSITY,
GRADUATE SCHOOL OF PUBLIC ADMINISTRATION,
Cambridge, Mass., April 17, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: This is the revised version of my answer to your questionnaire, which you wish to include in the compendium. I think it is now ready for printing.

May I ask whether it would be possible to get a number of prints?

Very sincerely yours,

GOTTFRIED HABERLER.

FINANCIAL CONDITIONS OF THE UNITED STATES

Reply to the letter of Senator Harry F. Byrd, chairman, Senate Finance Committee, of Februray 17, 1958, by Gottfried Haberler, professor of economics, Harvard University

I shall organize my remarks along the list of questions attached to the above-mentioned letter, but shall not attempt to comment on every question in the list.

Question 1. Give a definition in your own words of "deflation" and "inflation."

I define inflation as a rise in the price level, more precisely of the level of consumer prices. This is, I believe, what most people understand by inflation. Sometimes, however, a more exacting definition is proposed—namely, a mere rise in aggregate expenditure. The difference is this, that under the second definition we would have to speak of inflation when in a growing economy prices fail to decline. For example, from 1954 to 1956 consumer prices were very stable while total output (GNP) was rising. Hence total expenditure rose, and under the second definition this was a period of (mild) inflation.

I think a good case can be made for the proposition that in a rapidly growing economy the price level should be allowed to fall a little (how much I shall not attempt to determine). I shall nevertheless stick to the definition of inflation in terms of prices for the following reasons: (1) This is what most people seem to mean by inflation. (2) Although a gently falling, long-run trend in prices has certain advantages, long-run stability of prices is not incompatible with long-run growth in production and employment. (3) We shall be lucky if we prevent the long-run trend of prices from rising. There seems to be no use to set up superstandards (a gently falling price level which would be the implication of the more exacting definition of inflation) which cannot be attained in practice.

It should be observed, however, that if we want to succeed in keeping the long-run price level approximately stable, it will be necessary to have periods of falling prices, because it would be unrealistic to assume that we can avoid periods of rising prices. (This is a theme to which I shall return again below.)

It would seem to be natural to define deflation as the opposite of inflation—that is to say, as a fall in the price level. If we do that, then by definition we can never have inflation and deflation at the same time. On the other hand, it is clear that we can have inflation and depression (or recession) [1] at the same time. That is to say, it is possible that rising unemployment and falling output are associated with rising prices. This somewhat unusual situation we are experiencing right now in the early months of 1958. (On the explanation of this phenomenon see question 11 (a) below.) We have here a choice. We can define "deflation" either synonymous with "depression" (or "recession"), or as the opposite of inflation. If we define its as synonymous with depression, it is not the opposite of inflation; we can then have inflation and deflation at the same time—as, for example, at the present time.

A third possibility is to define deflation as a fall in the quantity of money or, better, as a contraction in aggregate expenditure. (The latter definition is preferable to a definition in terms of the quantity of money because it allows for changes in the velocity of circulation of money.) Deflation in this sense is the opposite of what I called above "inflation in the second sense"—expansion of aggregate expenditure.

The three things called "deflation"—(1) drop in real output and rise of unemployment, (2) falling prices, (3) contraction in aggregate expenditure—usually go together, but not always. Hence it is necessary to distinguish the three meanings, if confusion is to be avoided.

I shall use the word "deflation" as the opposite of "inflation," i. e., as a decline in the price level.[2] But if we do that it must be clearly understood that deflation in that sense is not always undesirable. As mentioned above, there are good reasons to hope that in periods of rapid growth of output per head, not only the price of individual commodities (namely, of those whose cost of production is falling because of technological progress), but also the general price level will be allowed to decline. The reasons are partly considerations of social justice, partly the prevention of a secular rise in prices. A decline in the price level allows fixed income receivers to share in the fruits of economic progress. And since it often will be impossible to prevent a rise in the price level, there should be periods of falling prices—or else we shall have a secular tendency of prices to go up, which in the long run may have serious consequences. (For more on that see question 11 (b).)

Many economists would argue that just as it is often desirable that prices in general should be allowed to fall, it is often desirable that they should be allowed to rise. In my opinion, these cases are comparatively rare except in the sense that a price rise often appears, at least in the short run, as the lesser of two evils. The most important example of that sort is the familiar one that wages are pushed up by

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[1] I do not think that it is possible to make a sharp distinction between recession and depression. "Recession" is simply a mild case of "depression."

[2] Everybody is, of course, free to choose the definition he prefers provided he sticks to it and is aware of its implications. Moreover, it would not be a good idea to choose a definition which runs clearly counter to general accepted usage. The trouble with the word "deflation" (to a lesser extent with the word "inflation") is that there does not exist a firm general usage.

powerful trade unions. Then the dilemma arises for the monetary and fiscal authorities either to let the price level go up or, if they control aggregate effective demand and thus hold down prices, to permit a certain amount of unemployment to develop. Apart from this dilemma, on which I shall elaborate below (see question 11), I cannot see many cases in which a general price rise can be justified. In an earlier period (let me say before the 1940's) when depressions with sharply falling price levels used to occur, it could be argued that after such a prolonged or steep price decline prices should be allowed to rise somewhat. But today such price declines are not likely to occur. Hence there does not seem to be any justification for a compensating price rise.

In other countries such as Great Britain where international trade plays a much greater role than in the United States, a general price rise may be necessary when world market prices go up. (This is the case of "imported inflation.") In an economy like the American, which largely dominates the world economy, this cannot be regarded as a valid justification for allowing inflation to develop.

Question 2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

Broadly speaking, three types of policies must be relied on to avoid undesirable inflation and deflation: (1) monetary policy, (2) fiscal policy, and (3) wage and possibly price policy.

Monetary policy (including credit and banking policy) must be the first line of defense, but monetary policy cannot always do the whole job alone.

I do not believe that any major new legislation is required in the area of monetary and banking policy, except that it may perhaps become advisable, in the event that we enter a period of inflationary prosperity (which I would expect in the not too distant future), to give authority to the Federal Reserve System to regulate consumer credit, nothwithstanding the fact that the Federal Reserve Board has expressed unwillingness to be vested with such authority. But this is surely not a pressing problem at the present time.

Fiscal policy (in the sense of Question 9 below) is a very powerful but rather unwieldly weapon. In periods of depression like the present or periods of fast inflation, this weapon has to be used. Its use will require ad hoc legislation. But unless Congress be willing to give the executive branch of the Government authority to vary taxes, within limits, I cannot think of any major legislative reform in that area. What is required in the area of monetary, banking and credit policy as well as in the field of fiscal policy, is good judgment, courage to apply existing weapons of policies, coordination of the farflung economic activities of the Government or, to state the same idea negatively, avoidance of contradictory policies to help special interests (for example, the shutting out of imports which necessarily raises the price of the imported commodities and so adds to the inflation pressure)—not new legislation, new agencies, and new bureaus.

Wage policy may well become a crucial factor. The long period of intermittent inflation and other factors have accustomed the labor uions to expect every year large wage increases (in the form of higher wage rates or of fringe benefits) which greatly exceed the annual increase in labor productivity (output per man or man-hour). If aggregate demand is controlled by monetary and fiscal policies so as to prevent inflation, a rise in the wage level of more than, say, 2 percent (or 2½ percent at the most) a year must lead to unemployment.

On the other hand, if aggregate demand is so regulated (by monetary and fiscal policies) as to maintain a high level of employment, a rise in the average wage level in excess of the normal annual increase of average labor productivity, which can hardly be more than 2 or, at the most, 2½ percent, must lead to inflation. (For further elaborations on this point, see questions 6 and 11, below.)

Dr. Arthur Burns, the former Chairman of the Council of Economic Advisers, has made the proposal that the Employment Act of 1946 be amended so as to make stabilization of the price level a basic objective along with the maintenance of a high level of employment and growth of production.[3] This seems to me an excellent suggestion. (For further discussion of various objectives of policy and their mutual compatibility, see question 6, below.)

Price policy in the sense of price control, "freezing of prices," "price stop," and the like, which have been recommended in certain quarters, seems to me entirely inappropriate, at least, in peacetime. Such policies are incompatible with the American free-enterprise system. They would lead to black or gray markets, corruption, favoritism, redtape, implying wastes, and inefficiency, which could only make things worse.

It goes without saying that this indictment does not include enforcement of the Sherman Act or an attempt to reduce certain prices by liberalizing import policies.

Question 3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942 to 1957. (You may wish to divide the period into two parts, 1942–50, prior to the accord, and 1951–57.)

Prior to the accord (before 1951), the hands of the Federal Reserve System were bound. It could not help but finance inflation.

After it regained freedom of action in 1951, the monetary control policies of the Federal Reserve System have been well designed and skillfully conducted on the whole, in my opinion, although the credit relaxation after 1953 may have been pressed a little too far, as Chairman Martin himself suggested.

Major criticism has been leveled against the Federal Reserve System's policy of credit restraint in 1957. In my opinion, these criticisms have been largely unjustified. The System was caught in a dilemma. It was confronted (and is still confronted) with creeping inflation. The price level was first pulled up by brisk demand, then pushed up by rising wage costs. With the benefit of hindsight, it is now easy to see that from a narrow cyclical standpoint credit should have been relaxed earlier. But, viewed from a broader standpoint, that is to say, taking cognizance of the fact that prices had been going up intermittently ever since the outbreak of World War II and continuously since the middle of 1956, and that a long-run inflation psychology had begun to develop, the policy of restraint was necessary, in my opinion, even though it undoubtedly contributed to bringing about the present depression.

[3] See his remarkable book, Prosperity Without Inflation. New York, 1957, p. 71.

Question 4. Beginning in August 1956 there was in increase in the Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

There are two broad factors that are responsible for the persistent rise in prices—demand pull and cost push.

The period from 1954 to early 1957 has been one of an old-fashioned peacetime investment boom. That means that during the first part of the period demand pull has been the dominant factor. In a certain sense, demand pull is always more fundamental than cost push, i. e., wage push. Even if wages are pushed up (in excess of the general rise in overall labor productivity), prices could not rise if demand was sufficiently controlled by monetary and fiscal policies. It could therefore be said that cost push by itself without expansible demand cannot push up prices. However, if in the face of wage push demand did not expand, the immediate result would be unemployment; and since we are more or less committed to maintaining overall demand at such a level as to maintain a high level of employment, the wage push draws the demand pull in its wake.

Broadly speaking, I should say that during the earlier part of the period, let me say, until the second quarter of 1957, the demand pull has been dominant. Since then, and especially at present, the wage push has become the dominant factor causing the rise in prices. (See also Question 11(a) below.)

Question 6. (a) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States.

1. Price stability.
2. Stability of production, demand, and employment.
3. Economic growth in production, demand, and employment.

There is no doubt in my mind that growth of production and maintenance of a high level of employment (avoidance of mass unemployment) is and should be the basic objective of economic policy of the United States.

Maximum growth of overall production is, however, not compatible in the long run with hundred percent stability of employment at or near the full employment level. By that I mean that mild fluctuations in output and employment of the order of magnitude of those which we had so far in 1948–49 and again in 1953–54 during the postwar period, or maybe somewhat larger fluctuations, cannot be prevented except by drastic interventions which would threaten the efficiency of the free enterprise system and thus slow down long-run growth of production and long-run improvement of economic welfare of the people.

While it is probably neither possible nor desirable to prevent the mild ups and downs in output and employment being accompanied by similarly mild fluctuations in the price level, I am convinced that it is possible and necessary for attaining maximum long-run growth to maintain long-run stability of the price level. A slight downward trend might be even better, but I would not press this point very much. It will, however, be a very difficult task to maintain stability in the price level. The principal obstacle is the incessant and excessive wage push exerted by powerful labor unions.

Question 6. (b) With respect to these three objectives (1) price stability, (2) stability of production, demand, and employment, (3) economic growth in production, demand, and employment, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

I think we have done quite well during the postwar period with respect to objectives 2 and 3, that is to say, with respect to growth and stability of production and employment. This was true, at least until recently. (It should be kept in mind that this was written in March 1958). As far as stability and growth of production and employment are concerned, the record since the end of World War II has been better than after World War I.

But with respect to objective 1—price stability—we have not done so well. If we do not want to endanger long-run growth of production and stability of employment, we shall have to do better in the future in that respect than we have done so far since World War II. (For further elaborations see question 11 below.)

Question 7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

I confine myself to asserting that from the point of view of cushioning a depression the high level of public spending is a favorable factor, for at least three reasons: (*a*) Public expenditure is a stable item not subject to cyclical declines in depression. (*b*) The leverage of the so-called "built-in stabilizers" operating through variations in tax receipts and certain types of expenditures is greater in a large than in a small budget. (*c*) When it comes to counteracting a decline in private expenditure and alleviating a depression, it is easier to increase public expenditure by a certain amount when starting from a high budget level than when starting from a low level.

From the standpoint of long-run growth, however, the level is certainly much higher than one would wish. But since substantially more than half of Federal expenditures are for national security it is difficult to see what can be done about it, so long as the international tension lasts.

In view of the high and unhealthy level of public expenditures I would favor, when it comes to alleviating a depression either by increased public works or by a cut in taxes, the latter method over the former.

For other considerations on that choice see question 9 below.

Question 9. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy, and then relate them one to the other. Please discuss these policies starting how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

As I have remarked earlier (see question 2 above) monetary (including credit) policy is the more flexible weapon for purposes of stabilizing the economy. But on the downswing of the cycle, as at present, monetary policy cannot do the job alone and has to be supplemented by fiscal policy. Here the basic choice is between (*a*) tax cuts and (*b*) a rise of expenditures.

In principle, I would favor the former method—tax cuts—for two main reasons: (*a*) It does not add to the already overextended activities of the Government; (*b*) it is easier to apply and acts quickly, while most types of public works require time-consuming preparations. There are, of course, exceptions to this last consideration and I would certainly not exclude an increase in expenditures altogether, especially not in the form of speeding up expenditures which will have to be made anyway later on, and such expenditures which rise automatically in a depression, such as increased unemployment relief.

It is sometimes claimed that tax cuts have the disadvantage that they cannot be easily and promptly restored once the depression is over. This objection could be overcome by limiting the tax cut to a certain period, 1 year for example, with the proviso that the old rates will come in force again automatically unless Congress voted to maintain the lower rates.[4] It should also be observed that many of the expenditures that have been proposed are of such a nature that they cannot be quickly discontinued or reduced in volume when no longer needed. Some will even involve permanent commitments.

Increases in expenditures, it is sometimes said, have the advantage that they can be better pinpointed on areas of labor surplus. This may be true to a limited extent, but it should be pointed out that to a certain extent this objective can be achieved without increasing the total level of expenditure by redirection of expenditures already scheduled. Moreover, most depressions, especially if they are severe enough to warrant the application of the heavy artillery of fiscal policy, are fairly widespread over the whole economy. If that is the case, pinpointing is not necessary.

During periods of inflationary prosperity monetary policy should be aided by fiscal policy. If the Government runs a deficit and adds to the public debt in depressions, it should aim at a surplus in prosperous years.

Question 11 (a). What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

The unusual phenomenon of rising unemployment and sagging production combined with rising prices, which we are experiencing at the present time (early 1958), is a very dangerous development. It means that we have the worst of two worlds.

The main reason for this disquieting innovation must be sought in the downward rigidity of, and upward pressure on, wages.

It is one of the most pernicious fallacies that a boost to wages is an effective method of increasing purchasing power and thus alleviates depression. A tax cut or increase in public expenditures strengthens purchasing power. On the other hand, a rise in wages may or may not increase purchasing power of the workers (depending on what it does to employment). But in any case, whether it does or does not raise the purchasing power of the workers concerned, it boosts cost of production, it pushes up prices (or prevents prices from falling) and so reduces the real purchasing power of all consumers, including labor itself, adds to the fires of inflation and thus makes it more difficult for the monetary authorities to relax credit restrictions.

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[4] However, a tax cut that is limited to a period of a year or less than a year may not be a sufficient inducement to increase expenditure. In other words, a temporary tax cut is more likely than a permanent one to result in larger saving rather than in increased consumption expenditure. I would therefore be inclined to recommend a permanent tax cut.

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In principle, I would favor the former method—tax cuts—for two main reasons: (*a*) It does not add to the already overextended activities of the Government; (*b*) it is easier to apply and acts quickly, while most types of public works require time-consuming preparations. There are, of course, exceptions to this last consideration and I would certainly not exclude an increase in expenditures altogether, especially not in the form of speeding up expenditures which will have to be made anyway later on, and such expenditures which rise automatically in a depression, such as increased unemployment relief.

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Increases in expenditures, it is sometimes said, have the advantage that they can be better pinpointed on areas of labor surplus. This may be true to a limited extent, but it should be pointed out that to a certain extent this objective can be achieved without increasing the total level of expenditure by redirection of expenditures already scheduled. Moreover, most depressions, especially if they are severe enough to warrant the application of the heavy artillery of fiscal policy, are fairly widespread over the whole economy. If that is the case, pinpointing is not necessary.

During periods of inflationary prosperity monetary policy should be aided by fiscal policy. If the Government runs a deficit and adds to the public debt in depressions, it should aim at a surplus in prosperous years.

Question 11 (a). What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

The unusual phenomenon of rising unemployment and sagging production combined with rising prices, which we are experiencing at the present time (early 1958), is a very dangerous development. It means that we have the worst of two worlds.

The main reason for this disquieting innovation must be sought in the downward rigidity of, and upward pressure on, wages.

It is one of the most pernicious fallacies that a boost to wages is an effective method of increasing purchasing power and thus alleviates depression. A tax cut or increase in public expenditures strengthens purchasing power. On the other hand, a rise in wages may or may not increase purchasing power of the workers (depending on what it does to employment). But in any case, whether it does or does not raise the purchasing power of the workers concerned, it boosts cost of production, it pushes up prices (or prevents prices from falling) and so reduces the real purchasing power of all consumers, including labor itself, adds to the fires of inflation and thus makes it more difficult for the monetary authorities to relax credit restrictions.

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[4] However, a tax cut that is limited to a period of a year or less than a year may not be a sufficient inducement to increase expenditure. In other words, a temporary tax cut is more likely than a permanent one to result in larger saving rather than in increased consumption expenditure. I would therefore be inclined to recommend a permanent tax cut.

Question 11 (b). Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

In my opinion, the idea that a continuous creeping inflation of 2 or 3 percent a year is unavoidable and innocuous is a dangerous fallacy which must be rejected.

I admit that the present method of wage fixing and the attitude of the powerful trade unions, which expect every year a large wage rise exceeding the average annual increase of labor productivity, poses a serious dilemma. But the problem cannot be solved by acquiescing in a continuous rise in prices. The trouble is that when prices rise by only 2 or 3 percent per year for a few years in succession, more and more people become alarmed and take steps to protect themselves. The labor unions themselves, whose policy is largely responsible for the continuing rise in prices, will ask for larger wage increases (or insist on escalator clauses) when they see that their wage rises are swallowed up by rising prices. Hence soon the price creep will become a trot and the trot a gallop. This is simply an application of the homely truth that while you may fool all people some of the time and some (though not the same) people all the time, you cannot fool all people all the time.

It has been objected to that argument that a galloping inflation is impossible in the United States. I am inclined to accept this proposition, but I submit that it misses the point. Why is galloping inflation impossible? Because the Federal Reserve will keep money sufficiently tight to prevent inflation from galloping away. But what the advocates of creeping inflation overlook is that after a while the mere attempt to keep inflation at a creeping pace (to prevent the creep from becoming a trot or a canter) will be suffering to bring about unemployment and depression.[5] This is after all what happened last year. The advocates of creeping inflation themselves blame the tight-money policy for the present depression. I personally would say that it was a contributing factor—but let me, for argument's sake, accept the proposition that it was the main cause. Then it is indeniable that a policy which held the inflation at a creep—it did not do more than that—brought on unemployment and depression. If money had been less tight, prices would obviously have risen even faster. Sooner or later the price rise had to be stopped or slowed down. It should be observed that if it had been stopped by fiscal measures (tax increases or lower Government expenditures) as some experts had recommended, the reaction would have been the same. In that respect monetary and fiscal policies are not different in their operation. If demand is controlled either by monetary or fiscal measures and wages continue to be pushed up, the consequence must be unemployment.

Some experts are optimistic and believe that if overall demand is controlled by monetary and fiscal policy, a little unemployment or

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[5] Another very dangerous possibility is that attempts will be made to suppress the symptoms of inflation by direct control of prices and similar measures. There are not many who recommend that line of approach at the present time. But suppose we spend our way out of the depression and strong inflationary pressure builds up again—will the monetary authorities again have the courage and the power to call a halt at the risk of once more causing unemployment? I am afraid we shall hear more and more voices calling for direct controls, the totalitarian methods of a war or siege economy. This is yet another reason why it is imperative that creeping inflation be avoided. And it can be avoided without creating mass unemployment provided wages are not allowed to rise faster than the gradual rise in labor productivity.

the mere threat of unemployment will induce labor unions to relax their pressure for higher wages.

I wish and hope that this view is right. It is true that when overall demand is controlled and employers cannot easily pass on higher wages to the consumer in the form of higher prices, their resistance to wage demands will be stiffened. But I very much doubt whether a little unemployment, let alone the mere threat of unemployment, will do the job. The next few months will probably provide the answer.

One thing is certain. If price stability is to be maintained and a high level of employment preserved, money wages cannot rise on the average faster than output per man-hour—which is hardly more than 2 percent a year.

I should like to point out one important implication of this fact. Technological progress and the rise in output per man-hour is, of course not uniform over the whole economy. Some industries, let me say, certain branches of manufacturing and perhaps agriculture display faster technological advances than some others—let me say most service industries. Hence, if the overall price level is to remain stable, the prices of the products of the more progressive industries must fall and the prices of the less progressive industries must rise. This presupposes, however, that wages in the more progressive industries cannot rise as fast as productivity in those industries. If stability of the price level and full employment are to be maintained, wages in these industries cannot be allowed to rise faster than average productivity of labor in the whole economy.[6]

Suppose that labor in the progressive industries is organized in powerful unions which force up wages in proportion to the rise in productivity in those particular industries—an assumption which does not seem unrealistic—then, it is true, prices of the products of these industries need not rise. But since the American economy is sufficiently competitive to generalize, sooner or later, such a wage rise, if not fully then at least to a large extent, over most of the economy, including the less progressive industries which cannot absorb the higher wage cost without a rise of prices at which they sell, the overall price level will go up.

It follows that the policy of wage increases in proportion to (let alone those in excess of) the rise in productivity in each particular industry is highly inflationary.

Question 13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy?

The formulation of this question suggests that there may exist some doubt as to whether the financial condition of the United States would permit the Federal Government to move at all "in major ways" to counteract a downward movement in the economy, whatever the level of unemployment. In my opinion, no such doubt should exist. At some level of unemployment action must be taken either by cutting taxes or

[6] Or if wages in the progressive industries are allowed to rise a little faster (in order to attract labor from elsewhere), overall price stability requires that wages in the less progressive industries be reduced.

raising expenditures and the necessary rise in the debt limit will have to be voted by Congress. To make an extreme assumption, a level of, say, 10 million unemployed would constitute a major calamity which would necessitate a major move in the above sense.

It is, on the other hand, very difficult to specify a definite level of unemployment at which major steps have to be taken. The decision must surely depend not only on the absolute level of unemployment but also on the speed of the movement, on how long a given level of unemployment has persisted, on the distribution of unemployment (whether it is highly concentrated in particular areas or widely spread over the economy), on the turnover of unemployment (that is to say, the length of time individual workers remain on the average unemployed), and also on the prospects that a change for the better or for the worse is in the offing.

In all these respects there is plenty of room for honest doubt and disagreement. If I were pressed to make a quick judgment (and therefore a tentative and superficial one subject to revision in the light of further study and better information), I would say that when unemployment reaches the 6 million mark and there are no clear signs of an early reversal of the trend, the time for a major move has arrived. There would then still remain the question on the precise nature of the move and of the dosage, that is to say, by how much taxes ought to be cut or expenditures be increased.

But let me repeat and emphasize once more that all these decisions would be much easier to make, because it would not matter so much how they are made, if ours were not a period of chronic inflation. If prices had not risen so much over the last 20 years, and if the upward pressure on wages were less intense than it is, and if therefore there was less danger that by overshooting the mark the flames of inflation will be rekindled, the authorities could with good conscience take the chance of acting too soon and too drastically. Ours being a period of chronic inflation and of intense wage push, they have to watch their steps much more carefully, which increases the danger of acting too late and too little.

Question 14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

I do not think that deficit spending by the Federal Government since the end of the war has been an important inflationary factor. But it cannot be denied that the large size of the budget (even if balanced) and the fact that the Government is ready to incur a deficit in periods of depression so as to counteract the decline in output and employment is, at least from the long-run standpoint, a highly inflationary factor. This is the price we have to pay for a high level of employment. But it should be stressed again that, if it were not for the excessive wage push, it would be possible to maintain a high level of employment and a large budget without creeping inflation.

Question 15. Can full employment goals be attained while maintaining a dollar that has relative stable purchasing power?

It follows from what has been said above (especially in answer to question 11) that full employment can be maintained without inflation (i. e., while maintaining the purchasing power of the dollar reasonably stable) only if the wage level is prevented from outrunning the gradual rise in average labor productivity (output per man or man-hour).

Question 16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

Escalator clauses in wage and other contracts are detrimental to economic stability. They tend to speed up the process of inflation and if generalized would lead to an intolerable instability of the price level.

Question 17. List and briefly discuss what you consider the causes of the present recession, and what should be done to terminate it.

As I have mentioned above, the present recession or depression is often blamed on the tight-money policy pursued by the Federal Reserve System or on its continuance beyond the time when it was really necessary.

In my opinion, this accusation is based on a very shortsighted view. The American economy—in fact the world economy as a whole—went from 1954 until 1957 through an ordinary investment boom as it has done many times before. True, the vigor and magnitude of the boom has been enhanced by the fact that a backlog of demand was still left over from the war. The disappearance of this backlog also aggravates the reaction. The last prosperity period has nevertheless come closer to being a regular prewar boom than any period we have had so far since the war.

It is true also that the price rise which took place during that period (wholesale prices started to climb about the middle of 1955 and consumer prices a year later) was not at all excessive by earlier standards even when disregarding war booms and immediate postwar booms. But the great difference, compared with price rises in earlier boom periods, is that these 3 boom years with rising prices are embedded in a period of almost 20 years during which there has never been any substantial price fall; in other words, the boom period in question came during an age of chronic inflation. This makes a great deal of difference and as far as the United States is concerned it is an entirely new phenomenon.

Now this investment boom had to come to an end sooner or later, as an earlier boom has. Presumably, the Federal Reserve could have kept it going somewhat longer by relaxing its tight-money policy. But there is always the danger that the subsequent reaction would be stronger, if the boom is allowed to go on longer. However, I would not press this point too much.

More important, in my opinion, is the consideration that this boom—which, to repeat, was not out of the ordinary by historical standards—occurred during a period of chronic inflation. If that had not been the case, the Federal Reserve might have been justified in taking a chance in prolonging it a little bit. Moreover, and that is even more important in my opinion, if the boom had not occurred in a period of chronic inflation, the Federal Reserve could have afforded to act more promptly and more vigorously once it became clear that the back of the boom had been broken. This condition, of course, still exists. If the present slump were situated at a valley of the price curve instead of happening at a high plateau (which is not even horizontal but has an upward though gentle inclination) monetary and fiscal policy could be applied with better conscience and hence more vigorously to end the slump.

Probably they will be applied anyway with greater vigor in the near future. Then we shall soon be back where we were: at an inflationary prosperity. That may be better than a depression with 6 million unemployed or more. But it is not a stable situation.

The chronic inflation simply has to be stopped and it can be stopped without perpetuating or creating an intolerable amount of unemployment provided wages are prevented somehow from outrunning the gradual rise of output per man-hour.

INTERNATIONAL TELEPHONE & TELEGRAPH CORP.,
New York, N. Y., May 23, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: In accordance with your request I have completed the questionnaire with respect to the investigation of the financial condition of the United States conducted by the Senate Finance Committee. My reply has been confined to the questions submitted and it is hoped that you will find them helpful in formulating sound recommendations to the Senate.

Very sincerely yours,

EDMOND H. LEAVEY.

Enclosure.

Question 1. Give a definition in your own words of deflation and inflation.

Answer 1. Inflation (as applied to money) is the reduction of the purchasing power of money; deflation, on the other hand, is the exact opposite; namely, an increase in the purchasing power of money in terms of goods or services. Inflation occurs when the demand for goods exceeds by a considerable margin the supply of goods. Inflation has been mistakenly defined by some as rising prices and deflation as falling prices. Changes in price levels are only one result of inflation or deflation.

Question 2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

Answer 2. It is doubtful if there is a control which would be practical and effective in curbing inflation and at the same time fall within the democratic concept of government. Resort to nondemocratic controls cannot be justified in any period other than that of war. It would seem that the only practical way of avoiding inflation would lie in complete Government control of all production, additions to plant capacity, prices, and wages. This, of course, is unthinkable. Governmental action to restrain inflation will usually involve some form of compulsory austerity which will be difficult to justify politically when the economic situation is prosperous. People will accept control of inflation only when they can be assured that the alternative is not serious unemployment and a fall in the standard of living and that it will not result in stagnation of the economy. Those people who are out of work today may have been worrying about the high cost of living last year but undoubtedly they would be willing to accept even higher costs of living rather than be out of work. To summarize, inflation or deflation probably can be prevented but the cure is one requiring governmental control which would probably be more dangerous than the disease.

Question 3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942–57. (You may wish to divide the period into two parts, 1942–50 prior to the accord, and 1951–57.)

Answer 3. 1942–50: This question assumes differing answers in point of time; to limit all excesses on both the upside and downside in general economic trends one could almost say that monetary control, in the sense that the term is used today, did not exist in 1942–50. The bond market during this period was stabilized by the Treasury in order to permit financing World War II and the Korean war as cheaply as possible. Direct controls (regulation W, etc.) were introduced to contain consumer competition for goods. This form of monetary control has its place within the proper objectives of the Federal Reserve Board. Even though desirable, it is doubtful the Nation would have been willing to finance a much larger portion of the wartime expenses by way of taxes relative to that raised by the sale of bonds which leaves an aftermath of swollen money supply and continuing debt-service charges. It would take political courage of the highest degree to ask the American public to do things the hard, even though better way.

1951–57: Hindsight would permit one to be critical of some of the actions of the Federal Reserve Board and/or the timing of these actions during this period. The increase of the discount rate in August 1957 was unfortunate. On the other hand, the pronouncement in 1953 that central bank policy would, in the future, accommodate long-term economic growth via a commensurate increase in the money supply was an unprecedented advance in sophisticated money management. The 1954 shot in the arm under the influence of the same kind of downward pressures that we see today, fostered the 1955–56 excesses which, in turn, were largely responsible for the current recession. Certainly the Federal Reserve Board has made some mistakes but its operations by and large merit public commendation and admiration that the Board has accomplished as much as it did in keeping us out of serious trouble in areas where there were no controls.

Question 4. Beginning in August 1956 there was an increase in the Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

Answer 4. Except for farm products and food prices, which had been declining from 1952 through the first half of 1956, other components of the Consumer Price Index had been increasing steadily. The decline in food prices tended to hide this rise. About the middle of 1956, the trend of farm and food prices reversed and started moving upward along with virtually all other prices. The main reason for the increase in food prices since the middle of 1956 has been the Federal Government's farm price support program coupled with vagaries of nature in certain instances which reduced available supplies.

One of the most important factors contributing to the increase in consumer prices was the continuing increase of labor costs which could not be absorbed by employers and had to be reflected, at least in part, in increased consumer prices.

Question 5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

Answer 5. Management of the public debt with a view to issuing and refunding Government bonds at the most opportune time of the business cycle has not been and could not be expected to be very successful. Attempts to time such flotations appear to have missed the mark. One result of this practice is that too much short-term debt is outstanding. From a practical viewpoint it would probably be better to float medium- and long-term issues at periodic intervals regardless of the stage of the business cycle.

Question 6. (*a*) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand, and employment.
3. Economic growth in production, demand, and employment.

(*b*) With respect to these 3 objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

Answer 6. (*a*) If the country is to progress and the Nation's economy is not to stagnate there must be some economic growth which, in turn, would provide for increased employment and production. Maintenance of stability of demand by economic growth would seem to be essential. It is my opinion that, of the 3 objectives set forth, the following is clearly the order of importance.

1. Economic growth in demand, followed by stepped up employment and production.
2. Stability of demand, employment, and production (again the three components have been stated in relative order of importance).
3. Price stability (not a policy basically; rather a result).

(*b*) The most important trend since World War II with respect to the three objectives covered by this question has been the economic growth. This economic growth has been at a higher sustained rate than in any comparable period in recent history. Brief leveling periods occurred during the 1937–38 and 1947–48 periods and we are presently in the midst or nearing the end of another period of adjustment. One of the most important trends was the endeavor immediately after the war to meet pent-up demand for all sorts of goods and services by expanding physical facilities. Demand for goods leveled off somewhat in 1954 and then was given another boost with the relaxing of consumer credit restrictions. This was followed by further extensive expenditures for facilities which brought about the boom in capital expansion in 1955–57.

It seems that he underlying cause of the postwar inflation has been the conviction on the part of labor, businessmen, and consumers that inflation was going to be with us for a long time and that all phases of the economy had to move faster in order to avoid losing ground.

Question 7. Give your opinion on the effect on our economy of current Federal, State, and local government spending.

Answer 7. There can be little question that Federal, State, and local spending has been a major factor in contributing to inflation during the postwar period by competing with private sources for available materials and labor. Additionally, Government spending is probably more inflationary than private because of the reduced efficiencies of Government as contrasted with private business in the expenditure of Government funds during periods when both are competing for limited supplies of goods and/or labor.

It is felt that here are many activities in governmental areas which could be reduced or eliminated particularly during periods of normal business activities. During the present period, however, Federal, State, and local spending undoubtedly will prove to be one of the stabilizing factors in the economy. The anticipated increase of $4 billion in such spending between 1957 and 1958 should offset, to a large degree, the anticipated reduction in expenditures by business.

Question 8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

Answer 8. The solution to this question can contribute more in my opinion to the economic well-being of the Nation than any other phase of legislation. Present Federal, State, and local taxes, undoubtedly, divert money into public channels that could be used more constructively in private economic activities. This is one of the chief reasons why thinking people are advocating tax reductions and reforms as the foremost method of easing the current recession.

It is my firm belief that both individual and corporate income taxes are unreasonably high. Individual income taxes are so high as to be confiscatory in nature and incentives to invest, expand, and advance exist only to the extent that one finds incentive in the satisfaction of accomplishment. A tax system providing incentives could bring about the formulation of more businesses which, in turn, would build far greater opportunities for the constructive employment of a bigger segment of our population. Such employment would curtail materially the need for continuing heavy governmental expenditures and make-shift economic devices which sometimes render relief in a temporary fashion but undoubtedly tend to further increase the Federal debt and intensify the problems of inflation. It is felt that under a tax reform that would limit personal income taxes to, say 25 percent, the taxes raised from the income generated by the additional private employment and related business activities would more than offset the decline in revenues attributable to reduced tax rates. To this improvement should be added savings brought about through the reduction of governmental activities which in many instances created jobs for the sake of jobs. The same tax problems which apply to the individual are also present in the corporate tax structure, particularly in an inflationary period, because under the tax burden today a young business has little chance of existing, let alone growing.

Our economy can be strong only if both corporate and individual incentives are such that people will build new enterprises and expand existing ones, thus broadening in a material way the Nation's prosperity. It is recognized that the type of tax reform and revision that is, in my opinion, needed for the future welfare of this country will require great political courage on the part of our legislators.

Question 9. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy, and then relate them, one to the other. Please discuss these policies stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

Answer 9. Fiscal policy is financial policy; it is the obtaining and expenditure of Government funds. Government fiscal policy is evidenced by the financial planning currently being attempted to offset the adverse effects of the business cycle. When private expenditures are high and Federal, State, and local expenditures are increasing, some budget surplus should be set aside for use when economic conditions are less favorable. The most successful governmental use of this theory that can be recalled was the public works fund in New York during the governorship of Thomas E. Dewey. This fund subsequently was used to finance the New York State Thruway and other projects. Fiscal policy probably does more in controlling inflation than monetary and credit policies. In practice, however, there are usually strong political pressures to expend budgetary surpluses which may have accumulated so that, when economic conditions deteriorate, the Government is faced with the necessity, as at present, of increasing Government expenditures in the face of falling Government revenues.

Monetary and credit policies relate to the supply of money and the conditions under which it is used or made available. Such policies have an effect on the degree of inflation and likewise they can be extremely dangerous in their long-range effect on the economy. The effects of such policies and controls as those exercised by the Federal Reserve Board on the reserve position of member banks tend to be temporary and do not, in the long run, prevent inflation.

The Federal Reserve Board's control over inflation is considerably less than when the Federal Reserve System was established. At that time commercial banks dominated the financial system. Through them the Federal Reserve was in a position to exercise effective control. Since that time, however, commercial banks have become relatively less important in the overall financial system which includes such activities as insurance companies, sales finance companies, savings banks, building and loan associations, etc. These large segments of the financial system are controllable only in an indirect manner by the Federal Reserve Board.

Another difficulty with control through monetary and credit policies lies in the inevitable lag between the controls imposed and the time they take effect. A pertinent illustration was the increase in the discount rate by the Federal Reserve Board in August 1957. This increase was intended as a check on inflation but, by the time its effect was felt, the economy was already showing signs of recession. Another difficulty with monetary and credit controls is that they have in many instances disproportionally restricted the activities of individuals and small businesses.

Question 10. (*a*) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank credits.) Also please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

(*b*) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

Answer 10. (*a*) Everything that occurs in the economic sphere involving production, distribution, consumption and services ultimately reflects itself in the supply of money. The supply of funds coupled with the general economic outlook is more important in resolving whether or not to borrow funds for some form of acquisition or expansion than is the cost of borrowing. One of the major causes of the current recession is the limited supply of money in the face of the inflationary trend that has been in existence since the war and seems likely to continue for many years to come. The problem with our money supply probably lies in the fact that production of goods and services has not kept pace with inflation; also, there has been an overexpansion of plant facilities coupled with excessive accumulation of inventories. Unquestionably, these excesses must be brought into balance and the period during which it takes place is certain to be a disturbing one for many segments of our economy.

It is common knowledge that savings have grown materially during the recent period of recession so that some improvement in the supply of money and in the movement of money can be stimulated by sound tax reforms and tax reductions. I believe strongly that tax reform and tax reduction would be the greatest single stimulant to a continuing healthy economic climate.

(*b*) The problems regarding the United States fiscal system have been built up over a period of years so that the amount of money now required to service the funded debt represents a substantial part of the annual revenue. Many of the services, agencies and functions of the Government are doing a good and necessary job. The degree to which others are essential and significantly contributing to the welfare of the Nation is open to question. The report of the Hoover Commission is one of the most constructive contributions available as a guide to increased efficiency and cost reduction in governmental functions.

Question 11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

(*b*) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

Answer 11. (*a*) It appears that inflation and unemployment exist side by side because of the rise in the consumer price index despite unemployment in durable goods and certain other segments of the economy. As a result of the wage contracts between employers and unions in recent years, 60 million employed can be receiving wage increases while 5 million unemployed remain out of work. Some time elapses between the slackening of demand and resultant reductions of employment; also, unemployment insurance, separation pay, payments from union funds and savings provide funds for some time after employment begins declining. In addition, the unions have negotiated to spread the work over the largest possible number of members so that, while family income is reduced, disposable income does not fall as rapidly as the rate of employment.

(*b*) If economic growth is accepted as desirable, a modest inflation each year may be concomitant to such growth. The only alternative to such inflation may be what we are experiencing at present—unemployment and retrenchment in industrial activities. Some inflation appears unavoidable in economic growth. Continuing inflation is expected in this country because of the burdensome problem of servicing the Federal debt which will probably continue to rise in the years ahead. The inflationary effect upon the economy of reducing the Federal debt is well recognized and it is doubtful that any Congress would be willing to face the political hazards which would be attendant thereto.

Question 12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy?

Answer 12. The growth of private debt in recent years undoubtedly has been one of the chief factors contributing to the economic growth of the country since World War II. Consumers and businessmen have shown their confidence in the Nation's future by incurring debt to increase output and introduce new products and services through costly research and development programs. The resultant expenditures have been a stimulus to economic activity and have improved the general standard of living. Private debt to finance installment sales has been one of the mainstays of our economy. It is difficult to imagine how the automotive, appliance and other consumer durable goods industries could have prospered as they have and provided employment and disposable income to a huge segment of the domestic economy had the consumer not resorted to private debt. Actually, private debt has grown at a lesser rate than the economy. In fact, as stated earlier, there is considerable evidence that one of the factors contributing to the current recession has been the increase in personal savings. Consumer savings are now at an all time high for normal peacetime. In the past 6 months to a year repayments on consumer installment debt have exceeded new debt incurred and some consumer credit authorities estimate that 1958 may be the first year in a decade or more in which the volume of consumer borrowings may show a decline from the preceding year. Many businesses have released sufficient cash through the reduction of inventories to repay or substantially reduce short-term debt.

Question 13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy.

Answer 13. As indications of economic recession appear, the Government should take steps to ease the supply of money. My earlier comments regarding revisions in the approach to income taxes should not be deferred until we find ourselves in depressed economic conditions. During the course of a recession some step-up in purchasing power would be encouraged if there was some abatement in withholding taxes coupled with tax reductions. In the present business climate tax reductions are viewed as the soundest and most rapid way of correcting a recessionary trend in the economy. Public works programs may be effective in the long run but considerable time is required before they can be put into effect and, in periods of recession, the time factor is exceedingly important. Furthermore, public works are inflationary because they increase the public debt and eventually reduce the purchasing power of money.

Question 14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

Answer 14. Increased Government spending is inflationary irrespective of whether the budget is balanced or unbalanced. Deficit spending merely postpones the ultimate adjustment since it has the effect of running presses to print money.

Our experience since the Korean war has demonstrated the fallacy of believing that there is any correlation between inflation and deflation and between budget surpluses and deficits. In the so-called constant-dollar period of 1951–55 there was a budget deficit every year with a total deficit for the 4 years of approximately $21 billion. Actually there was continuing inflation throughout the period, which was hidden by the decline in farm prices because of changes in farm support programs. In the years 1956 and 1957 the country experienced the sharpest inflation of the postwar period even though budget surpluses were shown in both years.

Question 15. Can full employment goals be attained while maintaining a dollar that has relative stable purchasing power?

Answer 15. It is believed that full employment goals can be maintained while maintaining the dollar with relatively stable purchasing power only if organized labor is willing to forgo wage increases greatly in excess of improvements in productivity, and if businessmen are willing to forgo unreasonable profits. The latter presents no great problem since the highly competitive nature of our economy is a most effective protection against unreasonable profits because of its pressure on price structures. Organized labor, however, has exercised strong political and economic pressures over the years for increased wages (whether direct or in the fringe benefits areas). Some segments of organized labor and pertinent labor legislation continue to be the "old man of the sea" to American industry. The vast amount of improvement in productivity is attributable to more efficient equipment which has been purchased and installed by the industries of the Nation, and not to any market improvement in the skill or output of individual workers. The rapid growth of imports of automobiles, watches, cameras, radios, office machines, textiles, apparel, etc. is evidence that the American worker is gradually pricing himself out of employment, not only in the domestic market but also in foreign markets which had been a major factor in our economy.

Question 16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

Answer 16. Escalator provisions in wage and similar contracts are compatible with economic stability only if they do not greatly exceed improvements in productivity which are currently estimated at about 2 percent per annum.

Question 17. List and briefly discuss what you consider the causes of the present recession, and what should be done to terminate it.

Answer 17. In my opinion the present recession is attributable to the following major causes:

(a) The release of pent-up consumer demand following the diversion to military production during World War II and the Korean war of productive facilities which, otherwise, could have been used for the production of civilian goods.

(*b*) The effect of this heavy demand and the accompanying limited labor supply (due to low marriage and birth rates during the 1930's) resulted in an upward pressure on price and wages.

(*c*) Overexpansion of productive facilities to meet the rapidly growing demand which placed undue pressure on the capital goods and building industries.

(*d*) In light of the above there is a probability the Federal Government contributed directly to the inflationary boom through increased Federal expenditures. There can be little doubt that some governmental authorities contributed directly to the current recession by the sudden sharp cutbacks in defense contracts during the latter part of 1957. It is also probable that the Federal monetary authorities, in their zeal to check inflation, may have checked the boom too abruptly and thus brought on the recession sooner than may otherwise have been the case; in any event this probably aggravated the decline.

The most immediate problem appears to be the restoration of consumer confidence. Such restoration requires the clear demonstration by the Government that it is genuinely interested in restoring confidence. It can probably be done best as follows:

1. A significant modification of the tax laws and a material reduction of taxes for individuals and businesses in order to stimulate purchasing for investment, expansion and current consumption.

2. A more orderly procedure for placement of defense orders. This does not mean more orders—it does mean elimination of any marked hiatus in placement of orders such as occurred in 1957.

3. Accelerated programing of already scheduled public works (particularly the interstate highway program which is far behind schedule) and projects of the Army Corps of Engineers.

4. Credit policies which will stimulate the supply and flow of money which, in turn, should improve the demand for products and bring about significant increases in employment.

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85th Congress } COMMITTEE PRINT
2d Session }

INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES

COMMENTS OF ECONOMISTS, PROFESSORS, AND OTHERS IN RESPONSE TO THE QUESTIONNAIRE

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE
EIGHTY-FIFTH CONGRESS
SECOND SESSION

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UNIVERSITY OF NORTH CAROLINA,
SCHOOL OF BUSINESS ADMINISTRATION,
Chapel Hill, N. C., April 8, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: In response to your request of February 17 I have prepared answers to the series of questions you have raised in connection with the inquiry of the Finance Committee entitled "Investigation of the Financial Condition of the United States."

This 38-page response to your inquiry is, of necessity, an abbreviated treatment of the several questions you raised. You and the members of the committee staff are to be congratulated for the penetrating quality and appropriateness of the questions you have raised. They are the right questions and your committee is performing a real public service by asking them.

I shall, of course, be happy to appear before the committee in further elaboration of my statement if that should be your subsequent wish. If you need additional copies of the statement, please let me know.

Very truly yours,

MAURICE W. LEE, *Dean.*

Attachment.

INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES

By Maurice W. Lee, Dean, School of Business Administration, University of North Carolina, Chapel Hill, N. C.

1. Give a definition of deflation and inflation.

The simplest statement is also the most useful. Deflation involves a decline in prices—inflation an increase in prices. The matter of defining these terms may, of course, be made much more complex. What of the case when consumer prices are rising and wholesale prices are declining? Here there are broad inflationary and deflationary trends coexistent in the economy. If it is assumed that the ultimate objective of an economy is to place a maximum amount of goods and services in the hands of final consumers then the more significant measure of inflation and deflation is the price index of final consumer purchases. With this in mind the mixed trend cited above would be characterized as inflationary.

Although the matter of defining deflation and inflation may be complicated endlessly the most useful concept remains, as suggested, the simplest. Deflation is a condition of falling prices. Inflation is present when the value of money is falling and the prices of goods and services is rising.

2. How can the economy of the United States best avoid either inflation or deflation? Should present laws be changed or new laws enacted?

Stated simply price level movements are the product of disparities between the flow of money into the market and the flow of goods and services. An expansion of the effective money flow, if not accompanied by a corresponding expansion in the flow of goods and services will lead to an upward movement of prices. Conversely an expansion in the flow of goods and services not matched by a corresponding increase in the effective money stream will lead to falling prices. The avoidance of either inflation or deflation requires that there be a continuing balance between the money supply and the supply of goods and services.

In our mature western economies goods and services are exchanged for money and money is then used to purchase other goods and services. We rely upon the profit system to provide the stimulus for maximizing the output of goods and services. We rely upon the banking system to provide appropriate expansions and contractions in the money flow commensurate with the flow of goods and services. We assign to the Federal Reserve System responsibility for supervising the operations of our banking system, for controlling the flow of credit through the economy. And Government through its tax and expenditure programs can draw money out of the economy or push money into it.

The ultimate responsibility for avoiding either inflation or deflation must rest with the Federal Reserve System and the Treasury. Today it appears that economic thought in this country has progressed from a strong conviction that the economy should be left to run its own course to a general and nonpartisan acceptance of the need for a stabilization policy which will prevent excessive fluctuations in the private economy. Both inflation and deflation must be contained. However, this does not mean that the economy should be held at some fixed static level. Some degree of economic fluctuation is essential.

In a free-enterprise economy progress and economic fluctuations are associated. New ventures are launched, grow and develop. Others, unable to meet the standards of the competitive system fail and disappear from the economic scene. The evolutionary processes of economic growth and development flourish in an atmosphere of freedom and moderate ebb and flow. Also, however, they may be destroyed if these economic fluctuations become too violent. This, then, is the essential problem of economic stabilization—to develop a program which will avoid excessive economic fluctuations while, at the same time, permitting the more moderate movements which are essential to the ongoing of a healthy, expanding economic system.

From this certain general principles emerge as guideposts for a program of economic stabilization. Such a program should meet the following tests:

1. Limit excessive economic fluctuations but not interfere with appropriate fluctuations which are required for sustained long-run economic growth.

2. Avoid, so far as possible, interference with the operation of the free market. Only where free-market forces give indication of producing continuing excessive deflationary or inflationary results will a program of economic stabilization be invoked.

3. Whenever possible, in choosing among different stabilization devices those which least interfere with the detailed operation of the free-market mechanism will be given preference.

4. Maintain a due regard, in the evolution of the stabilization program, for the dangers of producing excessive fluctuations in the economic systems of other nations.

The machinery of economic stabilization is now generally understood. It consists of monetary, fiscal, and debt policy—all indirect forms of control—and a panoply of direct controls. Among these latter which have either been widely used or widely considered for use are direct credit controls, price, wage, and rent ceilings—all aimed at the excesses of an inflationary situation—or agricultural price supports, deposit insurance, portions of social security and mortgage credit legislation—all relevant to periods of threatening deflation. Since subsequent questions of the committee call for detailed consideration of these matters only a brief summary comment about each will be presented at this point.

In terms of the four yardsticks noted above it is clear that direct controls such as price or wage ceilings should be regarded as weapons of last resort in the fight for economic stability. Controls of this sort involve a serious interference with the detailed operation of the free-market system. Once inaugurated they invite and, in fact, almost compel the adoption of other direct interferences with the free economy such as rationing of consumer goods and materials allocation programs for producer goods.

Principal reliance must be placed upon the direct tools of economic stabilization—upon monetary, fiscal and debt policy. These are general controls in the sense that they affect the total money flow available for the purchase of goods and services and allow the competitive system to continue its function of allocating economic effort and economic rewards.

Monetary policy is the most flexible of these general controls. It operates through variations in the discount rate, through open-market purchases and sales and through alterations in the reserve ratios required of member banks. It attempts to relate the total effective money flow to the flow of goods and services produced for sale in the economy. By seeking a balance between money and goods (and services) price stability is maintained. If the economy appears to be expanding too rapidly the Federal Reserve System can raise the discount rate thereby increasing the cost of member bank borrowing and thus dampening the expansion in credit money. In support of this rate action it may also sell some of its holdings of Government issues on the open market, thus additionally mopping up a portion of the purchasing power of the economy. It may, in addition, raise the reserve rates required of member banks thus reducing the amount of credit such banks can issue. These different tools of monetary policy will be closely coordinated.

Monetary policy has the great virtue of flexibility. It may be varied from moment to moment. But it is more effective in periods of threatening inflation than it is when an economic decline is underway. In times of deflation about all that monetary policy can do is make certain that there are funds available—it cannot compel that they be spent.

Fiscal policy, which may be subdivided into expenditure policy and tax policy, is much less flexible, much less quick on its feet than monetary policy. If Government spending is increased, more money will be pushed into the economy. If it is reduced, less money flows out into private hands. But changes in the rate of Government spending are not ordinarily made on short notice. A whole apparatus of executive and legislative decisionmaking must ordinarily be brought into operation before such a change can be realized.

On the tax side of fiscal policy much the same thing may be said. Changes in the tax rate structure may only be accomplished after decisions have been made in the executive branch and deliberations have been undertaken in the legislative branch of the Government. Tax rates appropriate to an economic expansion may thus be continued with full deflationary impact many months into a period of recession. Or, conversely, a low tax rate structure may be prolonged into a period of expansion thus aggravating the inflationary pressures of such a period.

Government deficits and surpluses have great impact upon the national economy and could be a vital force for economic stabilization. Too often in the past fiscal impacts have been counterstabilizing in their effect. This is perhaps not surprising since Government expenditure programs and tax programs are undertaken with an eye to many things other than economic stabilization. But if governmental fiscal impacts are to contribute to economic stability rather than instability more attention will have to be paid to the stabilization consequences of fiscal policy than has been the case heretofore. More will be said of this in the detailed evaluation of fiscal policy below.

Debt policy which involves questions of type, interest rates, and maturity distribution of Government issues should be closely related to matters of economic stabilization. Such has not been the case on many occasions in the past. The Treasury has generally been under pressure or has thought it was under pressure to minimize the cost of servicing the debt. This it could most conspicuously do by seeking the lowest possible interest rate upon its issues and by weighting the maturity spread of the debt heavily into the low interest bearing categories. This has caused the Treasury to become committed to a low interest rate as though that were the primary objective of debt policy. The tendency to ignore or place only minor emphasis upon the stabilization consequences of debt policy has, in the past, and particularly in the period preceding the accord, placed the Treasury in opposition to the Federal Reserve System—placed the Treasury in a position of stimulating inflation in times of inflation.

In conclusion at this point, experience with stabilization efforts up to the present time suggests that monetary policy is more effective in curbing an inflationary development than it is in coping with problems of deflation. And in practice most of the burden of dealing with inflation has been placed upon the monetary authorities. Fiscal policy, where it has not been a positive destabilizing force, has proved slow and ponderous in stabilization affairs. New legislation, by means of which the Congress might set basic tax rates but allow the executive branch to move the effective rates up or down within a moderate range could add to the flexibility of fiscal policy and produce a greater awareness of stabilization responsibilities among fiscal authorities.

Although caution is urged before resorting to direct controls one possible line of exception may be found in the case of direct credit controls. There is a great deal more to be said for such controls than for most of the direct types of regulation. If the monetary authorities were given power to vary the downpayments, interest rates, and length of payment periods on consumer and real estate credit this would be only a moderate intrusion upon the private economy and would still be in part a quasi-indirect form of control.

3. You have asked for an evaluation of the monetary policies of the Federal Reserve System in the period 1942 to the present.

During the war and early postwar years the primary job assigned to the monetary authorities was that of providing an orderly market for the large quantity of Government securities then outstanding. The decision had been made earlier to finance the war on as low an interest rate basis as possible. Once that decision was made there was little the Federal Reserve System could do except provide a plentiful supply of funds for the economy to use in purchasing Government issues bearing low rates of interest. Open-market policies were determined for Reserve officers by the requirement that they maintain a market for Government issues. Variations in the discount rate were not allowed since that rate had to be kept frozen in relation to the yield rate on governments. Thus monetary policy was made outside the Reserve System during this period and became, at best, a passive supporter of inflation. The impossible (under these conditions) task of preventing inflation was assigned to the direct wartime controls.

The year 1946 was a benchmark year in many ways. It marked the adoption of the so-called Full Employment Act. It also saw the termination of most of the direct wartime controls. The 1941–46 increase in money supply, held in check temporarily by direct controls, now burst upon the market as these restrictions were withdrawn. Wholesale prices jumped by more than 50 percent and consumer prices rose by more than a third between 1945 and 1948.

The tangled skein of Treasury-Federal Reserve relations continued in the postwar years. As early as 1945 the Federal Reserve System had expressed concern to the Treasury over the continuance of the preferential rate of 0.5 percent and suggested that both it and the fixed rate on Treasury bills be abolished so that an effective monetary policy might be devised. In the spring of 1946 the Federal Reserve System discontinued the preferential rate but agreed, in line with Treasury insistence, to continue its general support of the Government issues market. In the absence of restraining monetary policy the inflation continued.

In July 1947, following prolonged Treasury-Federal Reserve discussion, the rate on 1-year Treasury certificates was moved from seven-eighths of 1 percent to 1¼ percent, but the Federal Reserve was still committed to the support of Government securities. In June of 1950, with the outbreak of the Korean war, the Federal Reserve System argued that the renewed inflationary pressures which lay ahead made further inaction on the monetary front intolerable. The Treasury, confronted by prospects of material deficit financing, insisted that the Federal Reserve System continue to support Government issues at the prevailing low rates. In August 1950 the Fed broke away and the New York Federal Reserve Bank increased its discount rate from the frozen 1½-percent level to 1¾ percent. For the first time in nearly two decades monetary policy was moving toward a more active role on the stabilization front.

The accord of March 1951 was in the nature of a declaration of independence for the Federal Reserve System. By the terms of this arrangement the Treasury agreed to begin the issue of a new series of nonmarketable long-term issues at 2¾ percent, a rate which approximately fitted the new pattern being established by the Federal Reserve System. The Fed began to withdraw from active support of the Government bond market. As a consequence, Government issues, left to the free play of competitive market pressures, were off more than 3 percent by the end of 1951, and by the end of the following year were selling at a 3½-percent discount. On short terms the yield rose to the 1¾-percent discount-rate level and by the end of 1951 was running slightly ahead of the discount rate. For the first time in many years the discount rate was beginning to take hold as a stabilization device.

Banks, in need of funds, found it expedient to borrow from the Federal Reserve System rather than to liquidate their holdings of shorts. By the end of 1952 the yield on Government shorts stood above 2 percent and, with the discount rate still at 1¾ percent, bank indebtedness to the System was climbing steadily. In January of 1953 the Fed raised the discount rate to 2 percent and member bank borrowings began to decline thereafter.

Simultaneously with the increase in the discount rate, the System applied further pressure upon bank reserves by selling off nearly $1 billion of Government securities in the open market. Reserve ratios required of member banks were held at effective maximum levels. As the expansion progressed in 1952 and 1953 the Federal Reserve System was applying appropriate restraining influence. The conclusion seems justified that in this early postaccord period monetary policy was effectively developed and applied. The Federal Reserve System has been criticized for tightening credit too severely in this upswing and thus precipitating the downturn of 1953–54. The criticism seems wholly unjustified. In fact, there is reason to suggest that a failure of the Fed to so act at that time might well have led to a serious inflation leading ultimately to a decline of much greater severity.

The cycle turn in midsummer of 1953–54 found the Federal Reserve System moving to ease the turn and support the economy as it moved down. By May central bank officials appear to have concluded that the inflationary pressures had been held and that the power of monetary policy should be brought to neutral and then shifted into reverse to ease the problems of the transition from expansion to contraction. In May the System began to purchase governments on the open market, thus releasing funds to the economy. In July reserve ratios were reduced, thus providing a material easing of money-market conditions. It appears that monetary policy anticipated the turn and then as the economy settled into decline reserve ratios were further reduced and the rediscount rate was lowered.

It was suggested earlier that monetary policy is less effective in a contraction than it is in time of expansion. The 1953–54 recession was primarily a time of inventory liquidation and the easy availability of credit permitted consumers to maintain high level expenditures which shortened the period of liquidation and speeded the end of the decline.

From late summer of 1954 until midsummer of 1957 the economy was expanding. What of monetary policy during this period of cyclical upswing? Stated briefly, monetary policy was shifted from a condition of active ease to a gradual hardening of the money market and, in the late stages of the upswing, to a condition of strong restraint. To illustrate—the New York bank discount rate which stood at 1½ percent in the 1954 trough was moved steadily up by ¼ percent amounts through 1955 and 1956 and was increased ½ percent to 3½ percent in August of 1957 at the approximate time of the cycle peak. The general tightening of credit terms was apparent in the pattern of yields on Government bills which moved from a 1955 average of 1.73 percent to 2.62 in 1956 and a peak of 3.58 percent in October of 1957.

Consumer prices which, on an overall basis, had held remarkably stable from 1953 through 1955 began to move up in 1956 and had risen more than 5½ percent by the end of the summer of 1957. (The increase has continued since that time with consumer prices reaching record levels in the early months of 1958.) Here was a developing inflation. How did monetary policy attempt to cope with it? As indicated above discount rates were increased, reserve ratios required of member banks were held at high levels. Excess reserves were held at minimal levels and, in fact, were forced down slightly from an approximate three-quarter billion dollars in 1954 to approximately one-half billion in 1957. Free reserves (excess reserves less borrowings) were generally negative for the period after mid-1955. And the total money supply (currency outstanding plus adjusted demand deposits) did not increase and was, in fact, forced to contract somewhat in 1957.

Clearly monetary policy was being used strongly to offset the inflationary tendencies within the economy. And still in spite of the contraction in the rate of growth in money supply inflation continued to develop. The answer here is evident, in part, in the figures which show an accelerating income velocity of money.

This table indicates that the growth in money supply was held in check effectively and in 1956 and 1957 was below long-term trends and throughout the period held at levels below the rate of growth in gross national product. Money was turning over more rapidly. And this trend could not be controlled by monetary policy.

The income velocity of money, 1953–57

Period	Gross national product		Money supply		Velocity index	
	Total	Percent change, previous year	Total	Percent change, previous year	(GNP+M)	(1954=100)
1953	$363.2		$200.9		1.81	105.2
1954	361.2	−0.6	209.7	4.4	1.72	100.0
1955	391.7	8.5	216.6	3.3	1.80	104.7
1956	414.7	5.9	222.0	2.0	1.87	108.7
1957	433.9	4.6	226.3	1.9	1.92	111.6

In conclusion, it appears that the monetary authorities were using monetary policy about as effectively as it could be used to counteract the inflationary pressures of this last expansion. But the lack of fiscal discipline, the unwillingness or inability of the Treasury to press for higher taxes and larger surpluses during the expansion offset a well managed monetary policy program.

5. The committee has asked about the effect of debt management policies upon the national credit structure and the economy of the United States.

Clearly a Government debt equal to more than 60 percent of the national product will have impact upon the economy and the careful management of that debt is essential to the maintenance of a stable economic system. The following table may be useful in carrying this discussion forward:

Distribution of Public Debt, 1955–57

	June 1955	June 1957	December 1957
Gross debt	$274.4	$270.6	$275.0
Marketable debt	$155.2	$155.7	$164.2
Percent of gross	56.6	57.5	59.7
Change, June 1955		$0.5	$9.0
Savings bonds	$58.4	$54.6	$52.5
Change, June 1955		−$3.8	−$5.9
Marketable due in 1 year, total	$49.7	$71.0	$74.4
Percent change from June 1955		42.9	49.7
Percent, total marketable	32.0	45.6	45.3

The economic expansion of 1955–57 provided opportunity for reduction of the gross debt but the total of marketable issues increased between June of 1955 and the same month in 1957 and rose very sharply in the last half of 1957. At the same time savings bond totals, the principal item in the nonmarketable category fell consistently during this period. A sharp increase occurred in the category of market bonds due within a year. Maturities of a year or less constituted 32 percent of total marketables in June of 1955 but had risen to more than 45 percent in 1957.

This sharp rise in marketables maturing within a year means that the Treasury had to refinance some $70 billion of Government issues within the year. Refinancing of this magnitude means, inevitably, a very real impact upon the money market. Such an operation must seriously influence the terms of credit and impose special burdens upon the monetary authorities. Thus, for example, the failure of the Treasury to take a realistic view of the savings bond market caused material net redemptions of these issues, as shown in the table above. As holders of such bonds redeemed their portfolios the Treasury was forced to go into the open market for funds needed to finance such redemptions. The monetary authorities, in turn, felt compelled to provide sufficient funds to the banks to permit the absorption of the new issues. Thus again deficiencies in debt management policy impeded the effective operation of monetary policy in its attempt to curb the expansionist tendencies of the economy.

6. The committee has requested a discussion of three objectives of economic policy: (1) Price stability, (2) stability in production, demand, and employment, and (3) economic growth in production,

demand, and employment. It has also requested some comment concerning recent trends with respect to these objectives.

This line of inquiry is an excellent singling out and focussing of significant points. In reality it seems clear that all three of these objectives must be kept constantly in mind in the development of national economic policy. Economic stability was never intended to imply a freezing at any given level. It was meant to infer stability centering around a rate of sustainable economic growth.

There is for an economy at each moment in time a certain rate of growth which can be sustained without producing either conditions of under or over employment. It should be the objective of economic policy to hold the economy as nearly on course as possible. If the economy is allowed to fall below this growth line wasted resources appear, plant and equipment are not fully utilized and manpower is idle. Alternatively, if the economy pushes beyond the rate of sustainable growth, overfull employment appears with expensive bidding for materials, manpower, and managerial talent. The scramble for short supplies of all these factors of production produces wasteful cross-haulings of materials, upbidding of wage and salary levels and declines in relative productivity. These overfull employment levels are not sustainable because they carry the economy to cost levels which are not sustainable.

It is not possible to mark precisely that rate of growth which is best suited to provide sustained employment of all factors of production at levels which are neither overfull nor underfull employment levels. Perhaps something approximating 3 percent per annum, in real terms, comes close to being the sustainable rate of growth in our present economy.

There is reason for believing that the great burst of capital formation in 1955 and 1956 carried the economy to higher than sustainable levels, that conditions of overfull employment prevailed as this investment boom matured. In late 1956 and early 1957 the economy was beginning to feel the consequences of this too-rapid acceleration. Costs began to push up aggressively, prices started to climb and, in real terms, the output of the economy ceased to grow. As the economy shifted from an extraordinary rate of growth to growth at a declining rate and then no growth at all the consequences began to appear after mid-1957. The reaction to a nonsustainable, excessively large rate of growth in 1955–56 is now evident.

There are those who profess to believe that the economy cannot be held to an appropriate growth rate without a calculated and planned inflation. This point is discussed in detail in answer to question 11 (b) as posed by the committee. Here it may suffice to suggest only that a planned and publicized depreciation of the currency might, for a time, give a lift and seeming buoyancy to the economy sufficient to carry it above the sustainable growth level. To the extent that such a price-induced excessive growth was attained so then would the reaction to such an artificial and excessive level be the more severe.

The appropriate rate of growth is associated with the pattern of investment. Capital formation expenditures are undertaken in order to increase the output capacity of our resources, manpower, facilities, and managerial talent. Appropriate capital formation thus increases the productivity of the economy, thereby permitting a greater distribution of profits, and wages without increasing prices. Price stability, in short, is quite compatible with economic growth and rising real standards of living. And price stability introduces an element of uncertainty, a speculative one, which complicates rational economic decisionmaking.

7. What is the effect of current Federal, State, and local government spending?

The following table covers the five quarters starting with the last quarter of 1956. If this is taken as "current" spending as that term is used in the committee's query then it can be seen that Government spending rose moderately in the first part of 1957 then held at comparatively stable levels through the rest of the year.

Government spending—5 quarters

Period	Federal		State and local	All governments combined
	Total	National security		
1956: 4th	49.0	44.2	33.9	82.8
1957: 1st	50.3	45.5	35.3	85.6
2d	51.1	46.3	35.8	86.9
3d	50.6	45.8	36.1	86.7
4th	49.7	45.0	37.3	87.0

The following table shows the changes from quarter to quarter and makes it easier to note differences in spending.

Change in Government spending from previous quarter

[Billions of dollars]

Period	Federal		State and local	All governments combined
	Total	National security		
1957:				
1st	1.3	1.3	1.4	2.8
2d	.8	.8	.5	1.3
3d	−.5	−.5	.3	−.2
4th	−.9	−.8	1.2	.3

Total Government expenditures increased by $2.8 billion during the first quarter of 1957 and by $1.3 billion in the second quarter. But in the third quarter, as the economy turned down, Government spending also contracted, thereby aggravating the downturn. It is when we turn to Federal Government expenditures that we note the real sources of the destabilizing trend of expenditures. Federal outlays contracted by one-half billion dollars in the third quarter and almost another billion in the final quarter of the year. Almost the entire change, quarter by quarter, can be explained in terms of variations in national security expenditures.

Only the increase in State and local government expenditures served to offset the magnitude of the Federal spending decline, counteracting three-fifths of the Federal reduction in the third quarter and more than offsetting all of the Federal level decline in the final quarter. In concise answer to the committee's inquiry, Federal spending patterns in the past year have been a constant unstabilizing influence, expanding when the economy was expanding and contracting when the economy was declining. In the last half of the year State and local government expenditures have had a moderately stabilizing influence as they continue to expand.

8. What is the effect on the economy of current Federal, State, and local taxation?

Only rough approximations can be given in answer to this question since full data on State and local taxation in 1957 are not available. We may use the principal sources of State and local government revenue of 1956 to present the following array indicating the principal sources of State, local, and Federal tax revenues.

Type of tax	Percent distribution State and local tax revenue by type of tax	Percent distribution Federal tax revenue by type of tax
Property	37	....
Sales, receipts	28	14.5
Individual increases	5	47.3
Corporate increases	3	30.7
Other	27	7.5
Total	100	100.0

Total Federal tax receipts run about double those of the State and local governments. The Federal system relies primarily upon income taxes, personal and corporate, with receipts from the former running half again as large as those from the corporate levy. State and local governments place their primary reliance upon the property tax (local governments) and sales and other excise taxes (State) and this suggests the difference in effect. Because of the progressive nature of Federal receipts, tax income tends to rise or fall more than the rise or fall in general economic activity. State and local taxes tend to move, with a lag, in accord with economic activity.

The Federal tax system is much better suited to the purposes of economic stabilization than are the State and local systems which tend to lag behind changes in the economy. They will extract from the private income stream reducing portions of the total income during times of expansion and greater portions in times of economic contraction. They, therefore, tend to aggravate cyclical fluctuations in the economy. Conversely, the more progressive Federal system tends to take a greater share of total national income during expansions and take smaller portions during times of decline thereby serving, in part, to offset the fluctuations of the economy.

9. The committee has requested a discussion of fiscal, monetary, and credit policies with consideration of their use to restrain inflationary trends and otherwise help in preserving a stable economy.

The concept of fiscal policy ranges over the areas of expenditure, tax, and debt policy. Each of these relates in varying ways to the matter of stabilization policy and it is the relation between each of these three and stabilization which will now be explored.

Following the pattern noted earlier we hold that economic stability depends upon the balance struck between the two flows: (1) The flow of goods and services and (2) the flow of money or purchasing power. Expenditure, tax, and debt policy act directly upon the money flow and indirectly upon the flow of goods and services.

Tax policy considerations relate to the level of taxes and the type of taxes to be imposed upon the private economy. Broadly considered, increases in taxes work directly to reduce the supply of money in private hands. And in similar fashion, decreases in the level of taxation leave greater amounts of money in the private flow. Accordingly, it has become customary to speak of increased taxes as deflationary and decreased taxes as inflationary in their consequences. This is a useful view of the matter and a generally accurate one although some reservations may be held in abeyance for the moment and will be considered subsequently.

Viewed in this manner it follows that tax policy in a period of threatening inflation should be steered in the direction of higher taxes designed to sop up a portion of the excessive money supply. A reversed pattern of reduced taxes would be appropriate in times of deflation. But tax considerations may never be dismissed so easily. Those responsible for tax policy decisions cannot decide broadly to raise or lower the level of taxation—they must make their decisions with respect to specific types of taxes. Is an increase in the income tax more appropriate than an increase in excise taxes? If an increase in income taxes is decided upon shall this be done by raising all steps in the progressive structure, or perhaps by introducing increases only at certain parts of the tax range, or, alternatively, by simply lowering minimum exemption levels. Although each of these actions may be generally deflationary in the sense that they will withdraw purchasing power from the private economy the different proposals will have varying impacts upon different class of income recipients.

We know generally that those with lower incomes spend a higher portion of their income on consumption and those at higher levels save and invest a greater portion of their income. If the inflationary pressures in the economy are believed to stem largely from high level consumption tax increases which bear more heavily upon those with higher propensities to consume will be considered. If, on the contrary, the inflationary bulge is believed to have its origin primarily in an extraordinary level of investment spending then the tax increase will be made so as to fall most heavily upon the flow of investment.

However, it should be noted that serious practical difficulties stand in the way of an effective stabilization effort through the channel of fiscal policy. Taxes cannot be changed either up or down with great rapidity. Suggestions may be made through the executive branch which will be referred to appropriate legislative committees. Hearings will be announced and conducted. Committees will submit their reports to the Congress which may then act and refer the tax bill to the President for signature. This process may extend over months. Ordinarily stabilization actions must be taken with special regard to the importance of timing.

A peculiarly discouraging aspect of this matter is the perverse impact of the tax procedure. In times of threatening deflation the normal line of tax action involves a proposal for tax reduction. But the legislative consideration of a tax reduction may, in fact, seriously dampen both consumption and investment as those with purchasing power refrain from committing their funds in anticipation of tax-reduced lower prices in the future. The procedural steps involved in making effective a lower level of taxes tends to further deflate the economy. And, in a similar manner, the process of moving from a given level of taxation to a higher level intended to combat inflationary trends may touch off added bursts of new spending thus further aggravating the very situation the proposed tax action was intended to correct.

Monetary policy may now be considered briefly as it relates to the problem of economic stabilization. The great virtue of monetary policy lies in its flexibility, as was noted above. Monetary policy is quick where fiscal policy is slow. It has real limitations but this is one of its strengths. The great bulk of our money supply is credit money, created by the operations of our private banking system. The banks, in conformance with requirements of law and the dictates of sound bank management, maintain an appropriate minimum level of reserves against their deposits. In recent years the legal reserve requirements have moved, on the average, in a range of 18–20 percent. While maintaining reserves of at least these amounts the banks have conducted their business affairs for profit as any other business does.

Basically there are only two things a bank may do with its excess reserves, either (1) invest them at going rates of interest, or (2) lend them to borrowers at market rates of interest for such lines of credit. Banks move their funds between loans and investments as the advantages of each rise or fall in relation to the other.

The Federal Reserve System exercises a general control over the money supply through:

(1) Changes in the discount rates.
(2) Open market operations.
(3) Changes in minimum reserve ratio requirements.

The discount rate is the rate of interest charged banks when they borrow from the Reserve System in order to replenish their reserves. Open market operations involve the purchase or sale of Government securities by the Federal Reserve System. As the System buys securities it puts added amounts of money back into the private economy, pushes up the price of Governments and thus depresses their yield. When it sells it depresses the price, raises the yield, and draws money out of the private economy.

The Federal Reserve System also has power to change the minimum reserve ratios required of member banks with discretion to move these rates from an average minimum level of 10 percent to a maximum of 20 percent. These three tools are used in harmony and are carefully coordinated. Used in this manner they permit fine gradations of impact. The full weight of an increase in the discount rate may be softened by limited amounts of open market buying to ease a part of the strain placed on the money markets by the reserve ratio action. The easing effect of a downward adjustment of required reserve ratios may be offset in part by open-market purchases. In short, monetary policy may be administered with considerable finesse to produce delicate changes in the conditions surrounding the money flow through the economy.

But there are also definite limitations on the capacity of monetary policy to cope with economic fluctuations. In periods of developing inflation monetary policy can be invoked to stem the growth or even reduce the total money supply (although at times the constriction of the quantity of money will be offset by increases in the rate at which it is used). But in periods of economic contraction monetary policy is forced into a more passive stabilization role. Then it may ease money-market conditions but even though banks may thereby acquire additional loan potential monetary policy cannot induce consumers and investors to undertake borrowings to expand their purchases. The brakes on an automobile may be used to stop the movement of the car; releasing the brakes will not make it move again but only make movement possible if the impetus is provided from some other source.

In periods of economic contraction greater reliance must be placed upon fiscal policy to induce new spending in the economy. But fiscal policy actions normally come in "blocks." Tax levels are changed or items formerly taxed are removed from the tax rolls. Expenditure programs are approved—they are not partially approved—a new dam is authorized, not half a dam. These indivisible lumps in fiscal policy may be smoothed through the use of monetary policy, easing somewhat the the impact of higher taxes and making the shift to the new tax level a smooth one.

In periods of excessive economic expansion monetary policy must be applied firmly but should also be supported by appropriate fiscal policy actions with Government surpluses designed to withdraw funds from the private economy and ease the pressure upon monetary policy.

Further consideration of deficiencies in operation with respect to both monetary and fiscal policy will now be noted in answer to the committee's next query.

10. This question called for an appraisal of the adequacy or inadequacy of the monetary system in the United States and then asked for similar comments wi'h respect to the fiscal system. The two seem inseparable and will be considered together at this point.

If this question having to do with the monetary and fiscal systems of the United States is taken quite literally to mean the "systems," in the sense of an organizational structure, it may be observed that there do not appear to be serious deficiencies in either system, so defined. There are some who feel that the Federal Reserve System should be given more direct control over the variety of nonbank financial intermediaries. This would include insurance companies, mortgage companies, investment houses, and sales and personal finance companies. It is clear that these nonbank institutions do handle a growing proportion of the national savings and direct such savings into investment channels. But it is by no means clear that they are not already sufficiently influenced by monetary policy actions which go first at the banks and through them have an ultimate impact upon all financial intermediaries, including the nonbank ones noted.

But there is no reason to assume that your committee intended to limit this question so sharply. If the question is conceived as an inquiry into the adequacy of monetary and fiscal policy approaches to economic stabilization a number of relevant matters deserve comment. There are clear and evident weaknesses in the operation of monetary fiscal policy for stabilization purposes.

Timing is of the essence when dealing with the question of economic countercyclical measures. Changes in private investment multiply out through the economy quickly and in magnified form. Changes in consumption produce magnified changes in investment and national income. These changes must be prevented from producing excessive multiplied reactions in the economy and action to contain them must be taken quickly. It is here that the great weakness of fiscal policy lies. Changed levels of either Government expenditure or taxation can now be realized only after weeks or months of deliberation. By the time action is attained minor changes of the sort noted above have produced major reactions and the corrective action originally planned is quite inadequate.

Knowledge of this laggard characteristic of fiscal policy has induced too great a reliance upon monetary policy. This seems a clear characterization of the upswing, 1954–57, where inadequate fiscal policy action placed almost impossible burdens upon the monetary authorities. Similarly, in the downturn of 1953–54 failure to move promptly and effectively on the fiscal front placed excessive pressure upon the Federal Reserve System which then responded by making sizable reductions in reserve ratio requirements. The large quantities of money set free by this action undoubtedly sparked much of the great capital formation boom which characterized the upswing from the 1954 cycle trough. Other examples could be provided in quantity. These will perhaps suffice to make the point that a general awareness of the ponderous process of effecting changes in fiscal policy has forced too great a reliance upon monetary policy.

And, to repeat a point made earlier, the process of debating appropriate changes in tax policy is self-defeating. Public notice that the Congress is debating tax reductions will cause consumers to defer postponable expenditures, thereby aggravating the decline which tax reduction was intended to counteract. And the reverse case is also true. If the Congress, attempting to enact appropriate tax legislation in a time of threatening inflation begins debate on a bill to increase levels of taxation this itself will tend to induce a wave of consumer and investor expenditures to "beat" the tax increase.

Two major difficulties arise in the attempt to use fiscal policy for stabilization purposes: (1) The delay incident to the adoption of either tax or expenditure programs, and (2) the tendency of consumption and investment expenditures to move perversely thus weakening or even more than offsetting the proposed tax changes. And still the fact remains that monetary policy, alone, is simply unable to cope with the full forces of destabilization and must be supported by and at times yield the active role to tax and expenditure policy. One proposal might overcome these indicated deficiencies of fiscal policy.

If the Congress would authorize the executive branch to move effective tax rates up or down within carefully defined limits as set by the Congress the needed flexibility, the quick and undebated alterations in tax levels would permit tax policy to be brought quickly into play at the early and critical stages in an incipient expansion or contraction. Clearly the Congress should retain basic jurisdiction over the general broad levels of taxation, but the authorization for minor variations in current levels would add flexibility not now possible.

To use the phrase to which the committee directed inquiry, the greatest "inadequacy" of monetary fiscal policy for stabilization purposes stems from the procedural delays incident to the inauguration of changes in fiscal policy. Until this is corrected there will be too great a reliance upon monetary policy and danger that public consideration of fiscal policy changes will worsen rather than improve the stabilization effort.

11. (*a*) The committee has asked for an explanation of the seeming paradox that at times inflation and unemployment have existed side by side in our economy.

There is nothing really paradoxical about this once it is realized that our economy is something less than perfectly competitive. It is the function of the price system to allocate resources, capital, and manpower to their most efficient uses. Under a competitive situation, as particular types of goods pile up unsold, the producers of these goods would disemploy workers, reduce their demands for raw materials and equipment, and lower their prices to clear the market. Resources would flow out of such industries and toward others where such conditions did not prevail. If surpluses were accumulating generally in the economy prices and costs would decline generally to restore the balance.

In practice our economy, of course, is not perfectly competitive. Prices are set for contract periods, set by custom, by common understandings among "competitors." Costs are similarly set by contractual arrangement, by regulatory commissions, by contracts negotiated with suppliers and with unions. In those parts of the economy where such conditions prevail costs remain high even though sales are falling and, in fact, the reduction in volume may have the effect of raising net unit costs so that sellers are loathe to reduce their prices even though their output is piling up unsold inventories and workers are being laid off.

A second line of explanation takes into account the sources of current expenditures on consumption and investment goods in the economy. The fact that the committee has pointed to the simultaneous rise of unemployment and prices as a paradox implies that current spending is wholly related to current levels of income. But today's spending is not only a function of today's income, it is also influenced by the liquid reserves of spenders. And in 1957–58 both consumers and business firms have had moderately strong liquid reserve positions. In the initial stages of rising unemployment spenders will continue to spend to maintain their previous living standards even though this may cause them to draw down their reserves.

A third line of explanation makes simple note of the fact that unemployment may be concentrated primarily in a few industries, particularly in the early stages of a contraction, whereas employment levels may remain strong elsewhere in the economy. Likewise, the conditions of supply will be uneven throughout the economy so that critical areas of the economic system may remain, for a time, more in the grips of a sellers' market atmosphere than others. If the markets in relative tight supply are important segments of the total cost of living the weight of these limited parts of the economy which are still producing rising price trends may swamp the price declines shown elsewhere in the economy. In the first several months of the decline which started in the summer of 1957 food prices have risen strongly and since this is a dominant part of the total cost of living this more than offset declines elsewhere.

11. (*b*) The committee asked whether we should accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment.

Governments have always made strong efforts to protect the integrity of their coinage. In fact in colonial times the death penalty was imposed upon individuals who "clipped" the coins of the government. Similarly our Government works diligently to prevent the swindling of the people by adulteration of products, misrepresentation, or false labeling. In a democracy the people place their faith in the government to protect them from an adulteration of the money. It, therefore, appears to be the height of irresponsibility to suggest, as some have done, that the Government now adopt as a matter of cold calculation the regular and scientific debasement of the currency by projecting a gradual 2- or 3-percent per annum destruction of monetary values.

Inflation and deflation are simply processes by which the wealth and income of the economy are redistributed. A proposal to have the Government assure a steady rate of inflation is simply a proposal to have the Government take income and wealth away from certain classes of the population, in favor of others, through a process which is particularly mischievous because it is seldom presented to the public debate on such grounds.

It is sometimes argued that a 2- to 3-percent price increase per annum, dangled before the businessman will serve as a carrot to make him run harder in the pursuit of dollar profits. This is not only a false hypothesis but an insolent one. It assumes that the businessman will not soon learn that the larger dollars of profit may be smaller real profits, that the fixed plants and equipment which he is writing off against current earnings are being written off on a cost basis such that the reserves he is accumulating will be inadequate to permit replacement of such plant and equipment, or that his workers will not soon learn to discount future price increases in their current collective bargaining negotiations.

Even though the businessman was so stupid, and he is not, the whole hypothesis would still be a false one. It assumes that the projected price increase will compel a greater rate of capital formation than would a stable price level or, in other words, would induce a greater rate of capital formation than is justified by normal cost-price relations. If the proposition worked as its advocates posit it would, then it follows that the economy would be induced to a level of capital formation it could not sustain—an artificially stimulated boom would be followed by the bust the inflation made inevitable.

In specific answer to the committee's query, we should not accept a gradual inflationary trend—we should, on the contrary, do all within our power to resist efforts made to have the Government establish either upward or downward price trends. To the best of our ability we should attempt to maintain stable prices so that decisions by businessmen, by consumers, by farmers, in short all economic decisions will be based upon inherent cost-price relations and not upon the destabilizing force of a Government-induced inflation or deflation.

13. At what point should the Federal Government move to counteract a downturn in the economy?

There is, of course, no simple arithmetic answer to this question which can be defended under all circumstances. Without in any sense attempting to limit the matter to questions of labor force employment and unemployment but, instead, having reference to the unemployment of plant, equipment, resources, and the labor force, a point where unemployment moves into the range of 6 percent may be suggested as a rough "trigger point" for the inauguration of serious counteracting moves by the Federal Government.

It appears that unemployment did not exceed this 6-percent level in the troughs of 1948–49, 1953–54, or back in 1924 or 1927 but did move across this line in the contraction of 1929–33 and 1937–38. Contractions which do not cross over the approximate 6-percent line have been largely self-correcting whereas those which moved much beyond that point may gather momentum and call for deliberate intervention by the Federal Government. The declines which bottomed in 1924, 1927, 1949, and 1954 were essentially inventory recessions and did not involve the bulk of economic activities. In 1924 some 35 percent of all economic indexes were expanding. In 1927 the figure was even higher. In 1949 apparently some 40 percent of the series still showed expansion at the time of the cycle trough and the figure was only a little below that in 1954. In 1933 nearly 90 percent of all economic activities were contracting and the figure was approximately 80 percent in 1937. Our contraction which began in the summer of 1957 appears to be involving a larger portion of all economic activities than did these minor declines.

14. How much of a factor has deficit spending by the Government been in contributing to or producing inflation since World War II?

For information which will throw light upon the degree to which the Federal Government actually operated on a deficit basis during the postwar years the following table has been prepared. It shows Government cash receipts and cash payments from and to the public.

Federal Government cash receipts and payments, 1946–5

[Billions of dollars]

Year	Excess of Federal Government—		Year	Excess of Federal Government—	
	Receipts	Payments		Receipts	Payments
1946	(1)		1952		1.6
1947	$5.7		1953		6.1
1948	8.0		1954		1.1
1949		$1.3	1955		.7
1950	.4		1956	5.5	
1951	1.2		1957 [2]	1.3	

[1] Receipts, less than $50 million.
[2] Preliminary.

Through the peak year 1948 the Federal Government obtained net cash receipts from the public and the effect of Government balances was therefore deflationary. The year 1949 which marked the trough of the minor recession of the late forties produced a moderate deficit of $1.3, a minor inflationary offset to the economic recession. As the economic expansion resumed the Government cash position shifted to produce a deflationary effect until 1952 when the impact of the Korean war expenditures produced net payments to the economy. These payments became larger in 1953 as the economy reached its cycle peak in late summer and then began to decline. The sharp decline of net payments to the public from $6.1 billion in 1953 to $1.1 billion in 1954 meant a sharp drop in Government contributions to the declining private economy just at a time when this could be ill afforded.

As the economy began to move strongly up in late 1954 and 1955 the Government net cash payments added to the upward momentum. In 1956 net cash receipts grew rapidly to $5.5 billion, thereby counteracting, in part, the buoyancy of the private economy. But in 1957 net cash receipts fell sharply.

In the period since World War II there is little evidence that Government deficits, per se, have contributed in material ways to inflation. In 1953 when the Government made its largest net cash payments to the public these were equal to only 1.7 percent of the gross national product (and the last half of this year was a time of economic recession when deficits would have been appropriate). It is rather that Government surpluses have been reduced in times of inflation when Government surpluses should, in fact, have been increased—as witness the situation between 1956 and 1957. A rising and presumably necessary tide of defense expenditures was not matched by an aggressive drive for increased taxes so that net cash receipts of the Government contracted. The mounting inflation was aided by a reduction in the amount of cash receipts which the Government was taking from the private economy.

15. Can full employment goals be attained while maintaining a dollar which has relative stable purchasing power?

This question of the committee's appears to be closely related to 11 (*b*) which raised the question of the desirability of gradual planned inflation. There is nothing incompatible between price stability and full employment. The decade of the 1920's is illustrative. There prices were either stable or drifting moderately down while the economy remained at essential full employment levels.

16. Are escalator provisions in wage or other contracts compatible with achieving economic instability?

What invites the use of escalator clauses is the very thing discussed in detail under question 11 (*b*), the commitment to planned inflation. It is not such much that escalator clauses are objectionable as that the conditions which breed escalator clauses are, in themselves, incompatible with achieving economic stability. A fear that the Government is either unwilling or unable to prevent inflation is the situation which leads workers and others to insist upon the inclusion of escalator clauses in contracts.

Until there is a general acceptance of the importance of price stability and an aggressive effort on the part of the Government to maintain such stability there will be no reason to expect that those who now insist upon escalator clauses will reduce their insistence and, in fact, there will be reason to anticipate that the practice will spread.

One clear step which might be taken at the governmental level to make clear the Government's intention to address its efforts toward stable prices would be an amendment to the Stabilization Act of 1946 making it clear and explicit that economic stabilization includes, by specific reference, the stability of prices. The Government should be given the mandate to maintain stable prices and such an amendment to the 1946 statute would be an appropriate place to make such a declaration of policy.

17. What are the causes of the present recession? What should be done to terminate it?

No simple answer will explain the complex and interlocking forces which produced the downturn in the summer of 1957. As this is being written at the end of March 1958, it is becoming evident that this is a different kind of decline than the inventory adjustments of 1948–49 and 1953–54. Much more of the economy is involved. The decline in capital formation is assuming serious proportions. And unemployment, although heavily concentrated in a limited number of industries, is involving a greater portion of the labor force than the earlier declines did.

A search for the causes of this decline must give close attention to the tremendous capital formation boom which was underway as early as 1955 and continued at high level well into 1957. It must also take into account the slow decline in productivity figures over this same span of years. And it must note the gradual emergence of strong inflationary tendencies, which obscured the decline in the rate of growth and of the national product. It must also note the fact that residential construction reached a peak early in 1955 and began to slide thereafter. It may also note how total investment figures were concealed by the sharp rise in exports incident to the Suez crisis at the same time that a sharp rise in inventory liquidation was taking place at the end of 1956 and in early 1957. It will note how consumer expenditures which had moved strongly up in 1954–55 began to level off in 1956 and, when discounted for price inflation, failed to grow at all in the first half of 1957. It will also take into account the fact that average weekly earnings of manufacturing workers, which had edged steadily upward from 1954 to the end of 1956, thereafter began to decline while average hours per week were declining steadily after mid-1955.

It may also be noted that the increase in debt was less in 1957 than in 1956 and that in 1956 was, in turn, less than the increase in 1955 and that this was true of mortgage debt, consumer debt, and business loans from commercial banks. It will also be seen that the banks increased their indebtedness to the Federal Reserve System in 1955 and remained in debt in 1956 and 1957 and that their free reserves (excess reserves less borrowings) were negative during most of this period.

What caused the present recession? Primarily it was caused by the expansion which preceded it. In the early stages of the expansion from the trough in 1954 consumption expenditures moved out strongly. Investment expenditures responded and easy money market conditions facilitated a tremendous wave of capital formation. It now appears that business anticipations were excessively optimistic—that a good part of this optimism was based on the strength of consumer demand.

Much of the explanation for the strength of consumer demand may be found in the figures on consumer credit. During 1955 consumer debt increased by more than $6 billion; in 1956 it increased by another $4 billion. Consumer debt positions were not critical but consumers by 1957 were catching their breath, were repaying past debt, and reducing the rate at which they assumed more. They were spending more on maintenance and upkeep of homes they had acquired earlier and were beginning to postpone the purchase of new model durables. The rate of growth of consumption, which had stimulated business investment, was slowing and it now appears that by 1957 capacity had been built to excessive levels in many industries. The demand for new plant and equipment began to bear the brunt of this changed situation. And inventories which had been built up substantially to accompany the rate of growth in consumption after 1954 began to appear excessive by the end of 1956 and new orders were beginning to fall as attempts were made to get inventories back into line with sales. In the early months of 1957 a major reduction in inventory investment took place.

What caused the recession of 1957-58? In brief, and in an attempt to offer a generalized answer, the recession was brought on by too rapid a growth of investment, including inventories, construction, and plant and equipment expenditures. This growth in investment was geared to the rate of growth in consumption and not to the levels of consumption and could not be sustained. The final straw which broke the back of the expansion was the unexpected and extremely sharp cutback in Government outlays in mid-1957. But the economy was already overextended and vulnerable. Ebullient optimism changed to cautious conservatism. Stock prices broke down in August and by year end had declined by more than 10 percent.

PRINCETON UNIVERSITY,
INDUSTRIAL RELATIONS SECTION,
Princeton, N. J., April 8, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: This is in response to your letter of February 17 enclosing a list of questions in connection with the Senate Finance Committee's inquiry entitled "Investigation of the Financial Condition of the United States."

Rather than attempting to answer all 17 questions, which for adequate response would require a document of 40 or 50 pages, I have concentrated on 4 questions and am giving fairly brief answers to them.

The answers are enclosed, numbered according to the number of the question in the submitted list.

Very sincerely yours,

RICHARD A. LESTER,
Professor of Economics.

REPLY OF PROFESSOR RICHARD A. LESTER, PRINCETON UNIVERSITY

2. The economy of this country could best avoid either inflation or deflation (1) if the Federal administration were more acute in its perception of economic changes, (2) if the Federal Reserve authorities made fewer mistakes of diagnosis and were more concerned with production than with the Consumer Price Index, (3) if the monetary system were less directly tied up with the expansion and contraction of bank credit, (4) if Federal authorities had more control of consumer credit, and (5) if built-in stabilizers were made more effective.

I shall briefly explain each of these points. Before doing so it should be stressed that, since World War II, practically every country has been experiencing almost a continuous upward rise in its price level. This country appears prone to have some sort of slump or economy readjustment about every 4 years—1949–50, 1953–54, and 1957–58. Some of these "recessions" are largely inventory in character; others also affect capital-goods investment significantly. Consumption usually falls off only slightly, but a slight drop in consumption has a magnified effect on induced investment, including inventories.

The Eisenhower administration has clearly misjudged economic developments during 1957 and the first quarter of 1958. The President, in September 1957, after the Federal Reserve index of industrial production had been falling for over 8 months, recommended that people be more cautious in their buying for consumption. The January 1958 Economic Report was out of date before it was issued. Just before the President's report was released I wrote the enclosed letter, indicating how many economists were diagnosing the situation (letter to Tyroler).

The Federal Reserve authorities were raising the rediscount rate as late as August 1957 and pursued a tight-money policy far too long and with too much vigor in the latter half of 1957 and early 1958. They apparently had their attention too much on the Consumer Price Index and not enough on basic changes in the economy—industrial production, planned investment, and consumers' outlook and plans. The Consumer Price Index is a misleading guide for Federal Reserve policy. Not only is it too influenced by temporary factors (such as the weather destroying fresh fruits), but services account for one-third of the weights, and they lag in their movements—public utility rate cases take a long time to settle. Also, the index does not take sufficient account of changes in quality.

Between July 1957 and January 1958 the total of demand deposits and currency (seasonally adjusted) declined from $136 billion to $182.1 billion. Most of the $4-billion contraction was in demand deposits. A money supply that fluctuates that way helps to aggravate cyclical movements of business. A program of 100-percent reserve money would be desirable from the point of view of economic stability, but, of course, has no possibility of adoption in the foreseeable future.

Consumer credit, especially installment credit, suffers from marked fluctuation—expanding more percentagewise than disposable income in booms (as between 1854 and 1957). In a recession the large consumer debt has an unfortunate effect on the consumption of new consumer durable goods and, therefore, on industrial production and investment. How the Federal authorities could or should exercise more control over consumer debt is a problem, but adjustments in the amount of downpayments and length of them, as in housing and stock-market margins, is a type of measure that might be possible.

The Federal Government has permitted some of the States to destroy in part the effectiveness of one of the most significant built-in stabilizers, namely, unemployment compensation. Unemployment benefits in 1957 met a smaller fraction of the wage loss from unemployment in covered employment than was the case in 1939, when benefits were first paid. This is because the States, in competing for low unemployment taxes, have kept their benefits low—a much lower percentage of average earnings that was originally contemplated or provided. A prime case in point is the State of Virginia, which has had about the lowest tax rate of any State in recent years (averaging 0.5 percent of payrolls in 1957), and also has perhaps the most inadequate benefits (providing only 8 to 18 weeks of benefits for total unemployment, which is the lowest maximum of any State).

Interstate competition in low unemployment taxes and benefits has reduced the effectiveness of unemployment compensation as a business stabilizer, not only on the consumption side, by compensating for no more than about 20 percent of wage loss, but also on the tax side, by causing the employer payroll tax to drop in prosperous times and rise in percentage terms in slumps.

The Federal Government, which was responsible for the nationwide adoption of unemployment compensation, has an obligation to put a stop to the cyclical-aggravating effects of unemployment compensation and to make its benefits sufficiently adequate so that they will help to stabilize business on downswings.

13. One cannot and should not fix upon a percentage of unemployment or of decline in industrial production or some other index, at whose occurrence automatically the Federal Government would make major moves to counteract a downturn in the economy. The circumstances vary too much from one downswing to another to substitute a mechanical calculator for expert judgment and wisdom.

One important area in which the Eisenhower administration to date has failed badly in the current recession is that it has tried to fool the public by rosy predictions and to talk as though it would do something without, however, making definite plans and preparing a definite program. The announcement of intentions and a program of steps that will be taken if and when circumstances become such and such, provides businessmen and consumers with a basis for making their plans. In contrast, the confusion, the fluctuation, and the patently foolish statements of the administration, particularly the President, have served to shake confidence in the leadership at the top and have thus aggravated the downswing.

16. Escalator provisions in wage and other contracts are compatible with the achievement of economic stability. They do, however, when providing adjustment on a quarterly basis, mean a quicker catching up with price rises than under annual changes. However, annual negotiations can be just as inflationary if they anticipate future increases in the price level.

Long-term contracts can, however, help to give an upward bias to the price level where the bulk of long-term agreements are not renegotiated during a short recession and there are important orbits of compulsory comparison between unions and companies whose agreements expire in 1 year (say autos in 1958) and some of those not expiring until a year or two later (as steel and electrical equipment in 1958). The result can be that the pattern of considerably reduced wage increases or of no increase in periods of recession (as in 1949–50 and, to some extent, 1953–54) may be upset and the average of wage increases in recessionary periods may not be much below those in more prosperous periods. This matter is briefly discussed in the article I published in the New Republic for January 6, 1958, page 10.

17. The causes of the present recession are many in the sense that what occurs is influenced by numerous preceding events. Certainly, as explained in the answer under 2 above, the Federal authorities—the Eisenhower administration and the Federal Reserve authorities—are partly responsible in view of their mistaken judgments and mistaken actions. The sharp cutting of military expenditures in the third quarter of 1957 in order to keep under the $275 billion debt ceiling was a contributing factor.

As for action that should be taken to terminate the recession at this fairly advanced stage, the most effective measure would be a refund of say 10 percent of 1957 taxes. This would have a number of advantages over most of the proposals for a tax cut and over most increased expenditure programs.

It would not involve any change in present tax rates or in current withholding. It would provide taxpayers with a significant sum at once and not in driblets that surveys indicate would be either saved or used for nondurable items. It would provide money for people who were working in 1957 but became unemployed late in 1957 or in 1958.

Such a tax refund ought also probably to be accompanied by a reduction in the taxes on consumer durables, providing that the tax cut was passed on in the form of a corresponding reduction in price.

The trouble with expanding public-works expenditures on a large scale is that it takes a year or two to make the plans, buy the land, let the contract, excavate, and get to peak employment on the project, and most of the big projects are outside the centers of unemployment.

With a prospective deficit of perhaps $5 billion in the Federal budget for 1958–59, assuming no additional expansion in expenditures or cut in taxes, the great threat is of a bunching of Government expenditures in late 1959 and 1960 at the same time that businses is experiencing a rapid recovery. The consequence may well be a significant rise in the price level that can hardly be avoided because of commitments made in 1958. A 1957 tax refund of, say, 10 percent has the advantage that its effect would largely be confined to 1958 if it occurred before July 1.

In order to indicate the basis for my belief that some such measure as a tax cut like that proposed above is necessary—indeed is long overdue—I enclose a copy of a letter I wrote February 24 to the New York Times (published March 2) and a copy of a statement I prepared upon request, which appeared in the New Republic for March 17, 1958, page 16.

JANUARY 16, 1958.

Mr. CHARLES TYROLER II,
Executive Director, the Advisory Council of the Democratic National Committee, Washington, D. C.

DEAR CHARLES: Since I will only arrive just before noon tomorrow and could not get in touch with Ken Galbraith today, I am writing this letter to indicate my point of view on the item scheduled for the morning session, namely, the economic outlook for 1958.

In my judgment, the administration is altogether too optimistic about the outlook for 1958, and the reasons that President Eisenhower has given in his budget message for expecting an expansion "soon" are mostly long-term reasons, such as rapid technological advance and growing population, or they are reasons which rest on some weak reeds such as the increase in State and local spending.

My pessimism about 1958 arises out of a number of considerations:

(1) Employment has declined very rapidly in the last month and business confidence is rather significantly shaken.

(2) The economy now has a great deal of overcapacity so that easy money is less effective as a stimulant to investment.

(3) The recession appears to be much more widespread throughout our economy than was true in 1953–54 and also much more widespread internationally so that our exports are falling off.

(4) My information is that the survey of consumer spending plans which will be released in the near future is much more pessimistic than the preceding one.

(5) No development is on the horizon which would be a significant updraft to our economy, unless it is Federal spending. The areas of capital investment, housing, and even consumer expectations cannot be looked to for much help.

(6) Arthur F. Burns talked to our seminar last night and he analyzed the situation and gave it as his opinion that the recession this year is likely to be more severe than the one in 1953-54 and he saw no good grounds for the general consensus that things would pick up by the middle of the year, although he was not denying that that was a possibility.

(7) Yesterday the employment security division in New Jersey estimated that we have 200,000 unemployed in New Jersey, which would be almost 10 percent of the work force and their reports from employers on employment over the next few months indicate some additional decline until the end of January and then a leveling off.

Under all these circumstances, it would seem to me that this meeting is the most important one that our committee is likely to have in the first years of its existence and it seems to me incumbent upon us to provide a strong antirecession program which the present administration has not done and is not likely to do if the comments of the President in his press conference yesterday and in the budget message are an indication of the administration's sentiment.

Any such antirecession program should have among its elements the following:

(1) Clear-cut assurance that the Federal Government is prepared to take action quickly if the recession becomes any more severe or continues any length of time. This kind of assurance is necessary in order to restore business and consumer confidence.

(2) An increase in Federal spending for much-needed items, including defense, basic research (which today's paper indicates it is proposed to cut in half), education, health, and State aid.

(3) A drive to improve the level of unemployment benefits in the States and old-age benefits.

(4) Consideration of a tax-reduction program.

It seems to me that we face a real serious situation in the free world if we permit a continuation of a large volume of unemployment in this country and a spreading recession in the economies of our allies. In the cold war, economic recession in the economies of the Western World would constitute a major defeat.

I look forward to seeing you tomorrow.

Sincerely yours,

RICHARD A. LESTER,
Professor of Economics.

[The Times]

TO COMBAT RECESSION

PROSPECTS OF EARLY UPTURN DOUBTED, SPECIFIC PROGRAM URGED

(The writer of the following letter is professor of economics at Princeton University)

TO THE EDITOR OF THE NEW YORK TIMES:

We are threatened with sharp political division on the course of the current recession and the proper way to restore prosperity. It would be unfortunate if the Eisenhower administration should rigidify its defensive position on the diagnosis and treatment of our economic difficulties in disregard of the calculations and advice of experts.

Actually, prominent Republicans and administration advisers, as well as business and academic economists, have recently expressed conclusions varying significantly from the economic pronouncements of administration spokesmen.

GOVERNMENT INTERVENTION

A week ago Prof. Arthur F. Burns, of Columbia, former Chairman of the President's Council of Economic Advisers, declared that there was insufficient evidence to justify any prediction of an early end to the recession and that it would not be terminated by private expansion, but only by massive Government intervention. Those who have heard Professor Burns recently know that he is more pessimistic about the prospects for a pickup by the usual means than are administration statements.

Among experts there seems to be rather general agreement that, without aggressive Federal action to counteract the contraction, this recession will be more severe and protracted than those of 1949 and 1953; the upswing, when it comes, is likely to be less vigorous and less unemployment absorbing than the upswings that followed the two previous recessions, and international conditions have deteriorated so that it is dangerous now to gamble with a program of rosy predictions and halfhearted action that will be too little and too late.

Those opinions rest on such facts as the following: Compared with the previous two postwar slumps, this one has been more extensive, with all major private sectors, including exports, contracting.

Corporation and consumer liquidity have declined. The recent investment boom has produced large and widespread excess capacity, thus reducing the stimulating effectiveness of monetary policy. Also, the economic situation internationally has worsened and is weaker than during our two preceding downswings.

PRESENT PLANS

Consequently, in the absence of more vigorous Federal spending or tax-reduction measures, no development on the horizon promises a strong economic updraft over the next year or so. Plans for capital investment, housing, consumer, or State and local government expenditures offer little hope of strong pressure to bring about a significant early upturn.

Under the circumstances, this country can hardly afford the waste, the loss of prestige, and the disruption to international economic and political relations that a protracted recession here would create. In the cold war, economic recession and restrictive policies in the West would constitute a major defeat for this country, both materially and morally.

It is high time that this whole matter was given more serious nonpartisan consideration. The January Economic Report of the President is already completely out of date. Not only should the Council of Economic Advisers be requested to update that report, but a group of experts should be called to Washington to help prepare a fresh analysis and a specific program.

RICHARD A. LESTER.

PRINCETON, N. J., *February 24, 1958.*

In support of his prediction of last November that "the present decline in business will be shorter and milder than the contraction of 1953–54," Professor Slichter now offers an analysis that seems deficient on two scores: insufficient account is taken of expenditure plans and some important factors are neglected.

With respect to plans, the November-December Michigan survey of consumer buying intentions and outlook showed the most gloomy expectations in 5 years, even among the higher income consumers, and the surveys of planned business expenditures for plant and equipment have forecast a marked downward shift. The consumer forecasts have since been confirmed by the sharp drop in new auto sales and a considerable reduction in department store sales, and the declines in the past 6 months in disposable personal income and in security prices will depress spending over the near future.

As for the neglected factors, they include the reduced liquidity of business firms, the large and widespread excess of industrial capacity built up in the recent investment boom, the continued decline in our exports in the past year, more unfavorable international conditions than prevailed in 1953–54, and a slump in business confidence in the Eisenhower leadership so that "chinsup" pronouncements are followed by declines in stock prices.

Professor Slichter's rather optimistic prognosis not only rests on somewhat questionable analysis but, in part, on hopes that Congress "will wisely insist on spending more" on constructive programs than the President has recommended and that the Federal Reserve authorities will engage in an "aggressive easing of credit."

What is needed, however, is a definite program for action that will restore confidence by indicating a determination to take specific steps over the next few months, including measures unmentioned by Slichter, such as the Kennedy-McCarthy bill to provide decent benefits for the jobless. Such a program should not be hampered by worries about the Consumer Price Index, which suffers from temporary developments like the weather and has a short-run upward bias now because of various lags.

RICHARD A. LESTER,
Professor of Economics.

PRINCETON, N. J.

UNIVERSITY OF CALIFORNIA,
DEPARTMENT OF ECONOMICS,
Berkeley, Calif., March 27, 1958.

Senator HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: I was very flattered by your letter of February 17, in which you request that I submit answers to a set of questions concerning the state of our economy. I did not write to you earlier because I fully intended to have my answers prepared by April 1—the deadline suggested in your letter.

Unfortunately, an emergency trip to the East and a long bout with the flu have thrown me completely off schedule, and I find now that I shall be unable to prepare a complete report in the near future without seriously neglecting my duties at Berkeley.

I shall be happy in any case to offer a diagnosis of the present situation and to suggest in broad outline certain policies which might be effective in dealing with it.

The present recession should have come as no surprise to economists. To be sure, both its timing and its depth had not been anticipated. Currently available tools of analysis and prediction make it unlikely that reliable professional forecasts can be made either of the timing of a downturn (upturn), or of the depth (height) of a recession (boom). What can be predicted reliably is that the growth of our economy will exhibit ups and downs of a nonperiodical cyclical sort. To put it bluntly, we can't have our cake and eat it too. Our decentralized economy has been performing impressively well over the long run. The very fact, however, that it is decentralized means that we cannot expect it to perform without significant fluctuations. Spontaneous high rates of growth as we have been experiencing cannot be expected to be completely painless. In a sense, then, recessions and booms are the price of a high rate of growth in a decentralized economy.

It may be worth while to make a distinction between cyclical fluctuations which reflect inventory adjustments and cyclical fluctuations which reflect equipment adjustments. The former are of short duration, and are relatively superficial. The latter are of longer duration and have greater depth. I am convinced that we are experiencing an equipment adjustment. Capacity in certain sectors of our economy has outgrown current demand for output (given the present price-wage structure). Efficiency, improving technological developments, and new products may be expected eventually to turn the tide. It seems to me, however, that the recession may be expected to deepen before an upturn takes place.

It is unlikely that we will be successful in dealing with the current recession by relying exclusively on monetary policy. The monetary authority is doing what is required, but it surely is not enough.

Turning to fiscal measures, one may consider separately tax cuts and public expenditures. Tax cuts will be effective in increasing the aggregate flow of spending, but it is not clear that this will provide the answer. A personal income tax cut will provide a boost in consumer product markets. These markets, however, have not been seriously affected by the recession, and the tax cut might easily contribute to already present inflationary pressures in the midst of widespread unemployment. A reduction in the corporate income tax might lead to the undertaking of marginal investment programs by business firms, but unless the whole atmosphere is right these may not amount to a great deal. Also, a tax cut is hard to reverse.

I am much more impressed by the likelihood of success (success in the sense of cushioning the recession) of public expenditures. Public expenditures can be structured along regional lines in a fashion which will provide relief exactly where it is needed. Admittedly it takes time to begin spending appropriated money, but if my guess is correct that the recession will have depth and length this should not be a serious obstacle. It is not necessary for me to detail the nature of public expenditures which might be undertaken. Military projects, highway construction, and school-building programs should provide the major outlets. So far as the magnitude of the required expenditures is concerned, one can only guess. It seems to me that additional expenditures of between 5 and 8 billion dollars over the next 2 years will be adequate in providing a high floor to the current recession.

Please accept my sincere apologies for not sending you a more complete document. My personal circumstances have rendered this impossible.

Sincerely yours,

ANDREAS G. PAPANDREOU,
Chairman, Department of Economics.

MASSACHUSETTS INSTITUTE OF TECHNOLOGY,
DEPARTMENT OF ECONOMICS AND SOCIAL SCIENCE,
Cambridge, Mass., March 25, 1958.

Senator HARRY F. BYRD,
Chairman, Committee on Finance,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: Your questionnaire reached me at a very busy time. So I have been forced to reply to it briefly, concentrating on those questions where my specialized knowledge is greatest.

If you should want expert testimony, I would be glad to appear at an agreed upon time.

Sincerely,

PAUL A. SAMUELSON.

Enclosure.

ANSWER TO QUESTIONNAIRE OF COMMITTEE ON FINANCE BY PAUL A. SAMUELSON, PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Because of limitation on time, I am confining my replies to those questions where my views are likely to be most helpful.

Question 4

Last fall I attempted a diagnosis of the basic causes of the "new inflation" for the Sydney (Australia) Morning Herald financial supplement, and I enclose that analysis.

This was prepared at the request of the financial editor of the Sydney Morning Herald for its annual financial supplement, fall, 1957.

"WAGES AND PRICES IN THE UNITED STATES: FALL, 1957

"For a year and a half now the American Consumers Price Index has been steadily rising. There is much concern over this fact—in Congress, in the press, and in the public at large. The increase in prices has made labor anxious for further increases in wages. And it has started talk about the 'new inflation'—which is allegedly a new kind of price spiral not covered by the classic economics textbook analysis of inflation.

"I must confess that I was one of the economists testifying before Congress who can be held responsible for launching the notion of a new kind of inflation. Yet I am not sure the new inflation is really new, and I welcome the opportunity to review recent American price and wage trends.

"THE WAR'S AFTERMATH

"From 1945 to 1948 prices rose mightily in American markets. Removal of direct controls on wages and prices was, of course, the immediate occasion for the rise. But at the time most of us economists were inclined to speak of the wage-price spiral, using the words 'wage' and 'price' in that order.

"We tended to regard trade-union leaders such as the mineworkers' John L. Lewis and the autoworkers' Walter Reuther as the causal movers in this scenario. Many American economists then tended to attribute the price increase to a unilateral push from wages to prices.

"KOREA AND ITS AFTERMATH

"By 1948 prices generally began to level off. Then came the 1950 Korean war, sending staple prices skyward and unleashing a great deal of forward buying by consumers and businessmen who remembered the shortages of World War II. To the great surprise of most economists, after 1951 wholesale prices began to decline. And for the next 4 years we witnessed the satisfying spectacle of generally high American prosperity accompanied by little concern with an inflationary price spiral. While staple prices and other wholesale prices fell, our cost of living began to level off.

"By the middle 1950's many economists began to reconsider their wage-push diagnosis of the immediate postwar price rise. They began swing over to a quite different view: Namely to attribute the 1945–48 price increase to the swollen dollar demand that emerged as a result of the vast wartime accumulation of money and other liquid assets.

"In short, there was something of a flip-flop by economists from a 'wage-push' to a 'demand-pull' diagnosis of inflation. The wage rise was felt to follow on and reflect the price rise attributable to the pull of demand. And one group of economists, far from attributing that inflation to unions, began to argue that union lags in contract negotiation actually slowed down the wage rise.

"RECENT RESUMPTION OF INFLATION

"On the whole up to 1956 American economists ceased to talk much about the old dilemma of whether you can have simultaneously free markets, very high employment, and stable prices. From 1951 to 1955 American had for the most part all 3 of these good things.

"But all good things must come to an end, and since late 1955 prices have been rising. The rise showed up first in wholesale prices. The prices of industrial goods particularly showed a steady rise. Then by 1956 the Consumers Price Index began the steady increase which has continued up to the present day.

"Indeed just in the spring of 1956 when Arthur F. Burns, Eisenhower's eminent economic adviser up to last year, was making an important speech in which he argued that inflation was far from inevitable, actual prices were beginning their upward drift. This drift in consumers prices, the ones that figure in the cost of living, has been all the more remarkable in that by late 1956 American production had leveled off. And consumers prices have this year been rising in the face of declining metal and other wholesale prices.

"We have been in the paradoxical situation of having inflation at a time when manufacturing capacity has been in many industries above actual demand. Examples are the paper, auto, and steel industries; or TV and other consumer appliance lines.

"Or take the case of residential housing. The 1955 peak of 1.4 million housing starts per year has been followed by a fairly steady decline to the present level of about 1 million. Yet despite this reduction in volume, costs of housebuilding have continued to rise at a rapid rate.

"To sum up. If one ticks off in turn the usual factors that measure strength of 'demand pull' on prices, one finds in the last year that they seem rather on the weak than on the strong side. (The main exception to this may be in the field of durable equipment where 1956–57 demand has been quite strong and where there has also been a significant rise in prices.)

"A NEW INFLATION?

"It was the above facts that a number of us economists testified to before the Joint Economic Committee of Congress early this June. The financial reporters picked up this paradox of rising prices in the face of apparently weak demand and played up the concept of "the new inflation." Since then, Senator Byrd and several other public figures have also emphasized the concept of a new inflation.

"Now exactly what is the term supposed to mean? To some analysts, there can be but two kinds of inflation: demand-pull and wage-cost push. If you have eliminated the former, then by elimination you can prove that we must be in the latter. This then must be a wage-cost-push inflation. So goes the syllogism.

"And important new policy implications are drawn from the premise that this is a new inflation. Conventional Federal Reserve monetary policy—such as contractionary open-market sales of Government securities, raising of the discount rate, and raising of legal reserve requirements that the commercial banks must keep against their demand deposits—is usually thought of as operating on demand. So, if the inflation is not due to demand-pull, some jump to the conclusion that conventional central bank monetary policy is not the proper way to fight the inflation.

"And a similar inference is drawn as to the advisability of conventional fiscal policy—of increasing the budget surplus by raising tax rates and cutting government expenditure. If the new inflation is not caused by excessive demand, fiscal measures to curb demand are deemed by some not to be in order.

"SOME DOUBTS

"What are we to think of these views? First, note that two different issues are involved—an issue of diagnosis and an issue of therapy.

"With respect to diagnosis, we have to question that inflations can be simply divided into the two mutually exclusive categories of demand-pull or wage-push. Actually, there are all sorts of inbetween situations where the exact direction of causation is hard to determine and is certainly not one-directional.

"And with respect to therapy, it is not necessarily valid to argue that an inflation that one could identify as caused by wage-push can never be controlled by monetary and fiscal policies aimed to affect demand factors. For it might be the case that the push of wage increases can prevail only because demand factors happen to be permissive. Thus, if the Federal Reserve makes money very tight, a push of wages may have to result in unemployment and cuts in production. In the face of growing unemployment and declining production, the forces working toward an upward push of wages may find themselves overcome by counterforces. Hence, one way of putting out a fire caused by wage-push might be to use the chemicals of demand-depressants.

"THE FEDERAL RESERVE'S DILEMMA

"I suspect that something like this philosophy must be in the mind of Wm. McChesney Martin, Jr., Chairman of the Federal Reserve Board, whose frequent testifyings before Congress this summer have been alarming some Wall Street speculators. The Fed acts as if it feels that it has demonstrated its ability to end recessions of the 1953–54 type and is out to show that it can also succeed in curtailing inflation.

"If this is its goal, it has its work cut out for it. To curb by demand depressants an inflation that is due solely to wage-push and not at all to excess-demand could mean you succeed only by engineering at least a mild slump. Politically, this is a risky business. The Fed could win a pyrrhic victory that all friends of central banking might later regret.

"STRONG WAGE-PUSH SINCE 1950?

"This makes it all the more important to try to decide how much of our recent inflation has been due to unilateral wage pressures. Certainly if one clips the newspapers systematically, one does not get the impression that the great trade union leaders have been acting up unusually much in the last year. Except for the midsummer steel strike, 1956 seemed a year of less-than-normal strikes. Collective bargaining seems to be these days conducted in a less warlike mood than was true some years ago.

"Yet it has been the period since 1950 in which money wages have been advancing most rapidly relative to prices. The fall in farm prices long hid this fact.

"If the indexes of fireworks in collective bargaining do not seem to indicate strong unilateral pressure from the wage side, how can I account for the inflation we've had? Can it be due to the automatic escalator cost-of-living clauses that have been increasingly written into wage contracts since the famous 1950 General Motors-United Auto Workers' agreement?

"REAL WAGES SURPASSING PRODUCTIVITY GAINS

"Undoubtedly, once the price index begins to move, these escalator clauses do become a reinforcing factor making for inflation. Statistically, though, this seems as yet to have been a minor factor in a causal explanation of events since 1951. Only 4 out of 67 million workers are now covered by escalator cost-of-living clauses.

"And most of what has to be explained is not a rise in wages just big enough to match the upward increase in prices. Rather we have to explain the fact that since 1951 our money wages have been steadily rising faster than prices. Indeed the wage increases have been greater than the increases in physical labor productivity that were simultaneously taking place.

"Perhaps more important than the cost-of-living escalator clauses in wage contracts have been the "built-in improvement clauses" in such contracts: These improvement clauses automatically give workers higher wages with each passing year, on the theory that they reflect steady improvements in productivity. And workers, whether or not covered by such clauses, have come to expect such steady increases in real wages—independently of whether or not their productivity has in fact gone up in step.

"DIAGNOSIS

"Very tentatively, I might put forward the following interpretation of the present American scene. Labor and management accept it as axiomatic that money wages will rise each year. So the wage-push no longer requires a collective-bargaining battle or a grim recourse to strikes. Labor's wage-push is, so to speak, a push against an open door. Our high prosperity in the 1950's has made no one of the participants in this process have reason to regret greatly his actions.

"If this is truly the developing pattern, then militant Federal Reserve policy may be able to break this pattern only by making labor and (particularly) management regret its participation in the steady wage-push. Can we expect that mild depressants can accomplish this?

"I hope this tentative diagnosis is wrong, for those who worry about mild price inflation may find it a pessimistic one.

"PAUL A. SAMUELSON.
"*Massachusetts Institute of Technology.*"

I would today reinforce the view expressed above that in 1957 a general excess of demand over supply did not seem evident. Hindsight tends to confirm one's suspicions.

Question 5

Public debt management is closely connected with monetary policy. Now that the Fed tends to operate in short-term bills only, it is the Treasury's decisions with respect to stretching out the debt that have many effects on the pattern of bond yields that open-market purchases of bonds by the Fed used to have. If one wishes to make long-term credit easier to get and cheaper, one foregoes stretching out the debt. Conversely, in times when fixed investment is over brisk, and the market will not buy new long-term Government bonds except at a very high yield—then, unpopular as this may seem to the Secretary of the Treasury, that is the time to issue new long bonds.

The Federal Reserve does not have the duty to keep Government bond yields low through thick or thin. But it does have the duty to make sure that the combined impact of Treasury debt-management policy and its own policies are conducive to aggregate stability.

Question 6

Our primary goal should be "economic growth in production, demand, and employment." Mere stability in these would be equivalent to stagnation. Other things being equal, stability in the price index is to be desired. But recent experience, confirmed by economic analysis, suggests that America may not be able to enjoy high and growing production along with stable average prices. One or the other may have to give. Which? In this period of intense competition with Soviet Russia, I'd regard modest increases in prices as the lesser evil.

Question 11

See reply to question 4.

A gradual inflationary trend should not be accepted as in itself desirable. Nor are we sure it is necessary. But if it should turn out to be necessary, see answer to question 6 for national priorities in this age of competition with Russia. (NOTE.—We do not know that continuous mild inflation must necessarily "snowball" into stronger inflation. Nor do we know that long maintenance of high demand will boomerang in a depression later. Most confident generalizations in this field are based upon uncertain knowledge, since neither economic history nor economic analysis provide us with definite answers.)

Question 12

Minor problem.

Question 13

It is the important duty of the American Government to step in with countercylical fiscal policy whenever the economy is seriously departing from stable growth. The Federal Government has immense reserve strength in its "financial condition," so that is no problem. The problem is that we should not overdo things on the expansionary or contractionary side.

Question 14

Postwar fiscal policy has on the whole been well-devised.

Question 15

See answer to questions 4, 6, and 11.

Question 17

The 1957 recession came from (1) cuts in defense spending, (2) cuts in fixed investment spending by business, (3) inventory decumulation, and a number of minor factors. Expansionary monetary policies by the Fed and Treasury, increases in much-needed public expenditures, and some judicious tax cuts will bring the recession to an end.

MACHINERY AND ALLIED PRODUCTS INSTITUTE,
Washington, D. C., April 1, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

MY DEAR SENATOR: I promised in my letter of February 28 to send something in response to the questionnaire accompanying your letter of February 17. I regret to say that as things have turned out this has proved a rash promise. I have been preoccupied with pressing duties and have been quite unable to find time for an adequate discussion of the varied and complex issues propounded.

It happens that I prepared an article recently for the Committee for Economic Development (published in Problems of United States Economic Development, vol. 1), which deals with a problem that runs through most of the questions posed by the inquiry, namely, the problem of inflation. I am venturing to enclose a copy of this article, not as a direct reply to your questions, but as a means of indicating in part what I would have said in such a reply.

I regret exceedingly that I have been unable to do more on this assignment, and I tender my sincere apologies.

Respectfully,

GEORGE TERBORGH,
Research Director.

Enclosure.

WAGE-INDUCED INFLATION [1]

The next couple of decades promise plenty of economic problems for the United States and a choice of the most important is not easy. No one problem can be expected to remain continuously preeminent over so long a period, for relative urgencies will shift with changing conditions. The choice, I take it, should turn on relative importance over the period as a whole. On this assumption I have selected a long-range problem that promises to be with us most of the time over the next 20 years, and that from all present appearances may well be with us at the end. I refer to the problem of maintaining a satisfactory level of production and employment without creeping price inflation.

While this problem has other aspects, the heart of it is a lopsided balance of power between management and labor in modern collective bargaining. With the privileges and immunities that labor unions now enjoy, it has become impossible, under conditions of reasonably full employment and expanding production, to hold the average rise in labor costs to the average rise in productivity. The inevitable result is a creeping advance in the general indexes of prices and living costs.

[1] Published by the Committee for Economic Development in Problems of United States Economic Development, vol. 1, January 1958.

We hasten to say that this proposition implies no criticism either of union leaders or of the rank and file. The labor movement represents a cross section of the American public, no better and no worse than the rest. Nor does it concern the so-called abuses of unionism, recently dramatized in the activities of Dave Beck, Jimmy Hoffa, and Johnny Dio. Deplorable as they may be, these abuses have comparatively little to do with the problem. They could be totally eradicated and it would still be with us. For it arises, not from the unlawful, but from the lawful, operations of unionism.

This is not an essay on demonology, therefore; it is on social institutions. The fault lies in the lopsided balance of power created by these institutions, not in human wickedness. Nothing is sillier than to blame unions for taking advantage of the power that is lawfully theirs, and certainly nothing is more futile than to hope that they will voluntarily forego its exercise. The remedy lies rather in institutional reforms that will create a noninflationary balance of power in collective bargaining, that is to say, a balance that will hold the general advance in labor costs to the general rise in the productivity of the economy.

I have nominated the problem of wage-induced inflation as the most important for the next 20 years, in part because the remedy seems so far away. For a condition precedent to remedial action is an agreed diagnosis. At present there is none. Union leadership still denies that the problem exists. The upcreep of prices is attributed to the excessive profits of greedy employers, who could absorb wage increases if they only would. It is still possible to find university professors who insist on theoretical grounds that collective bargaining cannot raise costs and prices above the level that would obtain in its absence. But even among those less obviously self-interested or doctrinaire, there is as yet no clear agreement on the problem. Public opinion remains either confused or nonexistent. As for the politicians, a subject so politically delicate as excessive wage demands is avoided if possible, and is mentioned if necessary only in terms of studied equivocation.

The standard posture of the politician in addressing this issue is a straddle. He implies he really doesn't know whether price inflation is due to excessive wage settlements or to excessive profits. So far as he can tell, both are equally to blame. He proceeds therefore to pious admonition to both labor and management, urging the one to be moderate in its wage demands, the other to be moderate in its pricing policy. It goes without saying that the public gains no enlightenment whatever from this political balancing act.

This is said, not to blame the politicians—I do not ask them to be heroes—but simply to confirm the absence of any strong sentiment against excessive wage settlements. There does not yet exist the necessary basis in public opinion for an attack on the problem.

We are the victims of a cultural lag. In this day of huge, monolithic labor monopolies, endowed with special privileges and immunities by the state, we still retain the attitudes and sentiments of an earlier day when a weak union movement was struggling against heavy odds. Labor is still regarded by most people as the underdog, and the public reaction to union wage demands is still, in the main, indiscriminately favorable. Thus when a powerful union leader in an already high-wage industry announces that he is going to exact 45 cents an hour in the next contract, the announcement is greeted, not with anguished protest, but with acquiescence or even positive approval.

This reaction is due not only to long emotional conditioning, but also to widespread acceptance of the myth, sedulously propagated by union leadership, that wage increases can come out of profits. They may come out of profits for brief periods of time in particular situations, but they cannot do so generally and for long without killing off production and precipitating a recession. We have had enough wage increases in the last 10 years to wipe out profits many times over, but they are still with us. Industry has passed on to the market in higher prices substantially all of the increase in labor (and other) costs not offset by rising productivity, and it will have to continue to do so if we are to maintain a prosperous economy. The notion that wage increases in excess of productivity can be "absorbed" is a popular delusion.

Another reason for the indulgent attitude of the public toward excessive wage demands is the common belief that wage increases initiated in one industry or sector of the economy will spread to others, with benefit to workers not directly involved. This belief can be summed up in the slogan "We'll get ours later." To what extent and under what conditions this expectation is valid, is a matter of debate into which I need not enter. For the point is simply this. Even if the expectation were completely valid—even if everyone were to keep pace with the wage leaders—the result would still be inflation. And inflation is the problem I am talking about.

Since the necessary climate of public opinion for an attack on wage-induced inflation does not yet exist, I can only conclude that we will have to live with the problem for a good many years. This does not mean that the upcreep of living costs will be continuous and uninterrupted. There may be times when falling raw-material prices (for example, the falling farm prices of 1951–55) will mask the effect of rising labor costs in fabrication and distribution. There may be periods of economic recession when the march of hourly wage rates slows up and profit margins are squeezed. But in conditions of prosperity and full employment—which it is the policy and obligation of the Federal Government to maintain so far as possible—we may expect that in general the cost of living will creep irregularly but persistently upward.

The basic problem, as I have said, is a lopsided balance of power in modern collective bargaining. We will live with this problem until we have the wit to diagnose it and the courage to do something about it. In the meantime, we must be careful that in our desire to suppress the consequences of this disbalance of power we do not overwork anti-inflationary policies designed to cope with other problems.

I refer primarily to credit and fiscal policies. These are appropriate for dealing with the kind of price inflation that results from excessive demand for goods and services—from a generally taut and overstrained economy—but it has still to be demonstrated that they can effectively prevent the price consequences of modern collective bargaining without generating worse evils in the process.

Credit and fiscal policies can undoubtedly reduce the bargaining power of unions, but they do so only by slackening the economy itself.

In a slack economy, cost increases are harder to pass on. Management resists wage demands more strenuously, and strikes are harder to win. But how much slack is required to hold wage increases, on the average, to increases in productivity? How large a figure for unemployment does this imply? And what is the price in lost production? More important still, is the maintenance of this degree of slack politically and socially tolerable?

There is another angle to this problem. The last question implies that it is within the power of credit and fiscal management to let the economy down to a certain level—the level at which wage increases average no more than productivity increases—and then to hold it there. No one with the slightest knowledge of economic affairs will believe this. It is simply not in the cards. The danger is ever present that the momentum of the retreat will carry the economy beyond the target level and call for countermeasures, the aftereffects of which will defeat the purpose of the policy.

So long as we have not solved the basic problem of the excessive bargaining power of unions, we will have to "roll with the punches." We will have to accept some degree of inflation as the price of prosperity and growth. A fanatical determination to stabilize the cost of living by credit and fiscal policies, come what may, risks worse evils than it attempts to cure. Until the ax is laid at the root of the tree, we will continue to harvest its bitter fruit.

GEORGE TERBORGH.

UNIVERSITY OF VIRGINIA,
Charlottesville, Va., March 27, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D.C.

DEAR SENATOR BYRD: Attached are my comments on your request of February 17. This has been a most interesting and challenging assignment. I have dealt with the questions with which I am most familiar but passed over the two dealing with the technical aspects of monetary control. The discussion of each question is an attempt to state my views. At times there is some discussion of the matters which received most attention in formulating the view. To fully document each of these matters would probably duplicate much of the work which has already been presented to your committee.

As I worked on the questions it seemed to me that the solutions need to be guided by the ideals formulated by the founders of our Nation and by consideration of our opportunities and obligations as a leader among the nations of the world. There is the constant temptation to substitute techniques for goals. Too, there is much impatience with the effects of a normal adjustment in the Nation's economy which leads to proposals that threaten our basic system of free enterprise.

If there is any way in which I can assist you further in this most important undertaking it will be my pleasure to do so.

Sincerely,

LORIN A. THOMPSON, *Director.*

COMMENTS OF LORIN A. THOMPSON, DIRECTOR, BUREAU OF POPULATION AND ECONOMIC RESEARCH, UNIVERSITY OF VIRGINIA, CHARLOTTESVILLE, VA.

1. Inflation and deflation are measures of change in the ratios of income and prices. Such changes are related to a norm which usually is a period of stability accepted as a point of reference. Inflation occurs when the changes in the ratio of income and prices result in enabling the purchaser to buy fewer goods and services with the same number of dollars as in a previous period. Deflation involves not only the converse of inflation but implies that a decline in prices with reference to income is brought about by imbalance of other factors in the economy.

In a free market changes in the income-price ratio tend to set up secondary causes which in time have the effect of restoring the balance. Thus the high prices of an inflationary period tend first to stimulate production, then to increase costs of materials and labor, and to discourage purchase. In time this chain of cause and effect brings about a state of overproduction which entails a deflationary period of readjustment.

Some sectors of the economy have much greater susceptibility to expansion and decline than others. All sectors do not move in the same direction at any given time. During times of general prosperity, some parts of the economy are often caught in cost-price squeezes with the result that such businesses fail. During periods of business decline (recession and/or depression) some sectors prosper. Sometimes this prosperity means holding their own while other businesses decline.

When the composite result of all economic activity is to reduce purchasing power, many sectors begin liquidation of inventories by reducing prices. This is an effort to change the relationship of prices to income in such a way as to stimulate consumption (buying) which in turn is expected to encourage more production. When inventory liquidation fails to provide the impetus for increased production, further liquidation occurs, with the result that more and more business concerns lose profits or incur losses. In time this leads to an increasing number of business failures, and general loss of confidence. As business confidence is shaken with respect to the need for further production, plant expansion and construction decrease, employment declines, savings are spent for current consumption, and the dollar values of property decrease. If other costs such as labor and interest declined simultaneously, the previous interrelationships of plant, property, labor cost, interest, and other factors would be readjusted to a lower level of dollars, but such relationship would tend to be stabilized.

For many reasons the preceding factors do not adjust themselves automatically, and once a decline sets in, deflation adversely affects those sectors of the economy engaged in production (agriculture, lumbering, mining, construction, and manufacturing). Such services as transportation, business service, and private individuals having high fixed costs and/or long-term contractual obligations are also squeezed as business volume declines. Those sectors of the economy with fixed dollar incomes are in a relatively more favorable position when prices are declining.

Some inflation and deflation is unavoidable. The Nation, if it is to benefit from inventions and discoveries in any field, can do so only by changing, modifying, and at times discarding facilities and methods which have become obsolete or for which there is a diminished need or demand. Much of our present economic difficulty stems from the attempt to undertake new responsibilities without discarding some of the old.

For example, the opportunity for successful agriculture has been diminished by the efforts at acreage and crop control, price guaranties, soil banks, excessive accumulation of surplus commodities, and the like. Such measures, although designed to help the farmer, have for the most part restricted his freedom of choice. Farmers producing crops subject to various controls have been paid by the Government for restricting the acreage. Output has in many instances increased despite acreage restrictions through improved farming practices. Crop support prices have left the Government in the awkward position of having to buy excess farm produce. The Government has in turn built and/or leased warehouse facilities to store more and more crops. Such policies of the Government have reached a point where corrective measures will of necessity be severe and unpopular.

Measures calculated to bring about a comparatively free agricultural market through the reduction and elimination of governmental controls are vigorously opposed on many fronts. Yet a move toward eliminating many of the current control measures over agricultural output appears to be very desirable despite the fact that the consequences of such a change in policy and procedure will adversely affect many. It would seem that rehabilitation measures to assist those adversely affected by agricultural policy changes which would result in a comparatively free agriculture are preferable to a continuation of present policies.

Examples taken from many sectors of the economy would show that governmental policies have become too restrictive in some ways and too lax in others. For example, the concentration of economic power currently exercised by large corporations and nationwide labor unions affects all people and sectors of the economy. The economic fortunes of the American people tend to be governed by the conditions growing out of balance-of-power agreements between big business and big labor. Even though big business and big labor are private organizations, because of their size and strategic position in the total economy, negotiations proceed as though each was a power bloc attempting to seek its own advantage without too much concern for the economy as a whole.

2. Cyclical fluctuations in the economy of the United States reflect the changes in the degree of confidence felt from one time to another with respect to future prospects. Investments for plant expansion or for equipment changes in a plant are made at such times as businessmen feel that added capacity will increase the profits, strengthen the position of the firm among its competitors, or both. If the feeling of management is to the contrary, expansion and conversion are delayed. Subsequent events often differ from the anticipations of business leaders about future prospects. During the last half century in America considerable effort has been directed toward providing built-in stabilizers. The aim of such laws and practices has been to minimize cyclical fluctuations in employment income, expenditures, prices, and credit control. Such mechanisms can be started and stopped more promptly by private enterprise than by public agencies. Among the more important built-in stabilizers are the Federal Reserve System, unemployment-compensation laws, old-age and survivors insurance, other social-security programs, laws regulating the sale and trade of securities, and the FDIC.

Institutional forces, such as government, big business, and big labor, restrict the speed with which adjustments can take place. Greater flexibility in meeting emergencies in the American economy is needed. Some students of such matters believe that bigness in government, labor, and business greatly reduces ability to meet changing circumstances promptly. The suggested cure is limitation of size. Such a policy would affect mergers in business and in labor. It is not altogether clear, however, whether restrictions on size would permit greater flexibility, increase competition, and permit business, labor, agriculture, and other industries to make decisions more promptly than is possible under the present laws. Better understanding of the complex relationship between business and government, if coupled with the determination to ride out small storms without panic, would do much to stabilize conditions.

3. Others in the group are more competent to discuss the monetary control policies of the Federal Reserve System. The timing of changes in monetary control policies is most often criticized. However, changes in monetary policy, to be most effective, must anticipate developments from 6 months to 2 years in advance. If the Federal Reserve Board acted this far in advance it would be subjected to the criticism of attempting to influence unduly the direction of the Nation's economy by inaugurating changes which were not justified. The recurring problem is to determine when bold and decisive action is required, and when deliberation and delay may be wiser. In this respect hindsight is always better than foresight. So long as those charged with the enactment of laws—their administration and enforcement, together with leaders of business and labor, act in good faith, reasonably prompt adjustment to worsening economic conditions is possible.

4. Many factors have contributed to the decline in the value of the dollar and a continuing increase in the Consumer Price Index since August 1956. Employment in 1956 first leveled off, then declined. Output in many industries has been reduced and unit costs of production have increased. The increase in general productivity which normally results from increased labor efficiency does not appear to have occurred during the last 2 years. Price increases have been made wherever possible to cover increasing production costs due to decreased volume and higher wages. Such developments are due in part, but not exclusively, to surplus productive capacity. Steel output, for example, is about 50 percent of capacity as of March 1958. The steel industry expanded during the years of World War II and thereafter so that the Nation could meet more adequately defense and consumer demand. A sharp drop in total demand, such as currently prevails, places the steel industry in the position of having to carry the costs of keeping its facilities and plant in readiness to meet any increases in total demand that occur. Reserve capacity in basic industries in generally regarded as desirable and necessary, there can be little doubt about the fact that during periods of relatively low demand, the costs of maintaining idle facilities increases production costs and decreases the prospect of profits. The break-even point (the percentage of capacity which must be used to meet all expenses) is much higher now than prior to World War II. This is true of many other industries also.

For this reason, sharp declines in demand, if sustained for any considerable period, can spread to many other sectors of the economy until the total economy functions at a lower level of output and consumption than formerly. A lower level of output and consumption means a declining standard of living, business failures, bankruptcy, increasing unemployment, and hard times. If the economic apparatus can continue to function, even at a somewhat reduced level of activity, readjustment can proceed with a minimum of trouble.

Increased sales effort has been used as one of the means of reducing inventories and of stimulating production. While retail sales have been extraordinarily good during the last several months, merchants generally have been reducing inventories wherever possible and limiting forward buying. This in turn has curtailed employment in manufacturing and transportation industries more than distribution and service. If sales are pushed unduly, as they were in the automobile industry in 1955, a decline in subsequent years may follow until the demand has increased sufficiently to again stimulate production. Overselling, which is most difficult to define, but whose meaning is generally clear, has not resulted in balancing the demand for goods with the supply available. The high level of production, on the other hand, has tended to reduce the amount of price increase. The foregoing, along with other factors, have continued the wage-price spiral during the recent period of declining output and increased unemployment. If current conditions were left alone, it is probably that the recent decline in the dollar value would be arrested. As a matter of fact it might improve. Tinkering, especially when attempting under pressure, can often do more harm than good.

5. There are many indications that the United States uses public debt as a means of expanding its price and credit structure. The Federal public debt currently is equal to about 63 percent of the gross national product. A part of the income of many business concerns and individuals is invested in United States Government securities. If the debt were reduced these funds would seek other investment outlets. Reduction of the Federal public debt at the present time would mean the curtailment of expenditures for national defense. There are interesting parallels in the level of defense expenditures in the United States, rates of productivity of industry, income levels, and mass purchasing power.

Since 1940, particularly, defense and war expenditures have led to an expansion of industrial capacity. Much of the increased output during the period from 1941 to 1945 was for war and national defense. The Government was the purchaser; industry the producer. The increased material requirements of the Government provided the basis for the enlargement and expansion of the industrial establishment. Funds paid to the Government were in turn spent for war material and for greatly augmented Armed Forces personnel. When military demands relaxed and members of the Armed Forces returned to civilian life, the output of the Nation's production establishments was channeled in the direction of satisfying civilian requirements. By 1950 many of the pent-up demands of civilians had been met and the size of the Military Establishment drastically reduced. With the outbreak of the Korean conflict the equipment, materiel, and personnel of the Armed Forces were again expanded. Curtailments since the end of the Korean conflict have been comparatively small.

The race with Russia for military supremacy and the developments in the field of atomic warfare and missiles have altered the nature of the United States Defense Establishment, rendering earlier weapons obsolete. The increased emphasis on scientific research and development will result in more rapid obsolescence of equipment and weapons which only a few years ago were thought to be effective. So long as the United States and other world powers feel it necessary to maintain and develop increasingly powerful and effective weapons of mass destruction and warfare, the prospect for reducing the Federal debt will be dim. If world conditions worsen, defense expenditures will be increased and this in turn will exert further pressure on wages and prices. A peaceful world, in which military requirements can be vastly reduced, offers the best hope of a more stable economy.

If it becomes possible to reduce substantially the outlays for national defense, there is little doubt that some serious deflationary readjustment would follow. This will be a small price, however, to pay for world peace, particularly if appropriate measures are taken to assist in relocating and retaining those persons whose jobs vanish as defense establishments close. The chance for this sort of readjustment appears, at the moment, to be very remote.

6. (*a*) Price stability is attained when costs of raw materials, production, and labor remain stable. To the extent that productivity increases somewhat faster than demand, there is an opportunity to reduce costs, increase wages, and stimulate demand. When these factors are in balance, technological improvement results in increasing the benefits throughout the entire economy. When technological improvements result in increased costs, such developments can temporarily reduce employment, demand, and real incomes. Price stability is accomplished only when the cost of production, demand, and purchasing power remain in balance. The price level at any given time results from the interaction of many factors and, in a competitive market, tends to regulate itself.

(*b*) Since World War II production, demand, and employment have increased. A part of this change reflected the pent-up demand which accumulated during the war years. Following the termination of the war and the removal of rationing and price controls, this pent-up demand gave the impetus for expanding production and employment, and triggered the ensuing wage-price spirals. Population growth and increase in mass purchasing power further stimulated production and employment. During 1949 and 1950, and again in 1954, production outstripped the demand for certain goods and services with the result that brief recessions occurred. Since 1954 world conditions have been such as to discourage any reduction in armaments. The demand for civilian goods has been maintained at a good level; it has not continuously equaled productive capacity. The result has been a decline in the rate of growth of many industries. For example, the boom in babies which began prior to World War II and continued at an accelerated pace at the conclusion of the war has increased the demand for educational facilities, housing facilities, recreation, food, clothing, and many other goods and services. The growing segment of the population 65 years of age and over has increased the need for special facilities and accommodations for this sector of the population. Since the war the labor force has not expanded as rapidly as the older and younger sectors of the population with the result that an increased proportion of women have entered the labor force and have contributed in an important way to the purchasing power of family units. In another decade, when the present large youth population enters the labor force, employment opportunities will need to be expanded more rapidly than they have since World War II, if the same proportion of the population 20 to 64 is to be employed.

7. As pointed out previously the high level of Federal spending, particularly on armaments and devices connected with national security, has underwritten a considerable segment of our economy. Moreover obsolescence has been rapid. The result has been the production of many goods and services that have little utility. Spending

does provide opportunities for the investment of capital, for expanding employment, and these in turn result in expansion of wages and salaries, and profits.

State and local governments in recent years have been confronted with rapidly expanding demands for a variety of public services. The boom in babies has created a need for more schools and more teachers at better salaries. Growing metropolitan areas have found it necessary to increase their expenditures for more and better roads, increased parking facilities, new and enlarged water systems, sanitary facilities, public health, to mention but a few of the expanding demands. The expenditure of State and local governmental funds results in more long-term benefits to peacetime life than the Federal expenditures for national defense. The outlays for school buildings, water systems, sanitary facilities, and roads stimulate all industries which produce the goods necessary to construct, equip, and operate such facilities and establishments. Such obligations which are currently a part of the State and local government lead to a consideration of taxation.

8. The effect of taxation on our economy is complex and involved. The revenue requirements of the Federal, State, and local governments determine the amount of taxes needed. The subjects of taxation employed by the three levels of government overlap. The increasing interest centers around the rates of taxation imposed on the many subjects taxed. Local governments are to a large extent dependent upon the taxation of property. Taxing wealth per se is unpopular. Taxation of earnings, income, gross receipts, and sales finds more popular support. Perhaps the most critical problem of taxation is the extent to which the total tax bill—that is, State, Federal, and local taxes siphons off a substantial part of the proceeds of business and the earnings of individuals. Tax revenues, however, are spent by governments for goods and services and, as pointed out above, stimulate the economy just as definitely as though the funds were spent by private enterprise and individuals.

It is largely a question of how the Nation wishes to finance and provide for the many services that it has come to expect of government. If we want national defense, we must pay for it, and since the only government capable of protecting the Nation is the Federal Government, it follows that there must be Federal taxation to meet these needs. Since it is customary for local governments to provide for water, sanitation, streets, fire and police protection, and general government, local governments must find the revenues to maintain such services. Education, public health, and welfare are areas in which there are joint operations. Some of the programs are jointly financed by the Federal, State, and local governments; others, such as public education, are mainly financed by a cooperative arrangement of State and local governments.

One of the controversial areas of taxation is the progressive income tax. It is argued that such a tax discourages initiative since the more one makes, the larger the proportion of earnings is paid as a tax. It is most difficult to determine whether the very high rates on large incomes deter individuals from participating fully in economic affairs. It seems quite clear, however, that the generally high level of Federal taxes has (1) provided much of the money needed for the construction, maintenance, and operation of many private businesses; (2) expanded employment and mass purchasing power; (3) absorbed a substantial portion of price and wage increases which in turn have provided more funds for Federal activities.

Federal spending, most of which has been and is for national defense and defense-related obligations, has contributed to the expansion of the Nation's economy. Since the Federal Government must tax individuals and businesses for its revenue, a part of current tax revenue goes for the expansion of plant, equipment, and facilities. Thus the amount of Government spending at any given time affects total spending. A part of total industrial production depends on Government purchases and contracts. If Government purchases and spending are curtailed at times when other buyers (private business, exports, etc.) are not in a position to absorb the output, business fails, unemployment increases, investments go sour, and confidence collapses. Thus tax cuts, especially if the final effect is to decrease public revenues, impairs the ability of governments to influence the level of economic activity. If government is to participate less in total economy, private enterprise must do more and be able to absorb the costs, employment, investment, and other obligations which governments have discharged. As matters stand now (March 1958) if Government spending were sharply reduced, unemployment would increase further, the number of business failures would accelerate, security markets would fall, and general confidence would be impaired.

The appropriate time to reduce governmental participation in the economy is during a period of prosperity. If governmental spending drops during periods of economic stress the results are likely to be severe and generally damaging.

9. Fiscal policy is a means toward many ends. Since the end results expected of fiscal policy are diverse and extensive, the goals and objectives of fiscal policy often appear to conflict. For example, higher interest rates on Government bonds increase the share of total revenue for debt service, lower interest rates conversely decrease the cost of debt service and can exert some influence on other interest rates. Congress, in having the constitutional authority to coin money and regulate the value thereof, is in a position to influence interest rates. It is not always clear whether interest rates are means or ends in themselves. The bases for determining this matter are complex and obscure.

Fiscal policies have been and are used as controls over other objectives. Within the past 2 years, higher interest rates and tight lending policies are believed by some to have throttled building activities and plant expansion. Increased interest rates alone could scarcely be expected to be the decisive factor. Borrowers have hesitated for other reasons, such as the relative advantages of building now as compared to some later time. Government fiscal policy, since it does affect so many facets of the life of individuals and business, should aim toward stability in the whole economy so far as possible. Bad timing of public-works programs has frequently resulted in giving a push to the wage-price spiral. At other times, such as the present, Government is not ready to begin large-scale public-works programs promptly enough to provide jobs for the unemployed. Advance preparation is difficult to schedule so that it will coincide with turning points of the business cycle.

The most important requirement of Government fiscal policy is that it promote the long-term interests of all the people in the Nation. If, for example, more money is necessary for national defense than is currently available, then fiscal policies and procedures should promote this objective. If, on the other hand, less money is needed, fiscal policies should be readjusted toward this end. The Federal budget must adjust expenditure requirements to revenues. In the process of allocating funds it is often difficult to draw the line between essential and desirable, but less essential, programs. Principles, when considered apart from their application, seem clear. Application of a principle to a set of circumstances is frequently involved and complex because one action influences so many others. There is the continuing hazard of deciding matters on the basis of principles without due consideration to the circumstances and limitations under which they must function. This viewpoint means that, before changes in existing policies are made, the alternative proposed must offer general all-around improvement. On the other hand, if a change of policy or procedure offers distinct advantages, no hesitancy in trying it seems justified.

The need in America is for an appraisal of all governmental activities in relation to the needs of our time and of the future. More concern should be given to such questions as:

(1) What functions and services is it necessary and desirable for each level of Government to perform?

(2) Which activities should be undertaken on a joint and cooperative basis?

(3) What activities now performed by Government could or should be carried out by private enterprise and under what conditions?

Studies and reports have been made on many of these matters but action has been slow and hesitant. Continuous appraisal and examination is essential if the activities and programs of Federal, State, and local governments are to serve the people. Rigidity and cumbersomeness in Government fosters and promotes inefficiency, waste, and entrenchment.

Fiscal policies of Government can be improved as the purposes of Government itself can be more clearly defined in relation to the times in which we live. Until the objectives of our domestic and foreign policies are more clearly set forth, monetary practice will continue to be more a matter of complex and skillful juggling than an instrument of national policy.

10. Others are more competent to discuss this question.

11. (*a*) Inflation (higher prices) often parallels increases in unemployment. This occurs when current unit production costs increase as the volume of output declines. Current price levels reflect financial commitments made by companies from 6 months to 5 or more years earlier. Such commitments were made in anticipation of the future. When the future of a former period becomes the present and differs from expectations, seeming paradoxes occur such as inflation and increased unemployment. If such developments are regarded as episodes in a longer adjustment cycle, the forces at work will readjust themselves and bring about a new balance. The debate usually centers about the desirability of some form of intervention which is expected

to alter and/or restore the former balance of forces in the economy. The problem is similar to that which confronts a physician with a patient whose state of health appears to be less satisfactory than at a previous examination. Do the results of the present examination and current symptoms suggest surgical, or some other kind of intervention, or should nature be allowed to run its course? In the field of medicine, radical procedures, of which surgery is one, are undertaken only when the probability of beneficial results is good, or when delays might jeopardize the prospect of recovery.

The American economy on the whole as of March 1958, is not as robust as at earlier periods. The current symptoms of unemployment and inflation will adjust themselves. The question is whether loosening of credit, tax cuts, extension of unemployment benefits and many other proposals will increase the vigor of the economy for the long pull, or whether such measures at best would serve only as temporary palliatives. In this writer's view productive capacity has been expanded beyond the point of meeting the consumer's usual demand for products and service. Such commodities as automobiles, refrigerators, washing machines, and television sets, to mention but a few, depend upon early replacement of such equipment by the consumer through obsolence and style change. The elasticity of consumer demand for this reason is much greater than would be the case otherwise. Thus purchases made this year reduce the prospect of sales next year, and the consumer's decision to postpone the replacement of old equipment, or the purchase of new, threatens at all times the stability of supply and demand. American industries, by and large, have a considerable amount of reserve capacity. Such a reserve has many advantages, but it has the disadvantage that a decline in consumer purchasing will often increase production costs by reducing output, and result temporarily in lowered profits, or losses. This is the process of readjustment which is to be expected in a relatively free market and economy. The alternative of elaborate controls calculated to minimize fluctuations in output and supply is oppressive, cumbersome, and expensive. It is doubtful whether such elaborate controls are ever necessary to regulate all facets of the economy. In the writer's view more elaborate controls are not justified now. As a matter of long-term policy many of our current policies and procedures need to be simplified and streamlined.

(*b*) Inflationary trends have been supported to a considerable extent by the expanding level of private and public debt. If the ratio of total debt to personal income increases, the opportuntties for investment are expanded. In the past a substantial part of investments have been used to expand plant, machinery, and equipment. Such investments are made with the expectation that unit costs of production will be relatively more favorable, and/or that market demand will increase. The dilemma of the American economy is that no certain guides exist for determining how much or how little capital expansion should be undertaken at any given time. Perhaps scheduling of capital expansion for 6 to 10 years in advance would help some. It would assist the construction and building materials industries to stabilize their output and employment. Considerable elasticity in this sector of the economy is perhaps inevitable, but it seems quite unnecessary for these industries to operate on a boom and bust basis.

A gradual inflationary trend is not necessarily essential to the growth and development of the Nation's economy. As suggested in question 1, inflation is brought about by disparities in the ratio of prices to income in different sectors of the economy. When one sector advances at the expense of another internal pressures are built up which seek to restore the relationship of some previous period. Wage increases are followed by price increases, or vice versa. Such wage-price spirals impair the income and purchasing power of annuitants, pensioners, and of all persons and institutions whose incomes are derived from bonds and/or mortgages. This results in some transfer of investment funds into channels in which earnings from investment have a more attractive relationship to current prices. Such pressures become inflationary when output and consumption are high. If consumption for any reason declines and continues below productive capacity for any considerable period the general effect is deflationary. If such a readjustment is met with measures calculated to increase purchasing, production, employment, and relative total debt, and if such measures are successful, then another round of inflation begins. The Nation has been going through this cycle periodically since 1939.

It may well be that a gradual inflationary trend is the price that the Nation must pay in order to maintain its position as a world power. Developments since the end of World War II strongly suggest this. People differ sharply as to the need for such a high level of governmental expenditures. The level of such expenditures has been so high for so long that a sharp and sudden reduction in governmental outlays would throw the whole economy into a tailspin. Reductions should be gradual and spread over a long enough period to permit the private sectors of the economy to readjust if we are satisfied with the amount and kind of national security such a policy will buy.

12. The growth of private debt in the American economy during recent years has contributed to fluctuations in production, employment, and to changes in the pattern of spending. In 1950 individual private debt was equal to about 48 percent of personal income payments, and increased steadily to about 64 percent in 1956. Such a change increases the amount of current income which goes for debt service for private individuals and business. More than 60 percent of the private debt is for home mortgages. In the housing field, the alternative to homeownership and debt is rent, hence the increase in mortgage debt has some advantages for the borrower. As individual buyers incur additional debts, including mortgages, the amount available for other purchases decreases. If the consumer elects or is obliged to restrict his purchases for lack of credit, inventories accumulate and eventually production and employment decline. In a sense we are paying today for goods bought yesterday, and as a result can buy less today. Those who have lost their jobs due to cutbacks in production can buy even less.

There is little doubt that the contraction of consumer credit would work a hardship on many sectors of the economy and this would be deflationary for the period during which consumer loans were being liquidated. If the economy survived such measures it would be stronger for the long pull. This suggests that much of our recent economic expansion has been based on the expectation of gradual inflation which in turn has encouraged an expansion of lending and borrowing. If the price-income ratio were to remain stable or decline somewhat, individual borrowing, which anticipates inflation or increases in value, would tend to be curtailed somewhat. It appears that further increases of private debt in relation to personal income should not be encouraged.

Debt, whether it be public or private, in the long run has similar effects on the economy. The size of the total public and private debt in relation to income and production have not changed greatly over the last half century. During the last decade there have been many pressures which indicate that this historic ratio may increase. Lending policies that are increasingly liberal tend to increase the dependence of the whole economy on credit expansion and this is an inflationary force. On the other hand, if credit were restricted and sharply curtailed the result would be deflationary and would undermine many established credit businesses in our economy. The major problem appears to be one of keeping the credit within bounds and such decisions in the last analysis depend upon the decisions of lending institutions when applications for loans are made.

13. One of the major shortcomings of Federal policy for many years is the fact that it has never been prepared to deal promptly with large increases in unemployment which accompany decreases in consumer demand and production. At present the people in distress are those who have lost their jobs and have no current source of income. Many of these people have been helped for a while by unemployment compensation benefits. Such benefits, of course, soon exhaust themselves and unless the worker can find another job he is without any source of income. Such proposals as income tax cuts will in no way benefit these people who have already lost their eligibility to pay such taxes. Income tax cuts at this time would benefit only those who have such tax liabilities and would do little to help the unemployed. Furthermore, such activities as public works programs cannot be started overnight. The most that can be hoped for is that the dates for commencing such projects which are ready be advanced. Accelerating the planning of public works and moving to the point where they can be let for bid will provide for an expansion of employment some months hence. Only those which can be commenced without delay will meet immediate needs for absorption of the unemployed.

Increasing unemployment is a special kind of emergency. In many respects it does not differ from floods, drought, or the catastrophes of war. If progress is to be made attention must be centered on those sectors of the economy that need help now. This means that such measures as the extension of unemployment benefits for those who have used their benefits be made now. Increased appropriations for direct relief for those who are jobless would carry these people until they can return to work. Meanwhile those sectors of the economy which are not in trouble require no attention at this time. Relief funds, if appropriated promptly to local governments, could in many instances be used for local cleanup and beautification projects which can be organized fairly promptly. To the extent that the person in need of relief money can render some service in exchange for the grant, his self-respect is maintained and the public gets some benefit from the money spent in addition to relieving the distress of the individual.

Such proposals as increased Federal spending and tax reduction at the same time make little sense. All that could hope to be accomplished is to postpone the day of reckoning and encourage continued inflation. Such a policy does not auger well for the domestic economy and places the United States in an increasingly difficult position in the matter of foreign trade. Debt, however acquired, must be paid in one way or another. One of the ways in which we have been managing public and private debt is through inflation. It seems pertinent at this point to examine critically any proposal which would deliberately foster further inflation. Such action should be taken only as a last resort.

14. Deficit spending by the Federal Government since the end of World War II has contributed to inflation by indirectly encouraging more expansion in the private sectors of the economy than would have been likely otherwise. There has been a disposition on the part of many people to accept the notion that man's wants are unlimited and for this reason there is no such thing as overcapacity, or overproduction. While one may admit that perhaps man's wants are unlimited his ability to use the services and appliances reflected by these wants is indeed limited. In a practical sense then, there is some limit to the number of automobiles that can be produced, sold, and driven. Similar circumstances are also true of other types of commodities. Thus if production and capacity are expanded too much faster than current rates of use, sooner or later dislocation occurs. It may be that too many television sets were sold last year so that it becomes more difficult to sell them this year. Within a year or two this situation will adjust itself. Tinkering with the production and distribution requirements cannot be expected to exert great influence over the basic relationship of supply and demand.

For some months plans for the expansion of plants and facilities among many private corporations have been modified. A general reassessment of the time at which such additional facilities will be needed is taking place. The result is that additional construction of new facilities for manufacturing and distribution industries has slowed down. There appears to be a need for a period of adjustment for the whole economy. The most urgent problem is relief for the unemployed and this should be dealt with directly rather than indirectly. If the unemployment emergency is handled as a relief problem there will be less need to attempt other hastly and ill-considered measures.

15. Full employment can be attained without reducing the purchasing power of the dollar if one allows for some flexibility in the definition of full. Some flexibility in the interpretation of the meaning of full employment is essential, otherwise the concept becomes arbitrary and unrelated to the circumstances under which individuals must live. This interpretation implies that employment to be full, may need to be shared during periods of decreasing demand. Reduced output has usually been used to prune the less efficient and effective workers. These have been dropped and become unemployed, while the more efficient and those who have seniority stay on and re-

main fully employed. If shared employment during periods of declining demand were more widely used by both industry and labor the demands made on Government for relief of unemployment would be less. The procedure in our society has been to shift misfortune and burdensome matters from one sector to another whenever possible. As unemployment increases the needs of the unemployed are met one way or another. To the extent that business is unable to continue the worker in employment, the burden is shifted to the community which means to some level of government. To accept this responsibility the Government must in turn tax business and individuals to provide the funds to underwrite this particular risk. If widespread employment is not met by Government it must be met by private individuals who help one another or who raise funds for various charitable purposes. However we look at unemployment, the more fortunate must provide for the less fortunate in some way or other during times of distress.

The way in which unemployment is dealt with can make considerable difference to the economy as a whole. The more elaborate the procedures for dealing with temporary and cyclical emergencies, the more involved and expensive the program becomes. The ability of the Nation to fulfill the goals set forth in the Full Employment Act of 1946 calls for prudent and effective management of temporary and emergency conditions.

16. Escalator provisions in wage and other contracts are not necessarily incompatible with economic stability. To a very considerable extent escalator provisions are designed to promote economic stability and to provide an incentive for increased productivity. The escalator provision in wage and salary contracts is based on the assumption that the purchasing power of workers will be more stable if wage levels are adjusted periodically to changes in the cost-of-living index. Such provisions have worked in the interest of stability. Business and industry so far as possible attempt to negotiate long-term purchase contracts at stable prices. The purpose of contractual obligations and escalator clauses is similar in that each attempts to preserve for some period in the future the same relationship between cost, price, and profit that has prevailed in a pervious period. Circumstances often develop which increase the difficulty of maintaining these relationships. Escalator provisions, like many other tools, must be used wisely if they are to make their full contribution toward economic stability. If the provisions in such contracts are unreasonable or the administration of the contracts is unwise, escalator provisions can be troublesome.

17. The causes of the present recession are somewhat obscure and not fully understood despite the fact that there are many current diagnoses of our situation. And there have been many proposed cures. It is one thing to identify what appear to be the main forces and institutions which affect our economic fortunes from one time to another and quite another to know how to manage these institutions in such a way as to promote maximum stability at all times. It is in this latter field that our methods and practices are perhaps not as well understood as in the matter of identifying forces and institutions. A management policy which seemed appropriate at the time it was made may prove to have been a mistake later. Perhaps an

illustration may help. A loan should benefit the borrower, the lender, and in a more remote way, the public. These three basic conditions must be satisfied for a sound loan and for sound use of credit generally. While there is some latitude as to what may constitute soundness it is unlikely that the manipulation of reserve requirements or interest rates will alter these basic considerations. Boosting reserve requirements and scrutinizing loans will act to curtail credit and such measures are justified when the practices of lending institutions are governed more by general regulations than by the essential objectives of sound credit. In short, the purpose of regulatory credit machinery is to reduce or limit abuses and not to obstruct the sound use of credit.

While it may appear a little trite perhaps the most important cause of the present recession has been the vigorous race for supremacy between competing businesses during the past decade. This has resulted in overextensions of productive capacity, and to vigorous high-pressure sales campaigns which have encouraged the consumer to buy more and more things. To promote sales and production goals consumer credit facilities have been expanded to enable the consumer to buy now and pay later or to pay as he uses. So long as the rate of activity in all of these arrangements continues at the same level or at an increasing level, everybody prospers. The mechanism, however, is so delicately balanced that a drop in consumer demand can back up all the way to the producer of the raw materials. What this actually means is that if total consumer demand is miscalculated even vigorous and frantic sales efforts may be unsuccessful in moving inventories. The economy cannot go forward until demand, production, and sales are brought into a better state of balance. Such fluctuations have occurred in the past and should not be considered as unusual now. The primary needs at the present time to curb the inroads of the recession are measures which will directly benefit the unemployed and those in need, and to defer any consideration of measures which would modify the ground rules under which our economic system has been operating. Certainly any changes in the ground rules should be fully and carefully considered before adopted.

YALE UNIVERSITY,
DEPARTMENT OF ECONOMICS,
COWLES FOUNDATION FOR RESEARCH IN ECONOMICS,
New Haven, Conn., February 25, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

MY DEAR SENATOR: Thank you for your letter of February 17 inviting my views regarding the financial condition of the Uinted States. I am sorry that I do not have the time or competence to answer all the questions you have put. On many of the questions of policy I do not have firm opinions; on many of the questions of fact and diagnosis I fear that our knowledge leaves the answers still uncertain. It would therefore take a very long essay indeed to give not only answers to the questions but also the reasoning behind the answers and the qualifications and uncertainties with which they should be hedged.

I will therefore confine myself to stating certain personal convictions on the key issues your questions raise, without being able to explain the reasons that have led me to them.

1. Price stability is a proper and important goal of economic policy, but it is not the only goal. It should not be pursued as an absolute, regardless of the cost in terms of other objectives. Full employment and economic growth are also important objectives, and some balance must be struck between these goals and the prevention of inflation. In my opinion, both Federal Reserve policy and fiscal policy have in the past 2 years been too greatly dominated by fear of inflation. It is for this reason that the Federal Reserve has been so late and so cautious in easing money, even though the signs of a slackened growth rate and a coming recession have long been apparent. It is for this reason that the budgetary policy of the administration is still directed toward limiting Federal expenditures and balancing the budget. I find the social costs of this quest for price stability too great. We are wasting our resources and our potentials for growth at a time when compelling international and domestic needs remain unsatisfied. I am not sure that the sources of recent rises in consumer prices are vulnerable to fiscal and monetary policies, unless the economy is made to suffer prolonged and substantial unemployment and excess capacity. These sources are partly the cost-push due to wage pressures, partly the delayed adjustment of some fairly sticky wages and salaries, utility rates, rents, and prices of services to the earlier postwar inflation, partly the reversal of the decline in agricultural prices. In order to prevent the obvious evils and inequities of inflation from having an undue weight in the formation of Government economic policy, I favor the institution of inflation hedges to protect the mass of small savers who are now, through lack of means or knowledge, too vulnerable to changes in the purchasing power of the dollar. The Government should offer bonds with purchasing

power guaranties; and variable annuities should be available to purchasers of life insurance.

2. In my view, deficit spending is now called for to get us out of the recession. I fear that the Federal Reserve has waited too long; business prospects have deteriorated beyond their control. The fringe of unsatisfied borrowers who would have gladly responded to an easier money policy 6 months earlier has now evaporated. The job is now one for fiscal policy rather than monetary policy. The needed deficit spending could be accomplished either by a tax reduction or by increased expenditure. I believe that a tax reduction would be a wasteful way of employing the labor and capacity the recession has made idle. The added consumption a tax cut would stimulate is of much lower priority, in terms of national need, than increased public expenditure for defense, education, highway construction, and other purposes. I do not favor make-work schemes of expenditure, but rather the immediate adoption of expenditure programs that could claim a high priority for resources even if we had no recession. Indeed at a later date, when the recession is conquered, it may be necessary to increase taxes in order to sustain these important programs without causing inflationary pressure.

Cordially,

James Tobin, *Sterling Professor of Economics.*

YALE UNIVERSITY,
DEPARTMENT OF ECONOMICS,
New Haven, Conn., April 10, 1958.

Hon. HARRY F. BYRD,
Chairman, Senate Committee on Finance,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: In response to your letter and questionnaire of February 17, I am giving you my views on some of the points raised.

All of the questions strike me as important, but many of them are very broad. On quite a few, the discussion has already jelled into fairly standardized patterns. In such instances, all one can really do is to register one's vote on the issue, without much hope of contributing a new idea.

Question 2. To improve our anticyclical policy, I would suggest the following:

(*a*) Provide some flexibility in withholding taxes, at the discretion of the President, for limited periods, say up to 6 months. Extensions of tax cuts beyond this ought to be subject to congressional action.

(*b*) Excise taxes might be made flexible and subject to the President's discretion. This might be particularly effective in periods of inflation, because the expectation that excise taxes may be cut causes people to delay their purchases, as we are seeing right now. An increase in excise taxes during inflation might have a powerful anti-inflationary effect, although it would temporarily distort the cost-of-living index.

(*c*) Price stability as an objective of policy might be written into the Full Employment Act.

(*d*) The advisability and fairness of subjecting industrywide labor unions to the antitrust laws might be studied.

Question 3. The Federal Reserve on the whole has done a very good job. In the preaccord period they might have struggled a little harder to get away from Treasury control a little earlier. Their fears that the bond market might collapse if credit controls were applied now appear to have been exaggerated.

In the postaccord period, I think the Federal Reserve did a good job in meeting the recession beginning in 1953. In the 1957 recession they probably overstayed their market.

The lessons of recent Federal Reserve experience I would summarize as follows:

(*a*) The effectiveness of Federal Reserve policy has perhaps come to be overrated since 1953, because of their relatively easy successes under favorable conditions.

(*b*) The absence of overall coordination of credit policy, including FHA, VA, CCC, etc., has become quite noticeable. I would hesitate to suggest some sort of monetary council, however, if that should lead to a serious abridgement of Federal Reserve independence.

(*c*) The evidence suggests that Federal Reserve restraint falls rather heavily upon investment, as against consumption. The result is to restrain growth. Flexible fiscal policy works mainly on consumption, rather than investment. If inflation restraint could be exercised more predominantly through fiscal policy we would probably get more growth. But before reducing the role of monetary policy, I would like to be quite sure that fiscal policy has really been placed on an efficient anticyclical basis, with adequate flexibility. At present, we have nothing of the sort.

(*d*) Recent evidence also suggests that monetary policy falls with disproportionate weight upon small business and upon municipalities. This evidence, however, ought to be studied more carefully before it is used in drawing conclusions as to the usefulness of monetary policy.

(*e*) Regulation of consumer credit and housing credit may become desirable if boom conditions such as experienced in 1955 should recur. It is particularly important that credit terms be tightened and shortened in good times so that in bad times we have something to relax. In our present recession, we are handicapped by the fact that automobile installment terms are already so long that they can scarcely be lengthened.

Question 4. The present inflation, in my opinion, was caused more by the action of labor and business in raising wages and prices than by excessive consumer demand for excessive money supply. As between labor and business, I believe that the main responsibility for inflation belongs to labor for two reasons:

(*a*) Profit margins of business have been shrinking rather than expanding recently. Business, in raising prices, usually has done no more than try to maintain profit margins. Labor, on the other hand, has demanded and obtained wages in excess of productivity gains.

(*b*) Labor, with a total share in the national income of about $220 billion, is much larger a factor than business with its profits (corporate and unincorporated) of about $70 billion. From 1950 to 1955, for instance, compensation of employees increased by $67 billion or 43 percent. Of this amount probably less than $30 billion (an increase of 20 percent) can be attributed to productivity gains. Inflationary wage demands of this magnitude would eat up the large part of profits in a few years, supposing business did not raise prices. Evidently such wage increases cannot go on indefinitely without inflation, even if business were disposed to sacrifice all profits.

Question 5. The importance of the national debt has been greatly overrated so long as the debt is competently managed. By that I mean an effort to maintain its maturity structure, avoid pegging of bonds by the Federal Reserve, and an obligation for the Treasury to pay the rates demanded by the market. If the debt is managed by reliance on Federal Reserve support it will most probably contribute to inflation, as it did before 1951. A very much smaller debt, however, equally mismanaged, would have the same effect. Although I see no objection to occasional increases in the debt as a result of antirecession policy, I would argue that in good times we should pay it off as a means of increasing capital formation. So long as the economy functions at full employment, the paidoff security holders will have to look for new investment outlets which will stimulate the growth of the economy.

Question 6. In the long run there is probably no serious conflict between stability of prices and economic growth. In the short run growth usually could be accelerated by inflationary policies. Assuming we were willing to pay this price, it would still remain doubtful how long the beneficial effects on growth would continue without being nullified by the adverse impact of inflation on saving, investment decisions, and productivity. The amount of inflation that we could "get away with" is probably less today than it has been in the past, because everybody has become conscious of inflation. The adverse effects, therefore, are likely to follow more quickly nowadays.

Question 7. I believe that Federal spending for a good many purposes today is too low. Among these I would include education, health, social security, cultural affairs, research, roads, parks and bridges. Federal spending strikes me as too high for agriculture, veterans, and rivers- and harbors-type projects.

In general, I believe that our standard of living has reached a point where the consumer can get more value in many cases for a dollar spent by the Government than for a dollar spent for himself. I base this upon my relative appreciation of education, research, health, and cultural projects, as against tail fins, TV's, and soft drinks.

Question 8. I would like to see certain reforms in our Federal tax structure, such as cuts in the personal and corporate income tax and a broadening of excises to make up the loss of revenue. On the whole, however, I think that our present taxes are not too difficult to live with. While they damage incentives and distort the use of resources, the damage probably is not overwhelming. Thirty years ago, the present tax system might have raised havoc, but meanwhile we have largely adjusted to it.

Many people greatly overestimate the effective burden of income taxes. A 20-percent effective rate does not apply, for a couple with 2 children and 10-percent deduction, until well above $20,000.

I would not want these general observations understood as arguing against a reform of our tax system as soon as possible, however, along the lines suggested at the beginning of this question.

Question 11. (*b*) A little inflation, in limited doses, is probably beneficial to growth and employment, as I have argued under question 6. Whether the chances of achieving the right dose are good enough to warrant making this a goal of policy seems quite doubtful to me. In practice I would, therefore, aim at price stability as the goal. I would argue for this even if it meant a somewhat lower rate of growth and a somewhat higher rate of unemployment, because permanent inflation strikes me as unethical and incompatible with a healthy social structure.

At the same time, it is obvious that the conflict of price stability on one side and full employment and growth on the other may be very serious. Depending on the behavior mainly of organized labor it may take so large an amount of unemplyment as to make the pursuit of price stability politically impossible. If, as I fear, that is our present situation I would suggest legislation along the lines suggested in my reply to question 2.

Question 12. Someone who believes in saving cannot be consistently opposed to debt. The savings must be borrowed if the economy is to remain stable. It is quite possible, however, that housing credit and consumer credit may have gotten out of hand in recent years. A tendency for corporations to overborrow may flow from the corporate tax structure.

I do not think that conditions in these fields are serious today, although a prolonged and deep recession might put a different face on this judgment. For anticyclical reasons, I would like to see some tightening of consumer and housing credit, as indicated under question 3.

Question 13. The answer seems to me to depend on the degree of inflationary danger. In the absence of such danger I would favor prompt action to bolster overall demand, but not to prop up weak industries that are in a long-term downtrend, such as agriculture and textiles.

Question 15. See answer 11 (*b*).

Question 16. Escalator contracts may be a serious threat to stability. A study should be made to get at the true range of effectiveness. Basically, however, they are a symptom more than a cause of inflation, and the proper cure is to stop inflation.

Question 17. With regard to action against the recession, I would suggest a suspension of the withholding tax for a month or 5 weeks, if there are no clear signs that the recession is bottoming out by the end of April. A tax holiday of this sort would give the economy a quick shot in the arm and help to clean out topheavy inventories. It would not give away revenues permanently, as a permanent tax cut would. The results of the action could be observed almost immediately, again in contrast with a smaller but longer tax cut. A year-end adjustment would have to be made so that all taxpayers get the same proportionate cut.

I would also like to see expenditures increased as an antirecession measure. Unfortunately, the kind of expenditures that are being voted these days do not seem to me to be of the highest priority. Their timing, moreover, will probably produce a maximum impact 1 or 2 years from now. Therefore, I limit myself to suggesting greater expenditures for research and education.

Sincerely yours,

HENRY C. WALLICH.

UNIVERSITY OF PENNSYLVANIA,
WHARTON SCHOOL OF FINANCE AND COMMERCE,
Philadelphia, Pa., March 10, 1958.

Hon. HARRY F. BYRD,
Chairman, United States Senate Committee on Finance, Washington, D. C.

DEAR SENATOR BYRD: Enclosed is my reply to the questionnaire forwarded in your letter of February 17. Please note that the two articles attached are an integral part of my reply.

Sincerely yours,

C. R. WHITTLESEY,
Professor of Finance and Economics.

ANSWERS TO QUESTIONNAIRE ON "INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES"

(Several of these questions are adequately discussed in a number of textbooks on money and banking. I have treated some of them in my own text more fully than I possibly can do here. Certain of them are covered in articles I have written, copies of two of which are attached.)

1. Give a definition in your own words of deflation and inflation.

There is no "correct" definition of these terms. Differences reflect the choice of different individuals as to features which they particularly wish to emphasize. The words conform best with general usage, however, when they are thought of as follows:

> Inflation, a persistent tendency toward rising price levels. "Creeping inflation" customarily refers to a continuing price-level rise amounting to around 2 percent a year, but unless qualified a considerably greater rate of increase than this is ordinarily implied by the term "inflation."
>
> Deflation, a situation of growing unemployment and idle capacity with some tendency toward weakness in prices.

2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

Changes which have taken place in the past quarter of a century have greatly moderated tendencies in the direction of deflation while somewhat increasing tendencies toward inflation. Reasonably intelligent monetary and fiscal policies (such as many competent economists inside and outside the Government are qualified to describe in detail) are sufficient to prevent serious inflation or deflation. The chief requirement for such policies is a reasonably high degree of freedom and independence for the monetary and fiscal authorities. The principal threat to such freedom is political interference originating with a wide variety of pressure groups.

If greater independence to pursue stabilization policies can be safeguarded by law this should be done. In addition, the Federal Reserve should be given further powers, including standby authority to regulate consumer and mortgage credit and possibly to impose special reserve requirements. (Present difficulties in the automobile industry as well as current problems of overcapacity could have been greatly ameliorated by the use of selective credit controls in 1955, as I suggested before a congressional committee at the time.) Laws should be enacted to enable the activities of the governmental lending agencies to be effectively coordinated with those of the monetary and fiscal authorities.

3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942 to 1957. (You may wish to divide the period into two parts, 1942–50 prior to the accord, and 1951–57.)

I have discussed all but the latest phase of this subject in an article entitled "Central Bank Policy in the Light of Recent American Experience," published in the Weltwirtschaftliches Archiv. A copy of this article is attached. As is pointed out therein, pages 22–24 and elsewhere, gross misconceptions prevail with respect to events, attitudes, and policies before and after the accord of 1951. Consciously or unconsciously, many of these misconceptions have been propagated by officials in high places.

Changes which have taken place in recent decades have rendered the Government bond market inherently unstable. Monetary (and to a less extent fiscal) policy has failed to make sufficient allowance for this fact. The latest gyrations in the bond market occurred in 1957–58 but are sufficiently explained in the article mentioned above, especially pages 29–30, 40–41, and in another article entitled "Monetary Policy and Economic Change" published in the Review of Economics and Statistics, copy of which is also attached. (Please note especially pp. 33–35.)

4. Beginning in August 1956 there was an increase in the Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

A minor correction: The rise in prices was not a cause of the fall in the value of money. Each is an expression of the other; they change together and necessarily in a reciprocal, i. e., inverse, relationship.

An important factor in the price rise was the somewhat fortuitous but sharp increase in the food component of the index in 1956. The impact of this factor was relayed through escalator clauses in wage contracts. A rather more basic element was the overexpansion of plant and equipment expenditures. This was influenced by overoptimistic expectations arising out of earlier excesses in consumer credit extension and in the demand for automobiles. The expression "wage-price spiral" describes a process; it does not explain causes. Fluctuations are inescapable in our free-enterprise, free-choice economy, but this particular disturbance could have been moderated by a judicious use of selective controls (as President Allan Sproul of the Federal Reserve Bank of New York and various academic economists argued at the time).

5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

The enlargement of the public debt came about so suddenly that our thinking and our policies failed to keep pace with it. We have tried and still are trying to maintain a small-debt philosophy in a large-debt world. Both Treasury and Federal Reserve officials have been at fault in their approach to the problem of the national debt.

The large national debt is not an unmixed evil. It has helped to impart stability to our money supply and safety to our banks and other financial institutions, but it has done so at the cost of an inherent tendency toward instability of the Government bond market. Fluctuations in security prices and interest rates have been so large as to contribute to self-inflammatory movements in the security markets, interfere with Treasury financing, create manifold injustices in the form of windfall gains and losses, and probably distort production and trade. I believe that we shall learn from experience and that by 1970 or perhaps sooner shall be managing the public debt quite differently from the way it has been managed up to now. The basic difficulty is that we have carried forward from a small-debt past ideas which are unsuited to the large-debt world in which we live and are destined to continue to live. The Canadians seem to have done a better job with debt management than we have; I suspect that we could learn a great deal from them.

6. (*a*) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand, and employment.
3. Economic growth in production, demand, and employment.

All three of these objectives are highly desirable. No rigid order of priority among them should be attempted; our goal must be to achieve all three. They are not incompatible or over the years necessarily in conflict. The important point to bear in mind is the need to effect a balance among them, recognizing that in order to achieve a satisfactory measure of one, for example, price stability, we may sometimes have to forego for the time being a conceivably attainable degree of another, for example, economic growth.

The danger lies in setting too narrow a target. If, for example, we were to establish a goal of no more than 2 million unemployed at any one time we should quite certainly be confronted with the imminent danger of inflation. On the other hand, if we were to set our goal in terms of a range of, say, from 2 to 5 million unemployed there need be no conflict among the three objectives. To arrive at the precise terms of an economic program would require careful study but one thing is certain, at the extremes, i. e., where either inflation or deflation threatens to cross the predetermined limits, the authorities should be prepared to move with the utmost vigor and dispatch. The certainty that strong measures would be forthcoming at the extremes would automatically tend to induce such responses on the part of the consuming and investing public that the probability of intervention by the authorities, far from being increased, would in fact be minimized.

6. (*b*) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

The price rise that occurred in 1955–57 was excessive and could and should have been avoided. Employment was perhaps at a level in excess of what is readily compatible with price stability. Certainly the rate of growth in business investment appears to have been abnormally high. In short, we did not effect a happy balance among the objectives of price stability, full employment, and economic growth. To the extent that we overdid the second and third objectives, high-level employment and growth, we interfered with attainment of the first, stability of prices. And if the result should be to have produced a depression the long-run effect may well have been to obstruct all three.

7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

Sustaining.

8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

The tax system of none of the governmental units approaches the ideal but we are pretty well adjusted to them. The familiar contention either that they impair incentives or seriously distort economic activity is not well substantiated. Waste and extravagance are undoubtedly encouraged to some extent. Tax reform is a perennial problem, but at any given time its importance is less than crucial.

9. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy, and then relate them, one to the other. Please discuss these policies, stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

This topic seems too elementary and detailed to enter upon here. I cover these matters in several chapters of my Principles and Practice of Money and Banking, Macmillan, revised edition, 1954. They are adequately discussed in many other texts and treatises.

10. (*a*) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank credits.) Also, please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

An ideally better monetary system could be devised but the one we have is the best by far that this country has ever known and it is good enough for the job it has to do. From the standpoint of overall economic policy, the most important improvement would be to increase the independence (from the President and Congress rather than from the Treasury) of the Federal Reserve and increase its flexibility and the number and variety of powers at its disposal.

10. (*b*) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

Fiscal policies for promoting economic stability are unavoidably deficient in promptness and flexibility. Whatever is possible should be done to overcome these defects. On the whole, however, remedial efforts should be directed principally toward strengthening the so-called automatic stabilizers. We should, of course, continue to close tax loopholes, improve administration, and try to overcome inequities.

11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

A considerable number of unemployed are to be expected under full employment or even under inflationary, i. e., overemployment, conditions. In addition, bottlenecks, as the German experience demonstrated after the First World War, can cause heavy unemployment even with rampant inflation. The idea, however, that an unprecedented combination of excess unemployment and inflation existed in the United States in February and March 1958 is erroneous. There was no significant inflation at that time and much of the rise in unemployment was of a seasonable character. Our error lay in assuming that the low figures of unemployment to which we had become accustomed in the preceding 3 or 4 years, rather than a somewhat higher figure, were to be identified with conditions of full employment. My answer to this question, therefore, is twofold. First, to the extent that unemployment coincided with inflation, it was to be attributed to frictional elements or bottlenecks. Secondly, the popular notion that a new economic era, characterized by chronic inflation combined with abnormal unemployment, has arrived is a delusion which time will shortly disprove.

11. (*b*) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

No, such a course is neither desirable nor necessary. See answer to question 6.

12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy?

The level of debt in terms of both totals and components does not alarm me for reasons discussed in chapter 9 of the money and banking text referred to above. The most important feature of debt is the rate of change in its amount, since it is this that is closely related to current spending on consumption and investment. A glance at the Federal Reserve Chart Book, Historical Supplement, will show how rapidly various forms of debt have risen in the United States since 1945 (see pp. 54, 68, 71, 114). The impetus thus given to aggregate demand for the products of American industry was beyond what could reasonably be expected to continue.

I find extremely disturbing the thoughts that:

1. Our prosperity may have rested to a significant degree upon this rate of debt expansion.
2. The rate of increase may not continue.
3. It may continue.

My answer, then, is that I believe that the rate of growth of private debt has at times since 1945 been excessive to the degree of jeopardizing the stability and continuing vitality of our economy. Moreover, I believe that this threat could have been appreciably lessened if the views of Allan Sproul and certain others (myself included) had been allowed to prevail.

13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways,

such as a tax cut and/or large increases in public works, to counteract a downturn in the economy?

The general outlines of my answer to this question have been indicated in my answer to question 6. If we sincerely believe what we continuously maintain, namely, that this country has a strong and dynamic economy, we should give it an opportunity to demonstrate its strength and resiliency. We cannot do so by coming forward with governmental crutches at the first sign of a downturn in business. I recognize the natural fear that a decline may become harder to arrest because it is allowed to proceed too far. Nevertheless, I should refrain from such measures as are suggested here until unemployment and the decline in industrial production have gone considerably further than at present. Figures for unemployment reached nearly 5 million in 1950 with a smaller labor force than at present. For seasonal reasons the totals characteristically rise in the early months of the year. I believe that precipitate action should be avoided and extreme measures deferred until unemployment has risen above the 5 million mark at midyear or somewhat above that figure at the usual seasonal peak of February, but I should leave no doubt whatever that the action of the Federal Government would be all out once it had undertaken to stem the downturn. (This does not, of course, preclude such earlier easing of credit as the Federal Reserve has already undertaken.)

14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

Deficit financing since the end of World Was II was not a significant factor in causing inflation. The inflation in this period was mainly the delayed result of developments that occurred during World War II and of factors resulting from the Korean war. Even the upward movement of rents and services which figured in the rise in the Consumer Price Index was of this delayed character. The latest phase of the inflationary movement, 1955–57, was partly the result of miscalculations by businessmen which contributed to overexpansion in certain lines and overinvestment quite generally.

15. Can full employment goals be attained while maintaining a dollar that has relatively stable purchasing power?

Yes. A critical point in answering this question, however, is the determination of levels at which the employment goal is set. See answer to question 6.

16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

They are not incompatible, although they are a complicating factor. Their tendency is to prolong a self-inflammatory movement of prices and wages once it gets started. This is one of the reasons why we must not be premature in adopting expansionist measures when a lull in an inflationary movement begins. Likewise it is a reason for increasing the powers, flexibility, and independence of the agencies charged with maintaining economic stability. Obviously, also, it gives price stability key importance in the list of objectives discussed earlier.

In short, to the extent that we prevent an inflationary rise in the price level from getting started, escalator provisions are not a menace to economic stability. To the extent that we fail to accomplish this objective, they do constitute a threat to stability.

17. List and briefly discuss what you consider the cause of the present recession, and what should be done to terminate it.

Among the causes of the present recession I would list the following:

Overexpansion of business investment in 1955–57.

Overstimulation of consumer durables, especially automobiles, and of housing somewhat earlier.

Undue reliance on general instruments of credit control.

Misconceptions as to the nature and history of inflation in this country.

Shortsighted price and wage policies for which both employers and union leaders are responsible.

My recommendations as to policy are indicated in earlier answers, especially under questions 6, 13, and 16.

Central Bank Policy in the Light of Recent American Experience

By Prof. Charles R. Whittlesey, Philadelphia, Pa.

For the United States the period after World War II was noteworthy for dynamic, almost explosive, developments in the field of central banking. Pronounced shifts in policy occurred. Subordination of Federal Reserve policy to Treasury operations during and immediately after the war gave way to a high degree of freedom and independence. Extreme reliance on fiscal policy for influencing economic activity, which, like the subordination of the central bank to the Treasury, was largely a legacy from the great depression and the period of war financing, gave way to increased confidence, perhaps overconfidence, in monetary policy in the form of traditional central bank controls over credit. Inflationary stresses proceeding from the Korean crisis subjected both monetary and fiscal policy to a severe test which was only moderately well sustained. This was followed by periods of pronounced instability in the market for United States Government securities.

The most important development of all from a scholarly viewpoint was the publication of a series of significant documents relating to all phases of central bank policy including relations with the Treasury. These were the product of two separate investigations, carried out by subcommittees of the United States Congress headed respectively by Senator Paul Douglas, of Illinois, long a professor at the University of Chicago and a former president of the American Economic Association, and Representative Wright Patman, of Texas, who was well known for his interest in monetary and banking affairs. The materials embraced in these documents included, besides reports of the subcommittees themselves, lengthy and revealing statements from the Secretary of the Treasury, the Board of Governors of the Federal Reserve System, and presidents of the Federal Reserve Banks. In addition, there were oral testimony and written answers to questionnaires from professional economists, bankers, insurance officials, and others. The documents were supplemented and brought up to date by subsequent hearings and committee reports.

A final development worth noting was a considerable number of proposals, chiefly contained in the documents already mentioned, for modifying the Federal Reserve System itself. Some of these took the form of specific recommendations or tentative suggestions from the Board of Governors and other officials of the Federal Reserve System. Others came from outside the system. They ranged all the way from proposals for minor changes in operating technique to the recommendation by a highly regarded economist at one of the country's leading universities that the Federal Reserve System be abolished.

I. CENTRAL BANK POLICY FORM WORLD WAR II TO THE TREASURY-FEDERAL RESERVE ACCORD OF 1951

The history of the Federal Reserve System in the first years after the end of World War II is chiefly a record of attempts of the Federal Reserve authorities to throw off existing limitations on their power to control credit. These limitations were themselves largely a consequence of policies introduced during the war. On the day after the entry of the United States into the war the Board of Governors announced that its major objectives would be: "* * * to assure that an ample supply of funds is available at all times for financing the war effort and to exert its influence toward maintaining conditions in the United States Government security market that are satisfactory from the standpoint of the Government's requirements".[1] Within a short time two distinctive measures had been put into effect to carry out these objectives. They provided for the purchase and sale of Treasury bills at a guaranteed rate and for establishment of a fixed pattern of interest rates on all Government obligations.

The statement of Federal Reserve objectives was regarded as clearly necessary at the time and was accepted without opposition. Likewise, the two principal methods for carrying out this policy were accepted as reasonable and appropriate. It was only gradually realized that the combination of policies was incompatible with effective use of the general instruments of credit control by the Federal Reserve authorities. The basis of this incompatibility is not difficult to explain. The agreement by the Federal Reserve to buy Treasury bills at a guaranteed rate made it possible for any member bank holding bills to demand reserves whenever it so desired. The commitment to maintain a fixed pattern of interest rates on all Government securities extended this power of member banks to control the creation of reserves to all banks holding whatever types of Treasury obligations were in existence.

In order to prevent yields from rising above the established pattern of rates, the Reserve authorities were compelled to purchase any issue whenever it was offered at a yield corresponding to the established pattern of rates. These purchases by the central bank supplied member banks with reserves whether or not the banks were sellers of the securities purchased. Thus the inevitable consequence of providing a guaranteed market for Treasury bills and of establishing a fixed pattern of rates on other Treasury securities was to make it impossible for the Federal Reserve authorities to refuse to furnish reserves. The initiative in determining the volume of reserve had by these means passed from the central bank to the member banks or other holders of Treasury obligations.

[1] Federal Reserve Bulletin, vol. XXVIII, Washington, 1942, p. 2.

In short, because of the policy of supporting the Government bond market, that is, maintaining a pattern of interest rates, it was no longer possible for the Federal Reserve to control the volume of member banks reserves. Because the Federal Reserve could no longer control reserves, it could no longer control credit by means of the general instruments of credit control. This was the situation in which the Federal Reserve found itself in the period of strong inflationary pressures following the conclusion of hostilities.

The effect of the support policy in impairing the general instruments of credit control was first pointed out by certain academic economists. Even if this effect had been recognized in advance, however, it would probably have made no difference in the adoption of the support policy; orthodox monetary methods had fallen out of favor and experience in the First World War when interest rates were allowed to rise was interpreted as justifying measures to limit increases in interest rates.

By 1950, partly because of the inflationary pressures released by the Korean war, the Federal Reserve found itself at odds with the Treasury over abandonment of the policy of supporting Government securities at par, a step strongly resisted by the Treasury. The conflict was colored to some extent by political and personal considerations. Both at the time and afterward the issue was often depicted in terms of an attempt, by a more or less authoritarian and socialistic administration desiring to continue to finance an unduly expanded public debt at an artificially low rate of interest, to overrule an enlightened and dedicated body of central bankers who were fighting to defend the public against inflation and the free-enterprise system against subversion. As will be shown presently, any such interpretation is anything but precise.

In the end, and after intervention by the President, which for the moment had the effect of increasing rather than diminishing the violence of the controversy, an agreement was reached in March 1951 which has since been known as the Treasury-Federal Reserve accord. The rigidity of the support policy was relaxed and certain changes in Federal Reserve personnel were effected. The harmonious relations which existed between Federal Reserve and Treasury after the accord may, perhaps, be explained not only by the terms of the agreement but also by the fact that both sides had become thoroughly sick of the squabble and could recognize the damage which resulted from the spectacle of the monetary and fiscal authorities appearing publicly to be at such great odds.

The accord is generally regarded as constituting a turning point in the history of Federal Reserve operations. For this reason, and because of certain misconceptions concerning the events of the period, a brief review of the major issues is in order. In the first place, the independence of the Federal Reserve from Treasury domination became a rallying cry for more extreme supporters of the Federal Reserve and for numerous critics of the Democratic Party which was then in power. It was expressed most vehemently by the very persons who a little earlier had been least willing to grant the Federal Reserve additional powers to carry out duties with which it had been charged or to allow it to control consumer credit.

It is to be noted that the Federal Reserve is legally a creature of Congress and accountable to Congress. In this sense it is administratively distinct from and independent of the executive arm of the Government to which the Treasury belongs. Moreover, the Federal Reserve Act, under which the System operates, is a safeguard against undue interference in the activities of the Federal Reserve even by Congress itself. On these points there is no real dispute.

On somewhat broader grounds, however, the simple truth must be recognized that there can be no such thing as the literal independence of the Federal Reserve from the Treasury, or, for that matter, of the Treasury from the Federal Reserve. Each is a prisoner of the other. The actions of either are bound inevitably to enter into the discharge of the other's responsibilities. The problem, therefore, is not one of independence but one of coordination. The evidence of the postwar years suggests that the operational independence of the Federal Reserve is threatened less by the Treasury than by Congress which at one time interfered with Federal Reserve operations by changing the terms of regulation W for the period of consumer credit and at another time summarily removed the power of the Board to apply such controls.[2]

A second major issue involved in the Treasury-Federal Reserve accord had to do with the priority of objectives and means. In time of war, as is generally recognized, the wishes of the Treasury tend to dominate the actions of central banks. Such a subordination of the central banks is apparently not something forced upon them against their will, but conforms to what they also regard as a necessity under wartime conditions. Even in peacetime, officials of the Federal Reserve repeatedly accepted the view that the existence of a large public debt is a factor requiring modification of monetary policies employed under a different set of conditions. Thus in their Annual Report issued in the middle of 1949 the Board of Governors declared: "In earlier periods * * * Federal Reserve policies could be * * * directed * * * toward * * * reserves * * *. With a large Government debt which is likely to be a dominant part of the debt structure for many years, the Federal Reserve has to cope with the dual problem of maintaining an orderly Government security market and exercising control over the volume of bank reserves".[3] In the same year, the Chairman of the Board of Governors was even more explicit in defending the support policy: "The market for Government debt securities must be one where investors can deal at all times with confidence * * *. For the foreseeable future the support program must be continued. This conviction is shared by all members of the Board of Governors, the Open Market Committee, and the Treasury".[4] In these and similar statements, officials of the Federal Reserve repeatedly stressed the importance of stabilizing the market for Government securities. The Treasury, in turn, was no less specific in demanding that policies be pursued with a view to minimizing the danger of inflation.

It is a gross misrepresentation to suggest, as has often been done, that the Treasury was unmindful of the hazards of inflation and the Federal Reserve unmindful of fluctuations in the Government bond

[2] Somewhat similar infringements of the Reserve Board's freedom of action occurred in connection with the control of real-estate credit (regulation X) and the voluntary credit-restraint program both of which were introduced at the time of the Korean war.

[3] Board of Governors of the Federal Reserve System, Thirty-fifth Annual Report Covering Operations for the Year 1948, Washington, p. 4.

[4] Thomas B. McCabe in a speech at Philadelphia.

market. The major difference in the attitudes of the two sides was not over objectives but over the policies required to achieve those objectives. Earlier statements from Federal Reserve sources indicated a belief that powers they already possessed were adequate or that additional powers would be forthcoming which would make it possible at one and the same time to maintain control of reserves and orderliness in the security markets. The subsequent split between Treasury and Federal Reserve officials may be assumed to reflect in some degree a disillusionment on this score by Federal Reserve officials which the Treasury had not yet come to share. The question may be raised whether under the circumstances criticism should more properly have been directed toward the Treasury for having continued to stress the second objective, which the Federal Reserve only a short time before had likewise stressed, or toward the Congress which failed to provide the supplementary powers which were requested by the Federal Reserve as a means of attaining the dual objective.

It is also apparent that there was a considerable difference of opinion as to what constituted the most appropriate instruments for achieving economic goals. The Treasury continued to place considerable faith in fiscal methods of combating inflation as well as in the selective instruments of credit control. The Federal Reserve, on the other hand, came to the point of advocating almost complete reliance on the general instruments of credit control, particularly open-market operations and discount policy which were precisely the instruments which had been largely stultified by the support program. The Treasury's position, it may be noted, was dependent upon Congress taking appropriate action to resist inflationary pressure by imposing adequate taxation and authorizing the use of selective controls. This sort of cooperation Congress was not willing to provide.

The precise merits of the two sides in the dispute over the support policy are not always easy to determine. It is impossible even at this distance to say which was more nearly in the right. But it may safely be stated that the accord enabled the Federal Reserve to escape to some extent from a position of subordination inherited from the period of the Second World War and that it thereafter became possible for Federal Reserve officials to carry greater weight in the formulation of financial policies jointly with the Treasury.

Developments after the accord will be described presently. Here an attempt will be made to dispel certain misconceptions as to the nature of conditions that prevailed before the accord. The view is frequently encountered that serious inflationary conditions prevailed before the accord and that a degree of stability close to perfection exist after that time. The conclusion is likely to be drawn, even when not explicity supplied, that it was the accord that made the difference. Such extreme statements appear even in statements submitted to Congress by the Federal Reserve: "The facts are that debt was monetized in volume and that the country suffered a serious inflation until the Federal Open Market Committee abandoned the pegs. * * * During the period of pegging prior to the Treasury-Federal Reserve accord of March 1951 * * * the Federal open-market account * * * performed the function of making continuous markets for most maturity sectors even including the very short end of the market. It did so, of course, at the expense of monetary policies appropriate to the stability of the economy. The reserve funds that were made available almost automatically under the technique of pegging operated to augment the availability of credit and thus to increase the demand for commodities to a volume that was in excess of what could be supplied. The result was to incorporate into the base of the price structure a spiral of rising costs and prices. This inflationary process was stopped early in 1951 when the Federal Open Market Committee discontinued pegging the prices of United States Government securities." [5]

This statement of events has been challenged by Professor Hansen in words that merit extended quotation for their explicitness and force: "There occurred no 'mounting' monetization of the debt. On the contrary, Federal Reserve holdings were $5.1 billion *less* in June 1950 than in December 1946. The debt was not 'monetized in volume.' The banking system held $14 billion less bonds in June 1950 than in December 1946, while the nonbank public held $13.5 billion more. The money supply did not increase. Currency plus demand deposits stood at $110.2 billion in June 1950 and $110 billion in December 1946. We did not have continuous inflation in the preaccord period. Wholesale prices in June 1950 stood at the same level as in September 1947, a period of nearly 3 years. Loans and investments of commercial banks remained stationary from 1946 to 1948, but rose moderately before Korea. Member bank reserve balances stood at $16.1 billion in December 1946 and at $16.3 billion in June 1950. Money and bank credit were not running wild * * *. It would be difficult to find statements more misleading than those cited above. The reader is not told that the peg on the short-term was removed 4 years before the accord. He is not told that the support of the long-term was a floor support, not a fixed peg. He is not told that during most of the period the long-terms were selling above the support price. He is not told that the money supply in fact did not increase up to Korea. He is not told that wholesale prices were falling for about 2 years before Korea. The reader is led to believe that there was a continued spiral of rising costs and prices all through this period. Nor is the reader informed that the price spurt following Korea was stopped a month before the accord—the weekly index reaching the peak figure on February 13, 1951." [6]

The facts, as Dr. Hansen has shown, are clear enough for the period from the end of the war in 1945 to the accord in early 1951. What is not clear and in the nature of things cannot be wholly clear is what these facts prove with respect to the monetary policies followed during the period.[7] The basic cause of inflation after the war was the extreme liquidity then present in the economy. This liquidity was a product of methods of war finance over which the central bank had no control.[8] Rationing and other influences prevented the expansion of

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[5] United States Monetary Policy: Recent Thinking and Experience, hearings before the Subcommittee on Economic Stabilization of the Joint Committee on the Economic Report, December 6 and 7, 1954, Washington, 1954, pp. 278, 20. (Hereafter referred to as hearings of 1954).

[6] Alvin H. Hansen, "Monetary Policy," The Review of Economics and Statistics, vol. XXXVII, Cambridge, Mass., 1955, pp. 116 sq.

[7] It is to be observed that Dr. Hansen's marshaling of facts is designed to contest the certainty of claims advanced by others, not to support counterclaims of his own.

[8] Criticism of inflationary methods of financing the war, particularly the limited reliance on taxation, was voiced during the war by numerous academic economists, but, understandably of course, not by Federal Reserve authorities.

the supply of currency, demand deposits, and other liquid assets from forcing prices up during the war years. The very success of price-stabilization efforts at that time aggravated the inflationary potential at the end of the war. The strong demand for consumer goods and capital investment, together with the early removal of direct controls over spending, was enough to cause inflation in spite of anything the Federal Reserve could possibly have done.

General instruments of credit control, such as would presumably have been available in the absence of a support policy, might have made it possible to check monetary expansion. But this, as Professor Hansen points out in the article quoted, was not the problem; the basis of the difficulty, rather, was the purchasing power already in existence. Whether more vigorous application of the selective instruments of control, designed as they are to control the use of money already in existence rather than the creation of additional money, would have helped is quite a different question. But it may be that, as Reserve officials have intimated, pressure from the public and more directly from Congress would, in any case, have made impossible the use of selective instruments of credit control.

The purpose of this brief review has not been to provide a blueprint of Federal Reserve policy as it might ideally have been during the early postwar period but to show what actually occurred in order to indicate the complexities that existed at the time as well as some of the confusions and misconceptions that have arisen since. All this is essential to an understanding of developments in the period following the accord.

II. MONETARY POLICY AFTER THE ACCORD

1. Summary of economic developments

The accord had been preceded by an inflationary upsurge arising out of the war in Korea. Business activity continued strong for some time after the accord but without the previous strong upward pressure on prices. The index of industrial production had hovered around 100 in the years after the end of World War II, rising to an average of 104 in 1948 and falling to an average of 97 in 1949. With recovery from the recession of 1948–49 and under stimulus of the Korean war, the index rose to 112 for the year 1950.

The seasonally adjusted figure for February 1951, the month immediately before the accord, was 122 and the unadjusted average for the year was 120. The index dipped sharply in the middle of 1952, primarily because of a strike of steelworkers, but rose thereafter with the average for the year standing at 124. The strength continued into 1953, carrying the adjusted index to 137 at midyear. A sharp reaction then set in, but even so, the average for the year was 134. For the first 9 months of 1954, the adjusted index ranged between 123 and 125, and the average for the year, despite some improvement at the end of the year, was 125. Recovery from the recession of 1953–54 was rapid, however, and by the summer of 1955 the seasonally adjusted figure at 140 was above the previous peak.

A roughly similar story is told by unemployment figures. Unemployment remained low after the accord, reaching a low point of 1,162,000 (partly because of seasonal influences) some months later than the peak of industrial production was reached. A rapid rise in unemployed then followed which carried unemployment totals to 3,725,000 early in 1954. Subsequent improvement, while substantial, left the total of unemployed a million or so above the figure that had prevailed before the recession.

It was in the field of money rates, however, that the most spectacular changes occurred after the accord. For years the prices of Treasury obligations had been subject to support at par by the Federal Reserve and during much of the time they had prevailed at levels considerably above par. With the abandonment of the commitment by the Federal Reserve to support Governments at par and the subsequent issuance of securities bearing interest at 2¾ percent, the older 2½ percent bonds fell below par as did other issues. The yield on long-term issues fluctuated more widely and more frequently than they had done before the accord and, as was to be expected, shorter-term issues also moved with comparative freedom. The price of long-term Governments, which had stood at an average of 102.73 in 1949 and 102.53 in 1950, averaged 98.85 in 1951 and 97.27 in 1952. The figure for 1952 reflected a monthly low of 96.27 in January and a monthly high of 98.91 in May. The figure for November, the month in which the Republicans under General Eisenhower defeated the Democrats at the polls, was 96.96. A decline set in which was gradual at first and then increasingly rapid:

December 1952	96.32	March 1953	94.31
January 1953	95.68	April 1953	93.25
February 1953	95.28	May 1953	91.59

A low point of 90.74 was reached for the week ending June 6, with individual issues falling a little below 90.

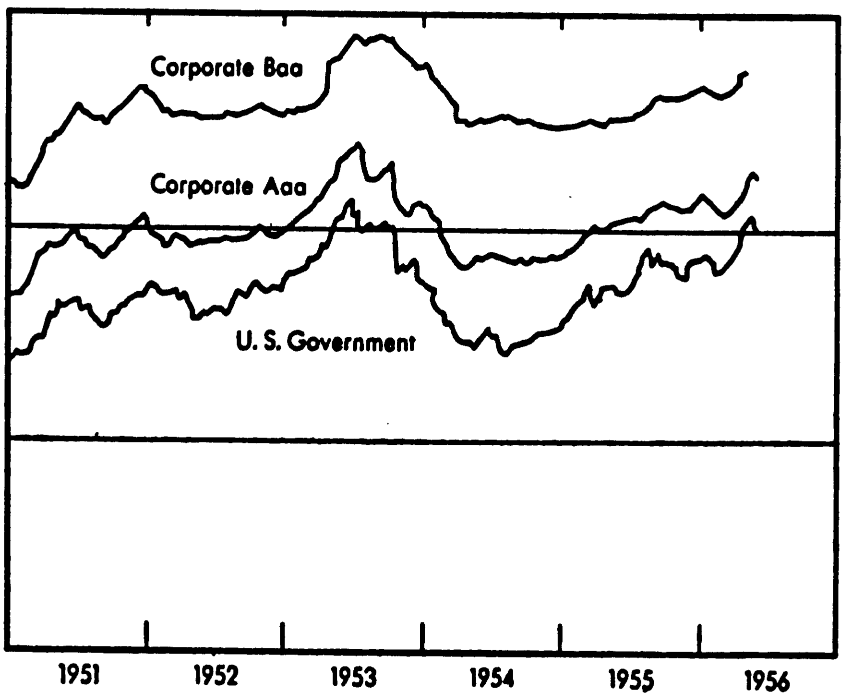
Following what was generally interpreted as a change in the attitude of the Federal Reserve toward steadying the Government bond market, a recovery set in and soon prices were rising as rapidly as they had fallen. For December the average stood at 95.85, close to where it had been in January. A month later it was at 97.42 and by April 1954 it was above par at 100.36. Prices close to par were maintained throughout 1954 but in 1955 weakness again devleoped which carried quotations down from an average of 98.97 in December 1954 to 94.04 in the last week of July 1955. After recovering from these levels weakness again developed in 1956.

Fluctuations of this character in the Government bond market, occurring at a time of peace, prosperity, and business optimism, were without precedent in the history of the United States. The fact that fluctuations in yields on short-term and intermediate Treasury issues were greater than on the long-term issues conforms to normal expectations. What comes as a distinct surprise is that Government bonds were less stable during these years than corporate bonds of either the highest or the next to the highest quality ratings (see chart I).

2. *Summary of Federal Reserve policies*

In an official statement the Federal Reserve reported that it endeavored after the accord: "* * * to adjust its policies so as to influence the level of bank reserves and the money supply in accordance with seasonal requirements, the capacity of the economy to produce goods and services, and sustainable economic growth in the economy. The discount function was restored as a means of supply-

Chart 1 – Bond Yields, 1951–1956[1]



[1] *Source:* Board of Governors, *Federal Reserve Charts*, Washington, May 1956, p. 25.

ing temporary needs for Federal Reserve credit in a manner that exerted restraint on unwarranted uses of such credit, thereby complementing open-market operations in influencing the availability of credit at member banks. Discontinuation of rigid pegging of Government security prices removed the possibility of monetizing the public debt through sale to the Federal Reserve System at the initiative of the holders, nonbank as well as bank, and without loss to them. The excess liquidity of the economy was thereby removed."[9] In resisting inflationary tendencies and later in its so-called policy of "active ease" directed toward combating the recession of 1953–54, chief reliance was placed on open-market operations.[10] Changes

[9] Hearings of 1954, p. 6.

[10] Federal Reserve authorities designated open-market operations as expansive or restrictive in terms not of their simple tendency when viewed by themselves but of their combined effect when taken in conjunction with other forces operating in the market. Thus net purchases of Government securities amounting to $1.8 billion in the second half of 1952 were classified as restrictive. They were restrictive in the sense that open-market purchases were limited to $1.8 billion rather than being of a larger amount; with purchases at this scale banks were still under pressure to borrow in order to obtain needed reserves. This is analogous to saying that purchases of $1 million of wheat have a depressive influence on price if it would take $1.2 million to offset changes elsewhere and prevent the price of wheat from falling.

It would be much more accurate to say that restrictive forces were operating to create a deficiency of reserves of, say, $2 billion and these were offset by purchases, necessarily expansive in themselves alone, of only $1.8 billion so that the combined effect was restrictive. Admittedly the net outcome is the same whichever way it is stated, but, aside from one's logical qualms over the way the Federal Reserve expresses it, the effect is to obscure, or even apparently to deny, the existence of nonpolicy influences operating in the economy. In the illustration given should not the restrictive effect be attributed to the external factors operating to create a shortage of reserves and not to actions by the Reserve authorities which offset them only in part? On the Federal Reserve's own assumption, to were also made in the discount rate. Removal or reduction of selective controls were timed, according to official announcements, not so much to influence economic conditions as to conform to congressional action or to relax limitations upon freedom of market action because they were no longer required. Later in 1955, small increases in margin requirements were introduced as a deterrent to undue activity in the stock market.

It may be said that during this period the Federal Reserve followed a highly orthodox, i. e., "correct," policy of keeping that degree of pressure or ease on member bank reserves that seemed suited, again according to orthodox principles of central banking, to promoting stability in business activity and prices. Reliance was almost wholly on the general instruments of credit control. The favorable course of economic developments, including the moderateness of the downturn in 1953–54 was widely accepted as a demonstration of the effectiveness of orthodox central bank policies.[11] The Federal Reserve authorities themselves were not above accepting a considerable share of responsibility for the prosperous state of affairs.[12]

The post hoc case in favor of following orthodox monetary policies during this period, while good, was perhaps not quite as good as was sometimes assumed. The claim that it prevented inflation, for example, runs up against the fact which was noted earlier that the peak of wholesale prices was already past before the accord went into effect. Prof. Gerhard Colm has suggested that not implausible assumptions could be advanced which would lead to quite different conclusions. It is conceivable that in the fact of mounting production, narrowing of the threat of global war, and swollen inventories, no serious threat of inflation existed after early 1951. It has been intimated by some that restrictive policies of the Federal Reserve may have been excessive. Prof. Milton Friedman has, in fact, gone so far as to argue flatly that the recession of 1953–54 was the direct consequence of restrictive measures adopted by the Federal Reserve.

Such words of criticism were distinctly the exception. In general, actions taken by the Federal Reserve during these years were regarded as having been intelligently formulated and of a character to contribute to the attainment of accepted goals of central bank policy. The precise degree of that contribution remains uncertain, as does the extent to which similar methods could be expected to cope with future disturbances.

Much greater controversy has centered about the violent fluctuations in prices of Government bonds, particularly in 1953. The Board of Governors tended to dismiss the incident as a simple market phenomenon of only secondary importance: "Interest rates rose during the

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have made no purchases at all would have been even more restrictive. It is extremely awkward to suggest that the purchases as such were restrictive.

To be exact, the Federal Reserve action was not of a character to restrict but rather to soften and ameliorate independent restrictive influences which were operating at the time. On this basis, the role of the Federal Reserve appears to be not that of a stabilizer which offset tendencies toward inflation and deflation, but that of a stabilizer which resisted the tendencies of independent forces to offset them too sharply. This may be of no less importance to the economy and is clearly no less to the merit of the Federal Reserve authorities. The distinction, however, is of great significance from the standpoint of intelligent interpretation.

[11] See, for example, Report of the President, Joint Committee on the Economic Report, Washington, 1955, p. 22.

[12] In discussing restraints applied in 1952–53 they stated that "inflation was prevented" (hearings of 1954, p. 8). The subsequent policy of credit ease was interpreted as making a major contribution to recovery from the 1953–54 decline.

period, reflecting the pressures of credit demand in excess of the available supply."[13] At other times the rise was interpreted as part of a tightening operation called for by the continuation of a severe inflationary threat.[14] On the other hand, various critics, particularly experts testifying before congressional committees, interpreted the sharp drop in bond prices as an unfortunate speculative incident resulting in considerable measure from bungling by public officials.

It may be recalled that the Democrats had been strongly criticized for maintaining interest rates at artificially low levels. Some of the most vocal of these critics succeeded to high positions in the incoming Republican administration. The financial community was inclined to assume, first, that the existing level of rates actually was unduly low and, second, that the new administration would allow or even encourage them to rise. It was expected that a vigorous effort would be made to lengthen average maturities of outstanding Treasury obligations by pushing the sale of long-term issues. Ensuing declines in the Government bond market tended to feed upon themselves. Reports circulated in financial quarters that lower prices were in prospect. Selling was induced, which contributed to lower prices, thereby substantiating the past rumors and generating fresh rumors of further declines. At this juncture the Treasury brought out a new long-term at 3¼ percent interest, a rate considerably higher than had been offered for many years.

The view that this was but the forerunner of still higher rates was strengthened by statements from the Under Secretary of the Treasury, a prominent ex-banker, that it would be the policy of the Treasury to offer whatever rate was necessary in order to meet the market. At about the same time the Chairman of the Board of Governors was quoted as stating in a public address that the Federal Reserve would intervene in the Government bond market only under extreme circumstances. The first official declaration was interpreted as an invitation to speculate on declining prices for Governments and the second as announcement of a policy of "let 'er rip."

By May and June, alarm over the weakness in security markets had become widespread. Without formal announcement of a reversal of policy, actions by the Federal Reserve in supplying reserves though open-market purchases and later in reducing reserve requirements were interpreted as constituting such a reversal. Thereupon expectation of a decline in Governments quickly gave way to equally firm expectations of a rise. With increased availability of reserves and a slacking in the demand for credit, banks and others who had been dumping Governments now turned to buying them. The rising trend tended to feed upon itself much as had happened during the preceding downward movement. No attempt was made by the authorities to interfere directly in stabilizing the market or Government bonds. Open market operations were confined exclusively to dealings in Treasury bills.

3. The problem of judging the effectiveness of monetary policy

Disagreement as to the exact role which monetary policies played in the events of the postwar decade, no less than the diversity of opinion

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[13] Hearings of 1954, p. 8.

[14] Such an interpretation is inconsistent with the statement in the Fortieth Annual Report Covering Operations for the Year 1953 of the Board of Governors that the reduction in margin requirements in February of that year was justified because by that time "inflationary pressure had moderated" (p. 88).

as to policies which should have been employed, calls for more detailed examination of the problem of measuring the effects of monetary policies.

A great deal of attention has been directed in recent years to the alleged "rediscovery of money." Growing confidence in the effectiveness of orthodox monetary policies contrasts sharply with the preceding attitude of doubt which was a heritage of the depressed years of the 1930's. It resembles in many respects the extreme confidence in Federal Reserve policies which featured the decade of the twentieth.

The question of the effectiveness of monetary policy is important not only on grounds of simple scientific accuracy. Some judgment as to the effects of particular instruments of control is presumably necessary in order for them to be utilized to proper advantage. Even more important is the thought that to underestimate their effectiveness may be to deprive the economy of benefits which they can confer while to overestimate their effectiveness may lead to the disregard of other techniques and so deprive the economy of a second line of defense in case they prove inadequate for some future emergency.

The difficulty of measuring the effectiveness of monetary policy arises out of the fact that the actual course of business developments is influenced by underlying conditions as well as by the policies employed at any particular time. Underlying conditions may change. How, then, is one to determine how much of the altered course of business developments following a change in monetary policy was the result of these measures and how much was the result of the change in underlying conditions? This is, of course, a familiar difficulty in the realm of social science.

Two illustrations will help to show how changes in conditions complicate the analysis of monetary policy. The period from the middle of 1952 to April 1953 was one in which the Federal Reserve, according to its published statements, was following a restrictive policy. It was also a period in which member bank borrowing from the Federal Reserve averaged between 3 and 4 times that of the preceding year. This is exactly the opposite of what would be expected to occur as the result of a more restrictive policy: Restriction would be expected to be accompanied by a reduction, not an increase, in the volume of member bank borrowing. It is presumably to be reconciled with the Board's claim that its policies were restrictive on the grounds that conditions had changed so that in the absence of the Federal Reserve restraints even greater credit expansion would have occurred. A less kindly interpretation would be that it showed that the restrictions were less effective than is contended and that the relatively stable economic conditions prevailing generally were attributable to other factors than monetary policy. Clearly there is no sure way of determining which interpretation is correct.

The second example is even more paradoxical. The Federal Reserve lists net sales and redemptions of Government securities amounting to $800 million from January to April 1953 as restrictive but it lists net sales of $900 million of Government securities from January to June 1954, as expansive.[15] In other words, the same phenomenon is given as restrictive in one instance and expansive in another. On the face of things, such statements appear thoroughly contradictory. The

[15] Hearings of 1954, p. 14. Cf. supra, p. 27, n. 2.

explanation apparently intended is that seasonal factors released reserves automatically to a much greater extent in the second period so that by limiting sales to only $900 million, abundant reserves were still available to promote expansion. The sales of $800 million in the previous year were apparently so large in relation to reserves then released by seasonal factors that member banks remained under pressure for reserves and the net effect was, therefore, restrictive.

There is no apparent ground for questioning this interpretation or for challenging the wisdom of the actions taken by the Reserve authorities, but it is reasonable to draw a moral: If a change in conditions could cause a particular course of action to be restrictive at one time and expansive at another, then such changes could surely be so great as to be the determining factor in changes in aggregate demand. Obviously, therefore, great caution must be exercised in ascribing a causal influence in the determination of business activity to any particular course of monetary policy or, indeed, to monetary policy in general.

The plain fact is that, with a few possible exceptions, the precise effects of central bank policies are not capable of proof. It is simply not possible to demonstrate conclusively whether a given change in the volume of credit is the cause of a change in business activity or the change in business activity is the cause of the change in the volume of credit. It is entirely conceivable that at one time causality may run in one direction and at another time in the opposite direction. The same sort of uncertainty attaches to the relation between changes in interest rates and changes in the volume and distribution of credit.

In reviewing monetary policy after the Treasury-Federal Reserve accord, it may be assumed that any of three interpretations is possible. The first is that the monetary policies were not responsible for conditions that prevailed from 1951 to 1956 but rather that these favorable conditions were the result of nonpolicy influences and would have existed in the absence of the measures taken, even though these measures may have been correct according to accepted standards. The second possibility is that monetary policy was, in fact, largely responsible for the favorable course of business developments from 1951 to 1956, but would not have been equal to the pressures and disturbances that prevailed from 1945 to 1951 [16] and may not be equal to tests that may arise in some future period. The third possibility is that monetary policy was a decisive factor in the course of events from 1951 to 1956 and that it can be counted on to meet any future needs. This conclusion amounts to saying either that monetary policy was important all along and that the period of its eclipse in the thirties and forties was a simple case of falling into error, or that the conditions which prevailed in those years may have been unsuited to the exercise of monetary policy but that conditions are now favorable, and can be counted on to continue favorable, to the pursuit of monetary policies as a stabilizing technique.

There is clearly no way of determining which of these three possible assumptions comes nearest to the truth. Reasonable men will differ as to which of them is to be preferred. But on one point all must agree: The only course that eliminates risk of disillusionment is to

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[16] The latter is substantially the position taken by Professor Hansen in the article quoted earlier (supra, pp. 23 sq.). In the same article he quotes Allan Sproul, president of the Federal Reserve Bank of New York, in support of this contention.

accept the view that the actual effectiveness of monetary policy is uncertain. By doing so we can hope to have alternative courses of action ready in case they are needed for some future contingency.

Prof. W. A. Morton of the University of Wisconsin has suggested that for the purposes of central bank policy it is not necessary to be able to predict the exact effect of a particular policy in order to justify its use. He quotes John Stuart Mill as having said that knowledge which is insufficient for prediction may be extremely useful for guidance. The point is surely well taken. It leads to the conclusion that central bank policy should be used as fully as the authorities see fit and that prevailing confidence in particular policies should be allowed full scope to vindicate itself. But at the same time it suggests that other instruments should be kept in reserve just in case the more optimistic hopes are not fulfilled. So long as it is recognized that precise prediction as to the effectiveness of particular policies is impossible, it may be expected that alternative courses of action will be held in readiness.

4. The problem of objectives

At one time it would have been generally agreed that the primary goal of monetary policy was maintenance of a fixed relationship between domestic currency and a given weight of gold or, what amounts to the same thing, a constant exchange value in terms of other currencies on the gold standard. At times attempts were made to extend and adapt the idea of monetary stability to include the maintenance of a stable level of commodity prices in terms of some standard index. In recent decades, the goal of monetary policy has assumed broader proportions. By the middle of the 20th century the paramount objective of monetary policy, for most countries of the world, including the United States, had generally come to be regarded as the maintenance of business activity, or full employment as technically defined.

The period under review will be found to have shown substantial progress toward the crystallization of a further objective of central bank policy, that of facilitating growth. Even if this were nothing more than a clearer recognition by monetary authorities and students of central banking of the growth element which is present in the concept of full employment, it would be of considerable importance. But it is much more than that and amounts to setting up a further objective of monetary policy.

If one were to characterize the essential nature of a central bank in a single word, it would probably be that of stabilizer. The focus of stabilization policy has shifted from time to time over the years as is indicated by the varying attention given to gold movements, exchange rates, price level, employment, and economic growth. The period since the depression of the thirties has seen the Government security market come within the range of central bank stabilization efforts. Moreover, central bank policy has been concerned increasingly with plural objectives, reflecting the desire to achieve more than one type of stability. Central bank policy will doubtless continue to be concerned with problems of stabilization. It is to be expected that degrees of emphasis on particular aspects of stability will vary, that techniques will undergo change, and that particular objectives will frequently come into conflict with one another.

It is unfortunate that while each of the familiar goals of monetary policy is desirable they are likely to come into conflict one with another. Monetary authorities are certain, therefore, to be confronted with the uncomfortable necessity of choosing among various desirable objectives or of effecting some sort of compromise among them. Pursuit of one goal is certain to involve the sacrifice of other goals. To compromise may well lead to the use of apparently contradictory methods. The authorities will then find themselves exposed to criticism on grounds which may be valid even though incomplete.

Whatever the perplexities to which it inevitably subjects the authorities, monetary policy must nevertheless be thought of in terms of plural objectives rather than of a single paramount goal. The problem is certain to be one of effecting a balance among objectives, even though the price of making progress in one direction is to fall somewhat short in another direction. Thus the attempt by the Federal Reserve to maintain orderly conditions in the security market was bound to make it more difficult to promote stable prices but was not necessarily to be condemned on that ground alone. It is to be expected that just as monetary objectives have undergone change in the past so objectives that seem important today may appear less important at another time or in the eyes of different individuals.

The existence of multiple goals implies the utilization of multiple policies. In the period after the Treasury-Federal Reserve accord the tendency to concentrate on use of the general instruments of credit control was hardly to be interpreted as constituting a permanent change in policy. It was rather an indication that the country was in a stage where economic conditions were such that monetary objectives and policies could be thought of in simpler, more orthodox terms that those that had prevailed a few years earlier. It is reasonable to expect that future changes in business conditions or other complications could again alter the main focus of objectives as well as the nature of instruments regarded as appropriate to the carrying out of monetary policy.

5. The problem of guides to central bank action

Difficulties that apply to economic policy in general with respect to the proper guides or signals to be followed apply also to monetary policy. There are similar questions as to the reliability of particular indexes of prices or production; as to their timeliness, that is, how great a delay there is in their becoming available; and as to how predictive they are, that is, whether they are indicators of future developments and not merely measures of what happened in the past. There is the important question of relevance, that is, their applicability to matters with which central bankers are concerned.

Apart from these general questions, there is the problem of what to do when accepted signals disagree. To illustrate: Between the middle of 1953 and the middle of 1954, unemployment in the United States rose by nearly 2 million at a time when the monetary stocks of gold were declining by $600 million and prices, wholesale and consumer, were practically constant. Thus the first signal called for policies of greater ease, the second for tighter policies, and the third for no change at all.[17] It is apparent, as Dr. Bopp points out, that this example can just as well be looked upon as a conflict of objectives touched upon in the preceding section. An alternative line of attack might be to define objectives only in the very broadest terms, such as promotion of economic stability. Under such a terminology, exchange rates, prices, or full employment would cease to be thought of as objectives and would assume the status of guides only. A comparable example is the possible conflict between internal and international stability which attracted the attention of many writers, Keynes among them, in the 1920's and which is involved in more recent discussions of a return to convertibility.[18]

A still more perplexing problem arises out of the fact that the same signal may mean different things at different times. Thus growth of inventories because fabricators and distributors are trying to stock up, as happened early in the Korean war, is a sign of inflation, but growth of inventories because demand has subsided and manufacturers and distributors are finding it impossible to maintain sales at existing prices, as happened in 1953–54, is a sign of deflation. Similarly, economists have sometimes called attention to the contrasting significance of a rise in interest rates which reflects an increase in optimism and one which reflects an increase in pessimism (hope inspired and fear inspired).[19]

An equally confusing situation arises when a permanent change occurs in the meaning of particular guides or in their applicability to the purposes for which they have been used. The Palmer rule and the real bills doctrine were perhaps never as fully valid as some of their supporters maintained. The greater probability, however, is that they were reasonably useful at one time but, with a change in economic conditions, lost contact with the real world and therefore their usefulness as guides to policy. The usual situation is not that theorists or administrators originate positive error; it is rather that generalizations are drawn which have relevance only in relation to particular circumstances. In the course of time, conditions change and the generalizations cease to be valid but they continue to command the allegiance of the orthodox on the ground that they are time-tested and proved economic laws.

Dr. Bopp has said: "The acid test of a guide is not the internal consistency of the logic or model on which it is based, but experience."[20] To the extent that casuality can be proved, which is likely to be extraordinarily difficult, experience may, perhaps, be accepted as a test of the past effectiveness of a guide to policy. Experience can never, however, be a proof of its future effectiveness. Past experience may even be positively dangerous. To the extent that past confirmation leads to a false sense of security concerning future conditions which are different, its contribution is negative. The lesson to bear in mind is not that we learn nothing from history but that

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[17] This example is from Karl R. Bopp, "The Rediscovery of Monetary Policy—Some Problems of Application," Federal Reserve Bank of Philadelphia, Business Review, August 1955, p. 5.

[18] See Roy Harrod, The Financial Times, London, July 19, 1955, p. 7.

[19] A somewhat different example is the preservation of price stability in the face of falling real costs of production. Such a situation is alleged to have existed in the United States during the 20th. The absence of price level change was currently interpreted, in line with conventional assumptions, as signaling stable economic conditions when actually it should have been regarded, because of the decline in costs, as having inflationary connotations.

[20] Bopp, op. cit., p. 8.

frequently we learn too much, or the wrong things, from history. We should take our history mixed with a strong dose of relativity, that is, relativity to the conditions which prevailed in the past and in the present.

The moral of these remarks is not that signals for the guidance of monetary policy are of no avail. It is rather that no signal or combination of signals should be allowed to harden into a rule of thumb. Signals, always subject to interpretation to prevailing conditions, are a necessary adjunct to the making of decisions. But they cannot be allowed to do the deciding themselves. Discretion, or discernment, is the indispe .sable ingredient of policy.

6. *The problem of confining open-market operations to short-term securities*

In the period after the accord the liveliest issue relating to the technique of credit control turned on the question of confining open-market operations to dealing in short-term securities. This is, of course, merely one aspect of the general question of the choice of techniques to be employed in carrying out monetary policy. After 1951, the still broader questions of whether or not to use fiscal policy, direct controls, and selective credit controls retreated into the background or narrowed to the possibility of future application. The problem of current interest was whether the Reserve banks should buy and sell Treasury obligations of all maturities or only those of shortest term, namely, 90-day bills.

The case for confining operations to the short end of the market was clearly stated by the Board of Governors: "In the first place, the risk assumed by professional intermediaries when they trade in bills is much less than when they trade in longer term securities. Bills are traded on a discount basis, and the great preponderance of bills outstanding at any one time have a maturity of less than 3 months. This means they will always appreciate to par within that period. Bills are ideal collateral, furthermore, and can always be used as security for loans * * * The main financial hazard attending professional operations in bills is that the holder will have to pay more in interest when he borrows to carry them than they gain in price as they approach maturity. Another reason is that the bill market is accustomed to relatively large transactions such as the open-market account must undertake in absorbing and releasing reserves. It is the market in which all financial institutions typically adjust their day-to-day positions. Trading is continuous * * * Finally, the financial markets do not attach the same significance to System operations when they are transacted in bills as they do to transactions in other sectors of the market. Financial experts know that the Federal Open Market Committee is more or less continuously engaged in putting funds into of absorbing funds from this market as it compensates for large day-to-day fluctuations in the amount of float, in Treasury balances, in the demand for currency, and in other factors. The appearance in the bill market of purchase or sell orders initiated by the Federal open-market account has no general long-term policy significance in the great majority of cases, and therefore does not so readily give rise to apprehensions that a change in policy is imminent." [21]

[21] Hearings of 1954, pp. 19 sq.

The stand taken by the Board was largely, it would seem, a carry-over from the situation which prevailed before the accord when the Government bond market was felt to be unduly dependent on the Federal Reserve support policy. The issue of a free as against an artificial market for Government bonds will be examined later in more detail. It may be remarked here, however, that President Allan Sproul, of the Federal Reserve Bank of New York, favored greater latitude with respect to dealings in securities of different maturities.[22]

A second objection to the "bills only" rule is that it amounts to a partial abdication by the central bank of one of its important functions. Private flotations have the benefit of underwriting support. It is argued that one of the primary functions of the central bank should be to provide comparable support in the flotation of Treasury obligations.[23] In the words of President Sproul: "If Treasury debt-management operations put a temporary but intense strain on the facilities of the market * * * the largest single portfolio of all should not always stand aloof (except for the purchase or sale of Treasury bills). Direct aid in helping to cushion the effect of massive maturities, new issues, or conversions of Treasury securities * * * would seem to me to be wholly consistent with the primary demands and objectives of monetary policy." [24]

He denied that such a policy involved constant intervention in the market or the pegging of prices. He quoted the Governor of the Bank of Canada in support of his position: "The Bank of Canada has been a constant trader in Government of Canada securities since we opened our doors in 1935 * * * We have endeavored to help make a market for all Government issues and have been very substantial buyers and sellers. In a sense, we perform a jobbing function, holding the inventories which are indispensable to a good market." [25]

In agreeing with the Open Market Committee that its policies should be reflected in the cost and availability of credit, he declared that "* * * this concern can find its best expression, at times, in open-market operations specifically directed at * * * longer term markets." [26]

Critics of the policy argued, first, that dealings in longer term securities could be a useful instrument, often citing Keynes' support of this contention.[27] It was pointed out that changes in capitalized values have come to be regarded, by Federal Reserve experts as well as by others, as an important feature of credit operations. The capitalization effect of changes in interest rates is strongest and most direct in the case of long-term issues. Sensitiveness of the market to dealings in long-term securities by the Reserve authorities, instead of being a disadvantage as the Board suggested, was interpreted as the very reason why they could be so effective if judiciously employed.

Finally, it may be objected that any hard and fast rule is an undesirable limitation upon the freedom of the central bank. It is gen-

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[22] The Board did not close the door completely to dealings in longer term securities. Such dealings, however, were endorsed only under conditions of extreme disturbance in the market.

[23] Hansen, op. cit., p. 111.

[24] Allan J. Sproul, Central Banks and Money Markets, New Jersey Bankers Association, Atlantic City, May 6, 1954, p. 5 (mimeographed).

[25] Sproul, op. cit., p. 5.

[26] Hearings of 1954, pp. 225 sq.

[27] John Maynard Keynes, The General Theory of Employment, Interest, and Money, London, 1936, p. 206.

erally agreed that an essential feature of central bank policy is flexibility. From that standpoint, this or any other relatively inflexible rule would be objected to. A rule such as this is unnecessary to dealing in short-term securities whenever the Open Market Committee finds it desirable to do so; but it is an obstacle to freedom of action (flexibility) in case the Committee should find a different policy to be called for at any time in the future. Mr. Sproul expressed concern that Federal Reserve authorities were "* * * in danger of placing ourselves in a straitjacket which would not permit us to accomplish what the Congress and the public might expect us to accomplish in terms of monetary management."[28]

The Board has taken the position that impulses originating in the market for short-term securities are quickly transmittted to other parts of the Government bond market through the operation of free market forces. But if the market mechanism is this easy and smooth, it would seem to follow, on the ground that the effects would be quickly transmitted elsewhere, that the Federal Reserve could equally well enter the market at any point. The logic of the Reserve's position is evidently that significant lags do exist in the transmission of the effect from one point of the Government bond market to another. This being so, the case for maintaining freedom to enter the market other than at the short end would seem to be strong.

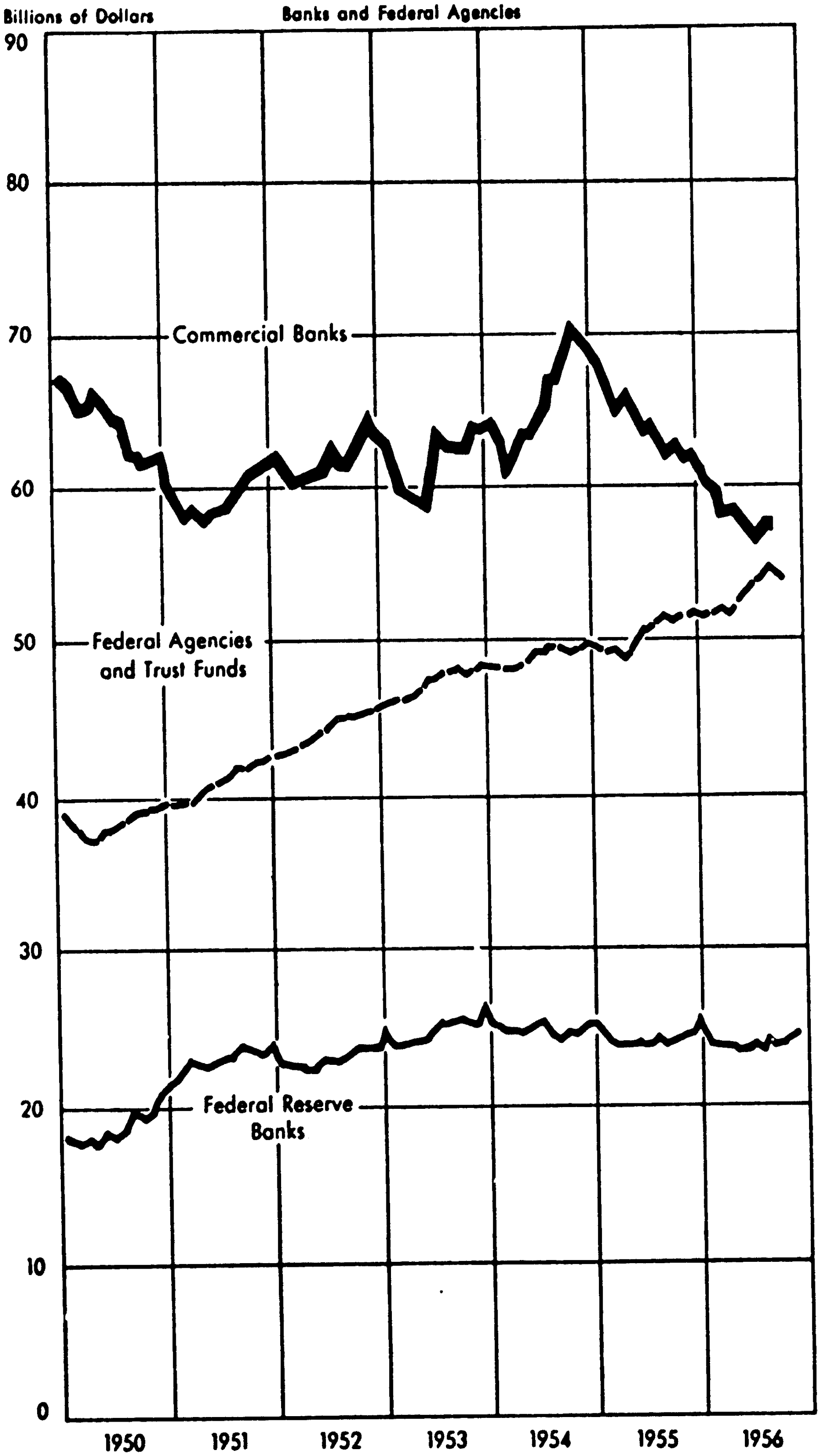
The firm stand taken by the Board of Governors for confining open-market operations to securities of the shortest term appears to reflect conceptions which derive from a period when the public debt was relatively small and which may have lost much of their validity in today's world of greatly expanded public debt.[29] The market for Government bonds has so changed its size and character from what it was in the past that traditional presumptions of the conditions of supply and demand in that market are no longer to be depended upon. While the conclusions drawn from the earlier presumptions are not necessarily invalidated by that fact, the change in circumstances surely calls for their careful reexamination.

As was noted above, the yields on Government obligations have fluctuated widely in recent years. Between 1952 and 1956 the price of long-term Governments was more unstable than the price of second-grade corporate bonds. Such a situation is completely contrary to historical precedent. It is here tentatively suggested that fluctuations of this character are a reflection of fundamental changes in the financial structure of the economy, and more specifically that the Government security market has been rendered inherently unstable primarily because of the portfolio operations of commercial banks.

Formerly, call loans were the principal medium for adjusting the reserve position of commercial banks. It is Government securities that now chiefly perform this function. Commercial banks are today the largest holders of Governments. Moreover, commercial-bank holdings of Treasury obligations fluctuate to a greater extent than those of any other group. This helps to explain why there is strong prima facie evidence that the purchase and sale Governments by commerecial banks contributes to variations in the supply and demand of Treasury obligations and thereby to fluctuations in yields on Government securities. (See chart 2.)

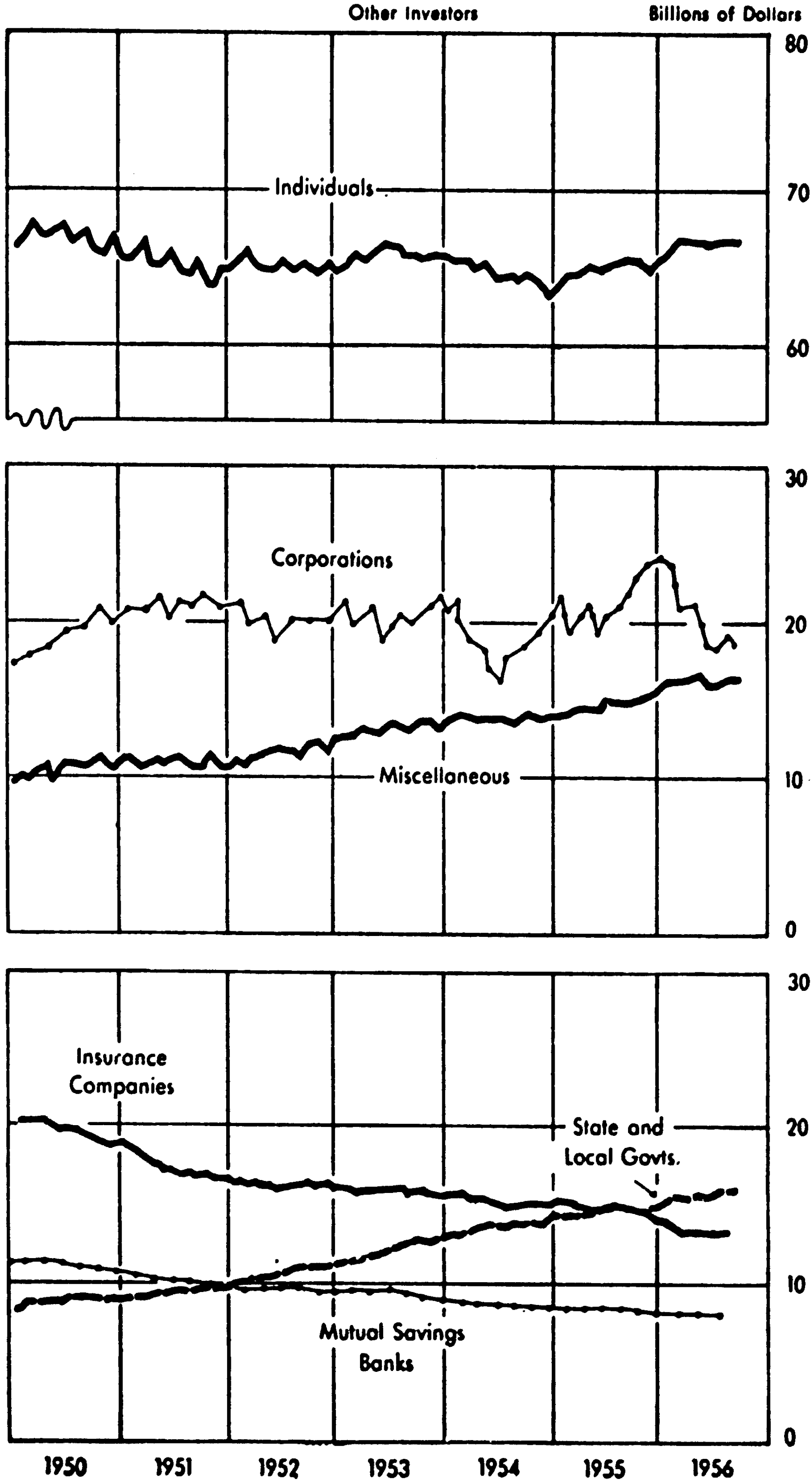
[28] Hearings of 1954, p. 225.
[29] Ervin Miller, Monetary Policy in a Changing World, The Quarterly Journal of Economics, vol. LXX, Cambridge, Mass., 1956, pp. 23 sqq.

Chart 2 – Ownership of U. S.



[1] *Source:* Board of Governors, *Federal Reserve Charts*, December 1956.

Government Securities, 1950 – 1956[1]



The record of correlation between changes in bank holdings of Governments and movements in yields on Treasury obligations is worth noting. In the first half of 1953 yields on Governments rose at a time when banks were cutting down on their holdings of Treasury obligations. About the middle of the year commercial banks added sharply to their holdings of Governments, partly because of a reduction in reserve requirements imposed by the Board of Governors, and this was accompanied by a rapid recovery in the price of Governments (i. e., decline in yields). The rise in yields at different times in 1954, 1955, and 1956 coincided with periods when commercial banks were reducing their holdings of Treasury obligations.

Changes in net buying and selling of Governments by banks, which seem to have had such an important bearing on yields, are influenced by the need to adjust reserve positions, the demand for loans, and the level of business activity, all of which are closely interrelated. At a time when business is advancing, the demand for loans is likely to be strong so that there is pressure on reserves. Banks tend to cut down on their holdings of Treasury obligations in order to accommodate the additional demand for loans. Selling by commercial banks naturally helps to drive up the yields on Governments. Similarly, a slackening of business activity would tend toward a contraction of loan demand with the result that banks would purchase Governments as the easiest way of maintaining earning assets. Such purchases would strengthen the price of Treasury obligations (i. e., depress yields). Obviously, there are other factors than those mentioned here that act upon interest rates in the market, and likewise upon the operations of commercial banks. But this analysis is sufficient to suggest the nature of changes in the securities markets and something of the manner in which they may influence the determination of interest rates.

The tendency toward instability is accentuated by a further characteristic of banks' dealings in the security markets. This is the fact that commercial banks as a group are likely to behave in an approximately similar manner. Because they are subject to similar pressures, and possibly also because of the familiar propensity of banks to keep in step with one another, it is likely that a considerable majority of them will be selling or will be buying at the same time. The stabilizing effect that would result if some banks were to buy while others were selling is therefore lacking and the way is open to strong upward or downward pressures on price such as the Government bond market has witnessed in recent years. To the extent that the market has developed inherent tendencies toward instability, a case may be presumed to exist for stabilizing action such as a central bank is well fitted to provide.

Enough has been said to demonstrate, if such demonstration were needed, that security markets of today are very different from what they were in an earlier generation. The existence of changed conditions does not necessarily mean, of course, that the rules and practices of a former time have become obsolete, but it does suggest that support for them must be founded on something firmer than nostalgia for the past. And it is surely not amiss to question, first, whether central banks in general and the Federal Reserve in particular have given sufficient recognition to the bearing of recent changes upon traditional conceptions of market behavior and, second, whether prevailing measures are properly adapted to meeting the problems that are certain to be encountered in a world of enormously expanded public debt.

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MONETARY POLICY AND ECONOMIC CHANGE

By C. R. Whittlesey

The purpose of this article is to examine certain aspects of Federal Reserve policy in relation to the bearing of various changes which have occurred in the economy during recent decades. The discussion will be concerned first with a number of current issues and later with various unresolved problems which are of less topical, but perhaps somewhat greater theoretical, interest.

I. ADAPTATION OF MONETARY POLICY TO CHANGING CONDITIONS

The description of politics as "the art of the possible" applies likewise to public policy in general and to monetary policy in particular. To say that central banking is an art rather than a science, as both students and practitioners of central banking have been accustomed to do, is not to deny that, in this as in every other branch of applied economics, scientific methods and a scientific attitude can be extraordinarily fruitful. But the fact does remain that central banking is an art. The principal weakness of central bankers lies not in any failure to recognize that fact but in deciding what constitutes the possible when it comes to the application of their art.

The main difficulty confronting central bankers is that what is possible for central bank policy is in no sense an absolute. It is not that what is possible is merely a matter of expediency, although expediency undoubtedly has to be considered; the policymaker who disregards what is realistic is only a little less ridiculous than the one who forgets what is ideal.[1] The more baffling consideration is that what it is possible for central banking to accomplish, and by what means, is relative to many things. These include such internal considerations as the objectives to which it is committed, the guides available to it, the instruments at its disposal. They also include such outside factors as the state of the economy, the international climate both political and economic, and the attitude of the public. While some of these endogenous and exogenous elements are subject to accurate determination or control, others clearly are not.

To suggest that the problems of the practitioners of the art of central banking is difficult is not to imply that they do as good a job as can legitimately be asked. A better job can be expected, however, only through heightened sensitivity to the changing environment in which

[1] A former member of the Board of Governors once privately defended his failure to vote for more vigorous measures on the following grounds: More positive action would have been likely to provoke strong criticism in certain quarters. As a consequence, Congress might have been induced to interfere with the Board by imposing restrictions or revoking authorizations previously conferred. Better to retain powers which they do not use than to run the risk that, by using them, so much opposition would be built up that the powers would be taken away. While the utility of having powers which are not employed may seem somewhat obscure, it can be argued that a greater emergency might sometime arise in which they would be put into effect. The same official was opposed to efforts to add to the Board's powers even on a standby basis for fear that Congress would interpret this as a bureaucratic grasping for power and, far from extending the Board's controls, would react by curbing or removing some of those already at the Board's disposal.
It is not possible to prove that this line of reasoning is wholly mistaken. But it clearly rationalizes a policy of inaction and makes a virtue out of weakness. All this in the name of realism.

central bankers operate and increased willingness to modify central bank actions in the light of these changes. And it is highly probable that the pressure to effect these adaptations will have to come mainly from students of the art who are outside the system itself.[2]

Free versus artificial markets

In the period after the Treasury-Federal Reserve accord the Board of Governors embraced the ideal of free security markets with great zeal. "Maintenance of orderly conditions" as the announced policy goal gave way to "prevention of disorderly conditions," and this in turn to "correction of disorderly conditions." The last of these formulations signified that the Federal Reserve authorities would refrain from action except to remedy a situation which had already proceeded too far. The stand taken by the authorities gave evidence of hardening into the doctrinaire attitude that there was no tolerable intermediate position between laissez faire and a rigid commitment to support Treasury obligations at par such as had existed before the accord.

A possible compromise, one consistent with practices followed in other markets, would have been to differentiate between interference which is likely to produce a more, and that which is likely to produce a less, ideal market. The latter (and undesirable) type of interference would include actions designed to hold prices more or less continuously at levels different from a long-run normal. The former (and presumably desirable) type of interference would include actions designed to restrain excessive deviations from that norm. The deviations would be assumed to be excessive if they were clearly based on rumor, speculation, or temporary abnormalities of supply and demand, especially if the fluctuations appeared to be of a self-inflammatory character. To admit that it would sometimes be difficult to determine whether price movements were of one character or the other is not to agree that they would never be clearly distinguishable. The fact that orderly marketing provisions have been introduced in other markets is a recognition that completely free operation of supply and demand is not synonymous with ideal markets.

[2] Professional economists and other students of central banking have the advantage that they are relatively free from the political pressures to which central bankers are subject. In the nature of things, also, they are a more inquiring, nonconformist breed of men. They are not immune, of course, to the human tendency to rely unduly on relatively short-run perspectives. One may recall the remark by Professor Ohlin to the effect that British economists tend to derive their theories from the events of the recent past (The Problem of Employment Stabilization, New York, 1949, 161).

A striking example of changing beliefs with respect to central banking has to do with the effectiveness of monetary policies in combatting inflation and deflation. In 1930 Keynes declared that it was easier for the monetary authorities to combat deflation than inflation (Treatise on Money, vol. II, 253). This conclusion was presumably influenced by the strong inflationary pressures loose in the world during the preceding years. Under the influence of deflationary conditions in the 1930's precisely the opposite opinion came to prevail. Attempts by central bankers to overcome deflation were likened to pushing on a string. Even though the contention may have possessed validity at the time, it amounted to the substitution of analogy for analysis. If the figure of a rod is put in place of the figure of a string the force of the argument disappears. The point is not that the rod analogy is valid and the string analogy false. Rather it is that the one may apply at one time and the other at another time.

It remained for the inflationary conditions after World War II to bring about a return to the position advanced a quarter of a century earlier by Keynes. The Economist of London remarked in its issue of October 29, 1955 (p. 368) on the prevailing but "still unproven view that bank rate is very much less effective in conditions of rising production than of falling prices."

The fault with both generalizations about controlling inflation or deflation by monetary means is that they leave out of account the bearing which the state of the economy has on the effectiveness of monetary controls. In the years after World War II we may have had a situation where Keynes' view approached much more closely to the truth than it did in the 1930's—though not, it may be said, for the reasons given by Keynes.

The foregoing analysis rests on the assumption that when the authorities interfere with free market forces their intervention will be discerning and moderate. Opposition which the Board of Governors expressed to intervening in the securities market was based on the assumption that its interference would be undiscriminating and arbitrary. Reference was made to "the constant possibility of official action, which from the standpoint of investors and market intermediaries would often seem capricious" and to "the danger that operations by the Federal open-market account may, *if executed through faulty techniques*, exert an unduly disturbing or even disruptive effect upon the market for United States Government securities."[3] It was said that not only are open market sales made from a huge portfolio held by the Reserve banks but "for all the market knows, they may be the forerunner of many more sales to come."[4]

If the Federal Reserve were to act capriciously, on impulse, or in a faulty manner and without reliable statistical information, the conclusion would no doubt follow that "transactions initiated by the Federal open market account, particularly transactions in intermediate issues, may seriously affect the efficiency of the market."[5] But the entire history of the Federal Reserve indicates that it can be counted on to act carefully, with circumspection, and on the basis of full analysis of factual information. Past actions of the Board may be open to the criticism of undue caution but never of caprice. The general tenor of the Board's comments from which these quotations were taken goes far beyond the limits of official modesty. It amounts to a declaration of responsibility. Comparable examples of self-slander must surely be rare in the history of central banking.

The opinion has frequently been expressed that Treasury and Federal Reserve officials were unrealistic in suggesting that the market for Government securities can be thought of independently of actions taken—or not taken—by the Federal Reserve.[6] When the Federal Reserve changes the amount of available reserves it clearly alters an important element in the supply of and demand for Government securities. At different times the price of Government securities has changed for no other reason, apparently, than rumors of an impending change in the level of reserve requirements. And the bond market was never more clearly influenced than by what was interpreted as the announcement of a policy of noninterference by the Federal Reserve in the spring of 1953.

The Board's opposition to artificial markets in Government securities was one phase of the countrywide impatience with restraints which followed the experiences of the war period. Their opposition was strengthened by recollections of uncomfortable moments which the Board had endured while rigid pegs were being maintained. Questions still remain as to whether the Board distinguished as clearly as it might have between different types of interference and

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[3] Hearings before the Subcommittee on Economic Stabilization of the Joint Committee on the Economic Report, December 6 and 7, 1954 (Washington, 1954), 16 and 17. [Italics supplied.] Hereafter referred to as 1954 hearings.

[4] Ibid., 19.

[5] Ibid., 20.

[6] An analogy drawn by Secretary of the Treasury Humphrey, wherein he likened the market for Government bonds to the market in which a farmer's wife sells eggs, was the target for enthusiastic ridicule by Senator Douglas and others. See 1954 hearings, 207; and Joint Committee on the Economic Report, hearings on the President's Report (Washington, 1955), 428–37.

whether it underestimated the skill and success with which an intermediate policy might be pursued and overestimated the tendency of moderate interference to degenerate into rigid support.

A dilemma exists, in that freedom of the market, strictly construed, is inconsistent with freedom of the central bank. It is the purpose of a central bank to achieve a more ideal market, which is not identical under all circumstances with a freer one. Any hard and fast rule is a limitation on the freedom of the central bank to maintain the flexibility which is essential to central bank policy. The "bills-only rule," whereby open-market operations were confined to Treasury bills, and which was part of the paraphernalia for achieving a free and broadened market for Government securities, was unnecessary for dealing in short-term securities whenever the Open Market Committee found it in the public interest to do so. But it was an obstacle to freedom of action (flexibility) in case the committee should at any time find that a different policy was called for. Allan Sproul, then president of the Federal Reserve Bank of New York, stated the issue very clearly when he warned that the Federal Reserve authorities were "in danger of placing ourselves in a straitjacket which would not permit us to accomplish what the Congress and the public might expect us to accomplish in terms of monetary management."[7]

Changed character of the bond market

It may be suggested that the firm stand taken by the Board of Governors on the issue of confining open-market operations to short-term securities implied a "small debt approach" to its responsibilities which may be inapplicable to the world of today.[8] Is the idea of refraining from suporting action at a time of Treasury borrowing realistic in a situation where Treasury financing has assumed present-day proportions? Can the Federal Reserve undertake to remain aloof from the bond market when the marketable debt amounts to $230 billion with the same assurance as when it was one-tenth that amount?

The price of Government bonds has fluctuated widely in recent years. Between 1952 and 1956 the price of long-term Government bonds showed wider fluctuations than the price of second-grade corporate bonds. Such a situation is as foreign to historical precedent as it is to normal expectation. It can only signify a considerable change in the character of the bond market. This conclusion does not prove that conventional policies are mistaken; nevertheless, it suggests that caution should be exercised in assuming that conventional policies are correct for conventional reasons.

The increased instability of the Government security market appears to be largely a result of the portfolio operations of commercial banks. Today, Government securities occupy the place once held by call loans as a medium for the adjustment of reserve positions by commercial banks. Commercial banks are the largest holders of Treasury obligations, and fluctuations in the magnitude of these holdings are sharper and wider than in any other group of holdings. It is reasonable to suppose, therefore, that changes in buying and selling by commercial banks are an important cause of changes in the demand and supply of Government securities and thus of fluctuations in the yields of Governments.

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[7] 1954 hearings, 225.
[8] Cf. Ervin Miller, Monetary Policy in a Changing World, Quarterly Journal of Economics, LXX (February 1956), 23–28.

This hypothesis is supported by examination of what happened to bank portfolios in different periods when the interest rate on Government bonds was changing. We find, for example, that the rise in yields in 1953 took place at a time when commercial banks were reducing their holdings of Government securities. The turnabout in yields at the middle of the year coincided with a sharp rise in commercial bank holdings of Governments, a rise made possible in part by the reduction in member bank reserve requirements. The rise in yields in late 1954 and early 1955 and again later in 1955 and 1956 occurred at times when banks were lightening their portfolios of Governments. In explaining what lies behind the actions of commercial banks in increasing or decreasing their holdings of Governments, a major factor to be considered is the demand for commercial loans.

It may now be tentatively suggested that the sequence of events is somewhat as follows: At a time when loan demand is strong and additional reserves are not readily forthcoming from the Federal Reserve or elsewhere, commercial banks are likely to cut down on the volume of Governments they hold in order to facilitate an expansion of loans. The selling of Governments by banks tends to force their prices down (yields up). Conversely, at a time when business is slackening, loans begin to decline, and banks, with the resources thus made available, turn to Governments as the simplest means of maintaining the volume of earning assets.[9] The effect of this buying by the banks is to drive up the price of Government securities (lower yields).

The foregoing analysis is obviously simplified. It takes no account of the maturity distribution of bank portfolios of Governments, and it ignores other holders of Government securities. Its purpose is to emphasize, even at the risk of overemphasis, the importance of commercial bank dealings in the Government bond market. But this is only part of the story. There is the further fact that commercial banks as a group are likely, in the very nature of things, to behave in a roughly similar manner. If some were selling while others were buying, the market would not have the same tendency to be unstable. But because they are subject to similar motivation and possibly because of a certain propensity toward following the leader,[10] there is a tendency for the majority of banks to be selling or buying at the same time. Thus the way is open to strong upward and downward pressures such as may account for the fluctuations in the Government bond market in recent years.

Even apart from the interpretation presented here of new and potentially destabilizing forces in the Government security market, it is clear that the existence of a large national debt, distributed as it is with respect to ownership and maturities, constitutes a distinct contrast with the economic conditions that existed before World War II. The question this poses is whether the prevailing attitude of the Board of Governors, with its insistence on aloofness and on confining its operations to the short end of the market, has taken suffi-

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[9] Other influences such as a change in reserve requirements may also affect their dealings in Governments.

[10] This similarity of behavior is partly a characteristic of banker psychology and not just a reflection of the leadership provided or pressure exerted by the central banking authorities. It is distinct also from the group response remarked upon by Keynes in the Treaties on Money in his famous analogy with party behavior (tipsiness and sick headache). The similarity referred to here has manifested itself repeatedly at times, such as during the 1930's, when reserves were redundant and to all intents and purposes banks were independent of monetary restraints.

cient cognizance of the change that has thus transpired.[11] Or does the small-debt philosophy still linger on in a period that is conspicuous for the great size to which the debt has grown?

II. UNRESOLVED PROBLEMS

The "locking-in" effect

The view has come to be widely accepted among both lay and professional followers of central banking that permitting a decline in the price of Government bonds is an effective means of preventing their sale, particularly by institutional investors. This alleged deterrent effect is sometimes referred to as a blocking-in effect or liquidity trap. The reasoning proceeds from the fact that insurance companies and other institutional and noninstitutional investors hold large amounts of long-term securities. Some of these securities, notably Governments, are treated as relatively liquid assets as long as they are selling above cost. As long as their price remains relatively high, they can be sold without loss or, conceivably, with a capital gain. If a decline in the bond market were to cause them to fall below cost, selling would entail a capital loss. Recognition of such loss in an accounting sense can be avoided by holding on to the securities as long as they are selling below cost. In the case of such safe securities as Governments, it is always assumed that final redemption will be at par or above, so that the abstention from selling involves no significant risk.

The essence of the argument is the contention that investors are extremely reluctant to accept capital losses through sale of securities below cost. It is assumed, therefore, that a decline of security prices below par[12] will "lock in" the holders of long-term securities, i. e., induce them to refrain from further selling. Action of the central bank in tightening money rates, i. e., depressing the bond market, is thought of as having the effect of "springing" the liquidity trap.[13]

The popularity of this argument among Federal Reserve experts and students of central banking, as well as businessmen, is sufficient indication of its persuasiveness. Unfortunately, the record has contradicted the theory upon various occasions. Following the Treasury-Federal Reserve accord, for example, the sale of governments by life insurance companies, far from decreasing, rose with the decline in

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[11] Official recognition of the point made here was given in testimony by Mr. Martin in 1956. The Open Market Committee's departure from strict adherence to the bills-only policy a few months before was defended on the ground that moderate purchases of intermediate securities might make it possible to avoid larger purchases of bills and thus result in a smaller net creation of reserves (hearings on the President's Report, 1956, p. 302). This was a significant endorsement of views advanced earlier by various economists.

[12] This is a minor oversimplification. Strictly speaking, the argument should be confined not to declines below par but rather to declines below cost. This will vary, of course, for different holders. The same possibility of loss would arise not only at sales below par but also in cases where bonds, bought at a premium and not yet amortized down to par, are sold at prices above par, conceivably considerably above. Likewise, if securities were acquired below par they could also be sold below par without any book loss necessarily resulting. The essential point is the effect of a decline below the price at which the securities appear on the owner's books.

[13] The alleged effectiveness of rising yields as a deterrent to the selling of governments is discussed at some length in the Patman documents, Monetary Management Policy and Debt, Part I, 363–68. Cf. also Albert G. Hart, "* * * holders could be frozen into bonds * * * by permitting yields to rise somewhat." American Economic Review, XLV (May 1955), 410. That similar views prevail abroad may perhaps be inferred from the following quotation from A. B. Ilersic, Government Finance and Fiscal Policy in Postwar Britain (London, 1955), 180. "Unless severely pressed, few individuals or institutions will liquidate securities at a loss, so that during a period of low bond prices, neither borrowers nor lenders will be active."

prices of Government bonds. This failure of statistical evidence to conform to alleged expectations was either ignored or attributed to special circumstances. Occasionally it was suggested, rather lamely, that the increase in sales of Governments at this time would have been even greater if the liquidity trap had not exerted a restraining influence. A better explanation of the failure of the statistical record to corroborate the theory is that the theory of a locking-in effect rests upon an incomplete analysis of the motivations which underlie investor behavior. More specifically, the argument as customarily advanced underestimates two important considerations which influence the actions of the managers of investment portfolios.

In the first place, the argument leaves out of consideration other developments occurring in the market at the same time. A drop in the market price of Government bonds is equivalent to a rise in their yield. If this were the only change taking place it would indeed provide an inducement for holding on to Governments. But if at the same time the yield on other types of securities were to rise even more, the spread in yield would thereby have widened; consequently, there would be more inducement than before to sell Governments in order to take advantage of the greater spread in yield through appropriate switches. Thus the argument as usually presented makes the mistake of looking on the level of yield on Governments rather than the spread between this and other available yields as the factor which governs the profitability of selling Governments or holding them.

The argument also abstracts from the bearing of very important tax considerations. A company may deliberately choose to establish a capital loss as a means of effecting a tax saving through charging the loss off against a capital gain elsewhere. This is a further, and at the present time a highly important, consideration bearing on the net gain to the investor from holding onto its Governments or from shifting, even with a capital loss, to some other investment.

In the second place, the argument fails to make allowance for expected future movements of security prices. It is highly unlikely that a decline from 100 to 98 will be effective in preventing sales if it is expected that the price will shortly drop to 96. And if the initial decline gives rise to an expectation that a further drop is likely to occur, it will have precisely the opposite effect from that which is customarily assumed. In such a situation, selling helps to drive prices down, thus confirming the negative expectations and contributing to the expectation of further declines. This is precisely what happened in the spring of 1953. It was not the low level of prices reached at that time that brought an end to the downward movement of bond prices, but indications of a change in policy by the Federal Reserve. When it became apparent that the Federal Reserve was prepared to intervene, the public quickly jumped to the conclusion that the bottom of the market had been reached. Expectations of a decline gave way to expectations of a rise in bond prices. These expectations, in turn, stimulated the market actions which tended to confirm and strengthen the expectation of rising quotations for Government bonds.

Expectations are a powerful influence in the bond market. At various times in recent years, expectations have been fed and price behavior influenced by rumors of changes in reserve requirements and discount rates and by reports concerning the rate about to be set on new borrowing by the Treasury.

The trouble with the locking-in generalization is its oversimplification of investor behavior. No theory, after all, is any better than the assumptions on which it rests. This particular theory rests on much too narrow a conception of the motivations of institutional investors. In particular, it assumes that their actions are governed to a decisive extent by the desire to avoid book losses. Such losses are admittedly a consideration. But investors are also affected by other considerations. These other considerations, moreover, may be far more influential in determining the actions of institutional investors than mere book loss.

The shortcoming of the theory of the locking-in effect is that it disregards other significant factors. It is readily demonstrable, for example, that failure to sell at a book loss, as in situations such as those indicated above, may result in a lower net gain than could otherwise be obtained. In other situations as well, sole regard for book losses would conflict with the desire of investors to maximize net return. Old fashioned economic theory was by no means perfect. But surely a theory which starts from the assumption that the desire to maximize net is of primary importance in the actions of businessmen is more to be trusted than theory such as this that rests on far flimsier and more ephemeral assumptions.[14]

The flexibility-inflexibility paradox

When interest rates were allowed to rise in 1952–53 a sharp contraction in the volume of new lending on VA and FHA mortgages immediately followed. This experience has frequently been referred to as a classic demonstration of the effectiveness of flexible money rates. A little analysis will show that it demonstrates nothing of the sort. What happened was that the rate allowed on such mortgages remained frozen while other rates were allowed to rise. The prevailing pattern of yields was thus distorted, with the yield on guaranteed mortgages far below, relatively speaking, the yields on other types of investment. The flow of investment into mortgages was reduced, presumably as a consequence of this differential in yields.

The restrictive effect on the volume of mortgage credit resulted not from the rise in rates per se but from the combination of a fixed rate on guaranteed mortgages and rising rates elsewhere. It was the reflection not of genuinely flexible interest rates but of a discriminatory policy, with some rates flexible and some fixed. The paradox is that the effectiveness, as an instrument of credit control, of the flexibility of interest rates which were allowed to move was conditioned upon the inflexibility of other rates which were prevented from moving.

The net effect of this combination of flexible and inflexible rates was somewhat analogous to the operation of selective credit controls.

[14] The foregoing is not intended to suggest that there is nothing whatever in the view that a fall in price may act as a deterrent to selling. If price were to fall so rapidly or go so low that a significant and early recovery were strongly indicated, investors would perhaps be encouraged to hold on. This is just another application of the point noted above that expectations are an important factor in investment decisions. It would still be necessary, however, to take into account what was occurring elsewhere in the market. At best the locking-in idea is a half truth which, through continued repetition, has gained undue acceptance. It is as though it were assumed that a half truth twice told becomes a whole truth.

Theoretically a similar result might have been achieved by lowering the rates on guaranteed mortgage credit alone while other money rates remained unchanged. The main conclusion to be drawn from the 1952–53 experience with mortgage credit, therefore, is that it appears to illustrate the effectiveness of discrimination, not of flexibility, in the management of money rates.

The "insurance money" paradox

In the spring of 1953, at a time when interest rates were rising sharply, the chief investment officer of a large insurance company remarked to a friend that officials from a certain industrial concern were coming in to obtain some "insurance money." This, he explained, was his name for borrowing which was based merely on a desire to make sure that possible future needs were covered at rates no higher than those then prevailing.

Borrowing designed to protect the borrower against the possibility of a further rise in interest rates may at times make use of standby agreements, that is, commitments to lend at stipulated rates of interest. A small charge (one-eighth to one-half percent per annum) is ordinarily made until the option is either exercised or canceled. At other times it takes the form of borrowing a larger sum than is required or of borrowing earlier than would normally have been the case.

In its annual report for 1953 the Board of Governors reported a large increase in capital flotations in May and June of that year "partly reflecting the fear that funds would be harder to obtain later on" (p. 94).[15] An officer of one of the Federal Reserve banks reported a New York financier as having declared that he knew personally of borrowing amounting to over $600 million which was pushed forward from the third quarter to the second quarter of 1953 for no other reason than to protect against having to pay higher rates than were then available.

To what extent the stimulus thus given to borrowing offsets or conceivably outweighs the restrictive effect of the higher cost of borrowing entailed in the rise of money rates is impossible to determine.[16] It is not difficult to demonstrate that higher rates have contributed upon occasion to the postponing of borrowing operations or even to their cancellation. It is no less true, however, that individual cases can also be found like those just mentioned where borrowing operations were advanced or induced. On the face of it there is no way of determining which tendency, if either, predominates. It is important to recognize, however, that the common disposition to assume that the restrictive influence outweighs the stimulative influence may merely reflect the particular brand of static supply-and-demand analysis on which most of us have been brought up.

By examining totals one can observe whether the net change in the volume of credit was up or down following a rise in money rates, but this does not prove what the effect of the restrictive action was: We still do not know what would have occurred in the absence of the

[15] Cf. the statement by Richard Youngdahl, of the research staff of the Board of Governors, that in the spring of 1953: "Credit demands remained intense but part of the demand was not for immediate use but in anticipation of needs by borrowers who wished to be certain their future requirements would be covered." *American Economic Review*, XLV (May 1955), 406.

[16] The possibility that borrowing may be stimulated in the manner indicated does not necessarily mean, of course, that there will be a similar effect on real investment.

measures taken. If total outstandings increased it is possible that they would have increased even more in the absence of the rise in rates, so that the influence of the higher rates was genuinely restrictive. But it is also possible to argue that a decline in total outstandings is likewise no demonstration of restrictive effects since the decline might have been still greater without the rise in rates.

Savings effect of interest rate changes

The preceding example related to the manner in which a change in interest rates may induce shifts in the schedule of demand for credit and thereby tend to counteract the effect which a change in interest rates is ordinarily assumed to have on the demand for credit. The next point relates to somewhat similar offsetting tendencies with respect to the effect of interest rate changes on saving and thereby presumably on the supply of credit.

Let us assume that a rise in interest rates is the result of central-bank action designed to promote economic stability and also that the public believes that such a rise will contribute appreciably toward attainment of that goal. If we accept the further assumption that one of the important motives for saving is uncertainty, e. g., that people save in order to provide for a rainy day, we immediately find ourselves involved in a paradox. A reduction in pessimistic expectations because of the stabilization activities of the central bank may lessen the incentive to save. To the extent that consumption is encouraged by the assurance afforded by the central bank, the result is to offset the restrictive effect which the rise in interest rates is presumed to have on investment,[17] thereby tending to sustain income and expenditures at existing levels.

The capitalization paradox

Renewed interest has come to be directed toward the transmission of the effects of interest rate changes by way of the capitalization of assets. Higher rates accompany lower prices of long-term bonds and other fixed income assets. A decline in the prices of these assets is alleged to have a chilling effect on the spirits of the people, since no one relishes the sight of a shrinkage in the market value of his assets. Thus higher interest rates go with a fall in the prices of real estate, bonds, and the like:[18] this with greater pessimism and caution; and these with a reduction in the demand for new investment.

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[17] The presumption of a restrictive effect on investment may also be open to challenge under the circumstances indicated. It can hardly be supposed that the marginal efficiency of capital will remain unchanged if the rise in interest rates increases public confidence in the future stability of business. Profit expectations would presumably be raised and the risk of loss diminished because of the lessened probability of fluctuations in prices and employment. The correspondingly greater inducement to invest may be expected to strengthen the demand for credit, tending to offset the restrictive effect on investment which results from the higher cost of borrowing.

The point both here and above is that confidence in the ability of the central bank to accomplish its objective may tend to destroy the validity of the reasoning whereby the ability of the central bank to accomplish its objectives is ordinarily explained. (In many situations, of course, confidence in the ability of the authorities to accomplish their aims is favorable to their attainment.) This is not to suggest that public confidence in central-bank policy is disadvantageous but that it may call for modification of the explanation of how monetary policy operates, as well as for modification of the techniques actually employed.

[18] The question of causality between interest rates and capital values is rather intricate and cannot be entered into at this time. The statement sometimes encountered (even in high places, as witness the Annual Report of the Board of Governors of the Federal Reserve System for 1954, p. 6), that an increase in yields causes a decline in the price of long-term securities is, of course, simple nonsense. Clearly the rise in yield and fall in price is merely an identity. The only way a decline in yields on Government bonds can manifest itself is by a fall in their price, and likewise whenever the price of Governments falls this constitutes a rise in the rate of yield on them. On the other hand, Professor Hansen has

Let us suppose, however, that weakness in the bond market encourages a shift out of bonds into stocks, both directly and through the channeling of new funds into stocks, rather than bonds.[19] And assume that the natural consequence of this redirection of investment funds is to contribute to buoyancy in stock prices. What of the possible stimulative effect of this on public psychology? Will the push of the stock market neutralize, or perhaps even overbalance, the drag of the bond market?

That this question is far from hypothetical is indicated by the fact that the two periods of notable heaviness in bonds, 1952–53 and 1955–56, were periods of ebullience in stocks. We can always retreat, of course, to the easy conclusion that the higher rates helped, at least, to control the stock market boom, i. e., that, even though the desired contraction did not materialize, the expansion might have been even greater without the increase in interest rates. Here again, however, we are up against conjectural history, and the probability is strong that preconceptions and past indoctrination will influence our final opinion.

It is not possible to say which influence of those mentioned here may be expected to exert the greater effect. But surely it may properly be suggested that there is need for caution in drawing easy conclusions from the capitalization idea and likewise that there is need for further study of the entire question.

A similar note of questioning and caution also applies generally to central-bank policy.[20] The simple fact is that precise conclusions are impossible on most matters in this area. Not only do other factors almost invariably enter in, but with changing economic and psychological conditions responses are seldom twice the same. The moral is plain that central bankers require a full complement of instruments and a flexible approach to their problems. This is the one sure conclusion that can legitimately be drawn.

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offered the observation that while this reciprocal relationship may be accepted as applying to bonds and mortgages, it should hardly be regarded as applying to all types of capitalized assets. In the case of real estate, for example, it may be correct to say that higher interest rates are the cause of a fall in real-estate values. The distinction obviously merits consideration, but is not essential to the present discussion which is confined to the market for bonds and stocks.

[19] The possible causal relationship is expressed in this form since the present discussion is concerned with a rise in interest rates (fall in the price of bonds) initiated by the central bank for the purpose of curbing stock-market activity. The rise in discount rates in April 1956 was acknowledged by Federal Reserve officials to be motivated by such considerations. In terms of market behavior it could be argued that a shift from bonds to stocks is likely ot occur not because bonds are weak but because stocks are strong. A rise in stock prices because of the expectation of higher earnings in a period of boom may induce a shift from bonds to stocks and thereby contribute to the higher level of interest rates which tends to characterize the latter phases of expansion.

[20] The foregoing discussion by no means exhausts the subject of unresolved problems, either as to their number or as to what might be said about them. Moreover, other problems are certain to crop up from time to time. During the period of tight money in 1956–57, for example, frequent mention was made in Federal Reserve publications and elsewhere of the tendency for higher interest rates to induce more active turnover of money. This suggests that the restraining influence which the general instruments of credit control purportedly exerted through limitation of the quantity of money was at least partially offset by the stimulus given to its rate of use.

Contemporary comment on the rise in velocity emphasized similiarities in the effect of changes in the volume and the rate of use of money as far as prices and incomes are concerned. It failed to call attention to the fact that an expansion in the volume of circulating medium may be presumed to involve the purchase of Treasury obligations and other credit instruments by banks whereas an increase in velocity does not. It is in accord with the analysis presented above to offer the opinion that this difference may constitute a signficant reason for past and prospective swings in interest rates.

FORD MOTOR CO.,
Dearborn, Mich., May 31, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: Enclosed is my statement in response to your questionnaire on the financial condition of the United States. I am most grateful for the extension of time you kindly granted me.

Sincerely yours,

THEODORE O. YNTEMA,
Vice President, Finance.

SENATOR BYRD'S QUESTIONNAIRE, FEBRUARY 17, 1958

Question 1. Give a definition in your own words of deflation and inflation.

Answer. Inflation and deflation have various meanings. For the purposes of this discussion I shall define them as follows:

Inflation—The phenomenon of rising prices.

Deflation—The phenomenon of falling prices caused by a decline in demand.

There are two main types of inflation: (1) demand-pull inflation, in which there is an increase in the volume and/or velocity of money and in which demand tends to outrun supply; and (2) cost-push inflation, in which there is upward pressure on wage rates and/or the prices of other factors of production, even though labor and materials are not in short supply. Cost-push inflation is usually accompanied by an increase in the volume or velocity of use of money, but this need not be the case if the cost-push inflation occurs in a recession. In actual experience we do not get pure cases of demand-pull inflation or cost-push inflation. Nevertheless, some inflations have their origin primarily in an expansion of demand and others in a rise of costs.

In this connection, it is worth noting that cost-push forces will accelerate and aggravate a demand-pull inflation. If labor and business are swift to raise wages and prices on the least pretext, and if wages and material costs are subject to automatic escalators, a bulge in demand and a rise in prices in part of the economy will spread rapidly through the rest of the economy, producing a much more rapid upward spiral of prices and costs than otherwise would occur.

A decline in the price level may be due to a falling-off in demand or to a decrease in costs made possible by improved productivity. When the decline in prices is caused by reduction in demand, this phenomenon is deflation. On the other hand, a price decline caused by lowered costs and increased productivity is not properly termed "deflation." Deflation—a decline in prices caused by falling demand—is accompanied by a contraction in the money supply or a reduction in the velocity of money use, or both.

Question 2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

Answer. A money and credit economy, producing durable goods in large volume, will have cumulative tendencies toward inflation and deflation. These tendencies cannot be curbed entirely without seriously impairing individual initiative, freedom of action and economic progress. They can, however, be kept from developing into severe booms and depressions. The most important means to this end are:

(1) A money and credit system that will not collapse and will provide adequate liquidity in depression. In such a system the money supply can be expanded in depression and contracted in boom times if necessary.

2. High enough credit standards so that a large volume of forced liquidation of loans and bad debts will not develop in a recession.

3. Automatic stabilizers, such as pay-as-you-go taxes and unemployment insurance, that not only tend to stabilize incomes but also tend to increase incomes in relation to the supply of goods and services in depression and decrease incomes in relation to the supply of goods and services in boom times.

(4) A central banking system that will restrain the expansion of money and credit in boom times and that will ease credit and increase the money supply in depression.

(5) Management of the public debt so that it does not thwart the contracyclical action of the central bank.

(6) Sufficient competition in labor and in business so that cost-push inflation will not push up the price level when demand is restricted by monetary and fiscal means.

(7) Fiscal action to reduce tax rates temporarily in depression if monetary measures are not adequate to deal with the situation.

(8) In time of genuine emergency, such as at the outbreak of war, quick application of price and wage controls.

On all these counts, except one, our institutions and know-how, though far from perfect, are adequate to give us a fair degree of economic stability. And we could achieve even greater stability if we would translate the technical economic knowledge we possess into appropriate action.

The one essential condition for stability that is lacking is sufficient competition in labor and in business to avoid cost-push inflation. This lack will, I believe, be fatal to economic stability unless it is remedied.

At present we have in business, outside the regulated public utilities, competition that varies a good deal in its character from industry to industry. This competition is not "perfect" in the technical abstract sense of economics which assumes for each market a large number of buyers and sellers, perfect knowledge on the part of buyers and sellers, costless transportation and communication, no unattained economies of scale, instantaneous adjustment of capacity to demand and independence of action by each buyer and seller. Competition in business is not perfect either in the everyday sense: it can be and needs to be improved. By and large, however, there is enough competition in most industries to keep prices and profits down to levels roughly equal to those necessary to compensate for the risks of the business. The tradition in business is competition. And there are laws on the books prohibiting monopoly and monopolistic practices—laws that have maintained reasonably workable competition in business.

A different situation exists in labor. Labor unions are monopolies established under the aegis of law. They are given special protection and even immunities and privileges that are not accorded ordinary citizens. They are not subject to much regulation or restraint in the use of their monopoly power.

During the boom of 1955–57 and in the recession of 1957–58 the unions have displayed their power to drive up wages faster than productivity and to squeeze profit margins. There is no reason to expect different behavior in the future from labor unions unless their powers are reduced. We can look forward, therefore, to continued and probably accelerated cost-push inflation in the future unless appropriate action is taken.

This problem cannot be cured by monetary or fiscal means. Prof. E. H. Chamberlin makes this point clearly in "The Economic Analysis of Labor Union Power."

"To deal with a wage-push inflation by monetary or fiscal policies is certainly not to deal with causes; it is rather an attempt to create a counter push by squeezing businessmen so that they will in turn squeeze labor. It risks economic contraction, to say nothing of major industrial strife. An obvious alternative is to diminish the degree of economic power in the hands of the unions, so that the pressure may be reduced at its source." [1]

Nor can this problem of labor monopoly and cost-push inflation be solved merely by increasing the degree of competition in business. The less able an industry is to pass on increased costs in higher prices, the easier it is for organized labor to encroach on the profits of that industry in the short run. Reduced profits, however, mean reduced investment, retarded growth, and increased unemployment. We shall still be left with the dilemma of either validating wages that outrun productivity by increasing the money supply, expanding demand and establishing a higher price level, or else suffering unemployment.

Industrywide organization of business to oppose industrywide organization of labor is not a happy solution. Although industrywide bargaining tends to equalize the economic power of business and labor, the results are unpredictable and often injurious to the economy. On the one hand, business may yield too easily to the union demands, knowing that if wage costs rise all firms will be affected equally. Or the opposite may happen: Unable to settle the issues peacefully, the parties may resort to economic warfare with an industrywide shutdown and heavy losses to employees, stockholders, others dependent on the industry and the public at large.

Wage and price controls are still worse as a solution to cost-push inflation. Wage and price controls will breed so much economic dislocation and inefficiency that they will impede and even stop economic progress. Before long such controls will break down because of administrative difficulties, evasion, and noncompliance.

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[1] Labor Unions and Economic Policy, p. 29. (The American Enterprise Association, 1958.)

The only satisfactory way to prevent cost-push inflation induced by the monopoly power of unions is to reduce that monopoly power.[8] As a first step, some or all of the legal immunities of labor can be removed, and unions can be made subject to the laws of the land that ordinary citizens must obey. (See Roscoe Pound, Legal Immunities of Labor Unions.[9]) The removal of the special immunities of labor unions may accomplish much of the reduction in the economic power of unions that is needed to prevent cost-push inflation.

If this first step is not sufficient, the second step would be the development of antimonopoly laws for unions and analogous to the antimonopoly laws for business. If necessary, it would be possible to limit federations of locals for collective bargaining to a size that does not give them monopoly control of labor and wages in an industry and to prohibit collusion among such federations in economic matters. It may not, however, be necessary to go this far to prevent most wage inflation.

The problem of wage inflation is relatively new. It began to emerge in the thirties, but it did not appear clearly until the boom and inflation of 1955–57 and the recession of 1957–58. Not only is the problem new, but it is beset by taboos and strong emotional reactions. What is needed is objective analysis of wage inflation and labor monopoly by competent, disinterested scholars and the publication of their findings. As economists in increasing numbers undertake such analysis, as the economic profession becomes better informed, and as the knowledge spreads to the public, there will develop a basis for action in dealing with labor monopolies. At this stage I would not urge specific legislation other than reduction in the special privileges and immunities of unions. Beyond that, I would urge continued investigation of the labor monopoly problem in educational institutions, in research organizations, and in Government so that we may have, as soon as possible, a foundation in technical knowledge and in public opinion for appropriate action.

Question 3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942 to 1957. (You may wish to divide the period into two parts: 1942–50 prior to the accord, and 1951–57.)

Answer. The monetary policy of the Federal Reserve System from 1942 through 1950 appears to have had three objectives:

(1) To supply a sufficient amount of money to the Treasury to enable it to finance the war.

(2) To keep the level of interest rates low in order to minimize interest costs to the Treasury.

(3) To provide ample credit and low-interest rates in order to maintain a full-employment economy.

From 1942–50, the Federal Reserve System appeared to be operating under the strong influence of the Treasury Department. The national emergency during the war period necessitated, to some degree, this subservient role. On the other hand, the inflationary pressures during the postwar period required restrictive credit policy rather than support of the Govenment bond market. It must be remembered, however, that

[8] For an excellent discussion of this problem see Statement of Edward H. Chamberlin before the Subcommittee on Labor Relations, Senate Committee on Labor and Public Welfare, May 22, 1958.

[9] The American Enterprise Association, Inc., Washington, D. C.

economic opinion at that time indicated the probability of the usual postwar recession and that credit policy was dedicated to the prevention of such a development. By 1947, however, the Federal Reserve System should have been concerned more with restricting inflation than preventing a business decline.

With the "accord" in 1951, the Federal Reserve System was no longer hamstrung by the commitment to support Government bonds. Since then, the System has used its powers to restrain inflation and mitigate cyclical fluctuations. I would commend the System for its courage and its wisdom, but at the same time I would offer these suggestions in regard to its recent actions.

With hindsight, it is apparent that restrictive monetary measures were continued too long in 1957 and that the increase in the rediscount rate in August 1957 was inadvisable. I am inclined to think, too, that the steps in recent months to ease credit might well have been taken more quickly.

At present, loans are obtainable by good credit risks, but interest rates to borrowers are still high. Bank-loan rates and long-term bond rates are considerably above the levels prevailing prior to 1955. It would be greatly in the public interest to increase the reserves of commercial banks and/or reduce their reserve requirements further in order to exert more downward pressure on sluggish interest rates.

Question 4. Beginning in August 1956 there was an increase in the Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

Answer. From March 1956 to December 1957 the BLS Consumer Price Index rose 6 percent. The BLS Wholesale Price Index started rising after mid-1955 and was 7.4 percent higher by December 1957.

This increase occurred across the board in practically all categories of commodities and was not concentrated in any particular group of commodities.

During this period there was no sudden bulge in demand and there were no important shortages of consumer goods and services. In general, productive capacity was adequate to supply the demand for consumer goods, raw materials were readily available, and, through the labor supply was somewhat tight, it was possible to increase production where needed.

The only important segment of the economy where demand pressed on available resources was in producers' capital goods and construction from mid-1955 to the end of 1956. The aggregate Wholesale Price Index is influenced substantially by these items and thus moved up earlier than the Consumer Price Index. For commodities common to both the Wholesale and the Consumer Prices Indexes, the timing and extent of price rise were similar.

In the period of general price rise from the second quarter of 1955 to the fourth quarter of 1957, total corporate profits after taxes (exclusive of profits from inventory price change which are not included in total national income) did not rise and then declined sharply in the last quarter of 1957, showing a decrease over the period of $2 billion. Unincorporated business and professional income was up about $1 billion and farm income was virtually unchanged. Employee compensation, on the other hand, increased $34 billion.

In recent years wage rates plus fringe benefits continued to rise at a rate of 5 to 7 percent per year, while in the last 2 years output per manhour outside of agriculture rose about 1 percent a year. Wages outrunning productivity raised costs and consequently prices, and at the same time provided higher money incomes to pay the higher prices.

The conclusions from this and other economic evidence are:

(1) The increase in consumer prices in 1956–57 was attributable primarily to the increase in wage rates in excess of the increase in productivity.

(2) The increase in consumer prices was not attributable to a bulge in demand or to shortages in supply.

(3) The increase was not attributable to a bulge in corporate profits.

(4) The increase was general and was not attributable in particular to price increases on products of large corporations.

There follow some notes on the increases in the major subdivisions of the Consumer Price Index since March 1956.

Consumer services account for a third of the index and are supplied for the most part by unincorporated business, by utilities subject to rate regulation, and by nonprofit institutions. They increased in price by 6.7 percent from March 1956 to December 1957. This was on top of a 12.6-percent rise from December 1951 to March 1956, during the period when other consumer commodity prices leveled off or declined. (See exhibit: "Consumer Price Index—Commodities and Services.")

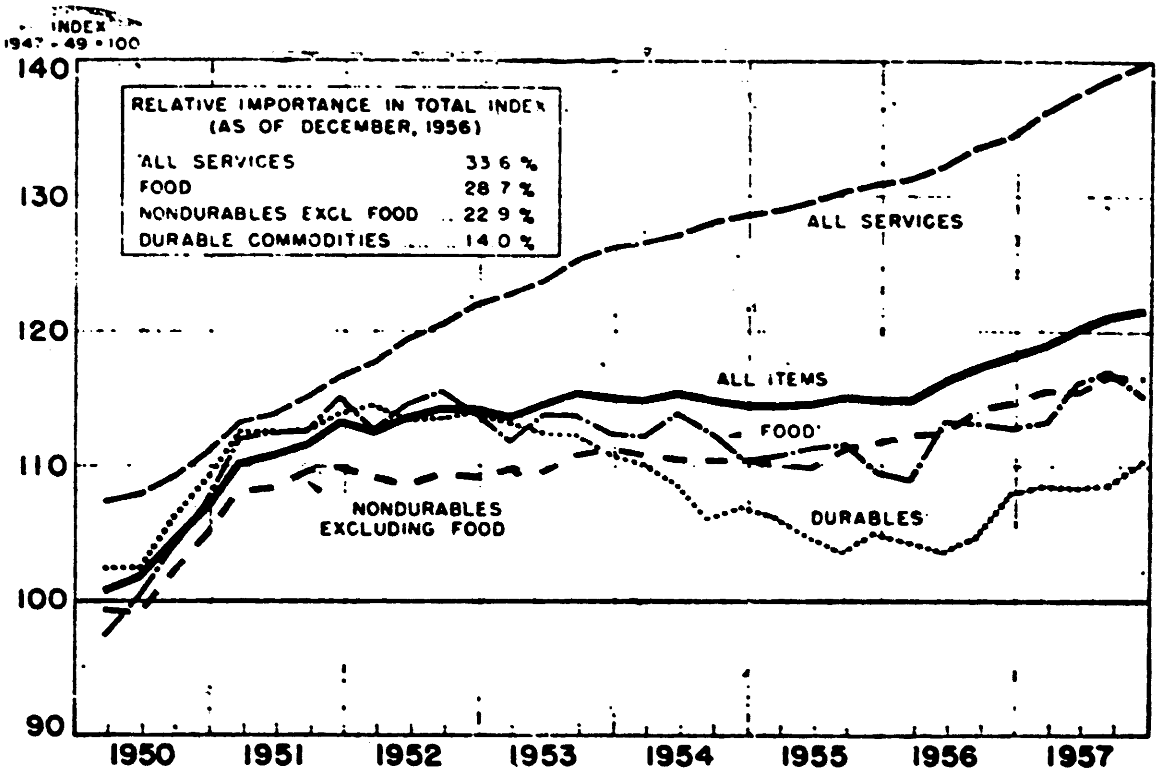
Foods, which currently account for about 29 percent of the index, contain a small amount of corporation profits in the consumer price. Most of the difference between retail and farm prices represents transportation, labor cost of manufacturing, and distribution. Transportation and distribution costs increased primarily because of higher labor cost. Food prices rose 6½ percent between March 1956 and December 1957. These prices only slightly more than recovered the decline after December 1951.

Nondurable commodities other food account for an additional 23 percent of the index. The largest segment of this group represents apparel, the production and distribution of which does not reflect high profits of large corporations. The textile and apparel industry, on the contrary, is usually plagued with low profits. Apparel prices increased 2.6 percent from March 1956 to December 1957. Prices of other consumer nondurable commodities rose 5.9 percent during this period. The rise in apparel prices merely recovered the decline after December 1951, but the increases for other nondurables was in addition to a rise of about 6½ percent from December 1951 to March 1956.

The other element of the Consumer Price Index—consumer durable goods—has a weight of 14 percent of the total index. Prices of consumer durables increased 5.8 percent from March 1956 to December 1957. Despite the recent rise, these prices were still nearly 3 percent below the December 1951 level.

QUESTION 4—EXHIBIT

CONSUMER PRICE INDEX—COMMODITIES AND SERVICES[A]



(A) FIGURES ARE FOR THE 3RD MONTH OF THE QUARTER
SOURCE: BUREAU OF LABOR STATISTICS

E 2 202—1/58

	December 1951	March 1956	December 1957	Percent change		
				1951–56	1956–57	1951–57
All items	113.1	114.7	121.6	1.4	6.0	7.5
All commodities	112.4	108.5	114.7	−3.5	5.7	2.0
Food	115.0	109.0	116.1	−5.2	6.5	1.0
Nondurables (excluding food)	109.8	112.1	117.3	2.1	4.6	6.8
Durables	113.9	104.3	110.3	−8.4	5.8	−3.2
All services	116.5	131.2	140.0	12.6	6.7	20.2

Question 5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

Answer. The management of the public debt has many facets. I shall comment briefly on only one aspect of the problem, the conflict between debt management and monetary and credit policy.

In general, debt management should not dominate, but should be accommodated to, the monetary and credit policy required by the state of the economy. If this principle is not followed and if the public debt is managed so as to minimize interest costs to the Government, the result will be an accentuation of cyclical fluctuations.

Interest costs can be minimized by concentrating the debt in short-term securities except during a depression when longer-term issues can be sold at a low interest rate. The first of these actions, carrying a large part of the debt in short-term securities, provides a huge volume of near money that can be easily converted into money and used to increase demand in boom times. The second of these practices, issuing long-term maturities in depressions, siphons off investment funds that might go to business and thus increase the demand for goods. The observance of such policies without regard to their impact on the cycle would serve to intensify depressions and booms. It would make the job of the central bank accordingly more difficult and would result in a real loss of income to the economy much greater than the possible gain from reduced interest costs.

As a general principle, the Treasury should try to extend the debt during an inflationary period and should concentrate in the shorter maturity range in its debt operations during periods of deflation. Because of the size of the public debt and the problems of marketing huge issues, it may not be feasible for the Treasury to sell long-term bonds only during boom periods and refrain entirely from selling them during a recession.

In time of war or other emergency when the Government must borrow heavily, the requirements of the Treasury will override the anti-inflationary policies that would otherwise be appropriate for the Federal Reserve System. In such circumstances, every possible effort should be made to borrow on long maturities and from sources outside the banking system so as to minimize the expansion of the money supply and the inflationary effects of deficit financing.

Question 6. (*a*) Discuss in their relationship to one another and according to your judgment of their relative and importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand, and employment.
3. Economic growth in production, demand, and employment.

(*b*) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

Answer. Price stability, stability in production and employment, and economic growth are all important objectives of economic policy.

Stability of the general price level is important for two reasons. First, it is necessary if we are to avoid arbitrary levies on, or windfalls to, debtors, creditors, persons with fixed incomes, and persons with flexible incomes. Ideally, the price level should decline gradually as productivity rises, so that all sectors of the economy may share in the benefits from increased productivity. Second, sufficient price stability is required so that money will serve as an acceptable store of value, and so that plans, decisions, and financial arrangements can be made satisfactorily in regard to business operations extending over months and years.

In this connection it should be noted that stability in the general price level does not imply rigidity or a high degree of stability in the prices of individual goods and services. Individual prices should be sufficiently flexible to draw resources into the employments where they will be most productive and to provide a balance between demand and supply.

Stability in production and employment is important for a number of reasons. Production that is lost in depression reduces the standard of living and retards the accumulation of capital needed for economic growth. Depressions and unemployment cause personal hardships and foster dissatisfaction and resentment. These often lead to attempted remedies that are injurious to the economy. It should be noted that stability in production and employment in each industry is not to be expected. There will be, and should be, expansion and contraction in specific industries in response to shifts in demand. Furthermore, the effects of general business fluctuations are not wholly injurious; a recession creates the need for increased efficiency and economy and these, in turn, contribute subsequently to more rapid economic growth.

Growth in production should be the major goal of economic policy. Our rising standard of living is, of course, dependent on such growth. Economic growth has its roots in improved education, scientific research, engineering development, better organizational and administrative techniques, incentives (especially profits), and the accumulation of capital. The principal hazards to economic growth are war, inflation that interferes with the function of money as a store of value, and impairment of economic incentives by monopolistic practices, by state controls and by too-high taxation of profits and incomes.

In general, it is unwise to sacrifice economic growth in any substantial degree for increased stability. The benefits of increased stability are for the most part temporary, but the benefits from economic growth are cumulative and permanent.

Among the important trends since World War II, the high rate of growth in production and the attendant high rate of accumulation of capital, are noteworthy. To some extent these represent recovery from the long preceding period of depression and war.

The last 12 years have been notable, too, for stability of production and employment. In part this stability reflects the prolonged demand for durable goods to build up inventories of such goods to desired levels. In part it reflects the action of automatic stabilizers and the decreased sensitivity of our money and credit system to depression influences.

The period since World War II has not been one of price stability. Nevertheless, the snuffing out of the postwar inflation in 1948 was a notable achievement of one of our most important automatic stabilizers, the pay-as-you-go tax system. At the peak of the inflation the system produced a $10 billion cash surplus in 4 quarters without any increase in tax rates. The spurt in prices that occurred in 1950 with the outbreak of the Korean war could have been checked by the immediate imposition of price and wage ceilings. Most of these controls could have been relaxed at an early date when the surge in demand subsided.

The most ominous instability of prices since World War II developed in 1955-57 and continued into 1958. During this period the rise in output per manhour slowed down markedly. Nevertheless, wage rates and fringe benefits continued to rise at a rapid rate, much in excess of productivity. The result was increased costs, increased prices, and reduced profit margins. In 1956–57 the Federal Reserve System tightened credit, thus dampening the demand for goods and services. In 1957–58, a substantial recession developed but wage rates and consumer prices continued to rise.

These developments are ominous because they indicate that wages will probably continue to outstrip productivity, thus causing higher costs and higher prices (in turn, to be validated by monetary expansion). If such price increases continue, they will injure still further people with fixed incomes. Moreover, the inflationary trend will tend to accelerate as more and more groups try to anticipate it and protect themselves against it by escalation. The result may well be an inflation and a profit squeeze that will threaten economic growth and stability of production and employment.

Question 7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

Question 8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

Answer. An adequate answer to these questions would require a tremendous amount of special knowledge that I do not possess. I shall, therefore, offer general comments on only a few points.

Government activity has grown to huge proportions. Referring to 1950, Solomon Fabricant wrote, "One out of every eight persons employed in the United States today is a Government worker. One out of every five dollars of the Nation's capital assets—even excluding public roads and streets and most military and naval equipment—is Government property. One out of every twenty dollars of the consolidated net sales of business is made to Government." [4] In 1957 total expenditures of Federal, State, and local governments amounted to $115 billion.

With Government operations of such magnitude, the receipts and expenditures of Government assume importance of the first order. Waste in Government significantly reduces the standard of living. A

[4] The Trend of Government Activity in the United States Since 1900, p. 8.—National Bureau of Economic Research, Inc., New York, 1952.

major change in tax rates or in expenditures can dominate and determine the course of business activity. Built-in stabilizers, such as pay-as-you-go taxes, unemployment insurance, farm payments, and old-age and survivors' insurance become powerful defenses against cyclical instability. The distribution of the tax burden influences consumption and investments, and affects significantly the rate of economic growth.

The postwar record, except for the Korean war, indicates that the balance of Government receipts and expenditures has tended to shift from time to time so as to counteract cyclical movements and promote economic stability. This has resulted mostly from the operation of built-in stabilizers, but partly also from tax cuts in 1949 and 1954.

The opinion is widely held, and I think rightly so, that the present distribution of the tax burden tends to weaken the incentives to work and to take business risks. In support of this position can be cited the extremely high marginal rates of the income tax, the high tax on corporate profits, and the double taxation of corporate profits, first to the corporation and then to the individual. The effects of these extremely high taxes are mitigated erratically by the lower rate on capital gains and by a considerable number of special arrangements permitting splitting of income, special deductions for depletion, conversion of income into capital gains, et cetera. Many of these special arrangements offer strong inducements to risk-taking and new business investment as opposed to the earnings of high-bracket personal income.

The high upper bracket rates on ordinary income and the special arrangements create serious inequities and distortions in business investment. It would be fairer and better for the economy to reduce the upper bracket rates substantially and thereby obviate the need for loopholes.

Question 9. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy and then relate them, one to the other. Please discuss these policies stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

Question 10. (*a*) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purposes of this question consider that the monetary system includes bank deposits and bank credits.) Also please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

(*b*) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

Answer. My answers to these questions would, for the most part, conform to the principles that are generally accepted by economists. The points on which I have comments to make are incorporated in the answers to other questions.

Question 11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

Answer. At times in the thirties inflation and large-scale unemployment occurred side by side. In recent months a more unusual phenomenon has appeared—rising prices coupled with increasing unemployment.

Even though large-scale unemployment exists, prices may rise if there is a sudden increase in demand, such as occurred in 1936–37, or in 1939 at the outbreak of World War II. In the recovery from a depression, prices likewise tend to move upward in response to increased demand before a condition of full employment is achieved. Again, the cost of living may rise during a period of heavy unemployment if there is a crop failure or if Government acts to raise farm prices.

These phenomena are less alarming than the kind of wage, cost, and price increases sponsored by the NIRA in 1934–35 while mass unemployment prevailed in the country. And they are less alarming than the kind of cost-push inflation experienced in recent years, which has culminated in strong union pressures for wage increases in the face of mounting unemployment.

The present cost-push inflation during a deepening recession is the product of monopoly power possessed by the unions and, it must be added, exercised by them without much regard to the general welfare. Using this power, the unions have continued to push up wages faster than productivity, thus increasing production costs and supply prices.

See also answers to questions 1, 2, 4, and 6.

Question 11. (*b*) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

Answer. Inflation is, per se, evil. It hurts the weak and the poor. It taxes the savings and the incomes of those who cannot protect themselves—small savers, old people, and widows and children living on fixed-dollar incomes, and school teachers and other public servants on relatively fixed salaries.

No one advocates rapid inflation, only a slow inflation of a few percent each year. But the effects of such inflation are cumulative and soon cause great hardship to those with dollar savings and fixed dollar incomes. Furthermore, there is no assurance that chronic inflation can be kept down to such a slow pace. As people recognize what is happening, they will turn to escalators and other protective devices that will quickly transmit and accelerate the effects of inflationary pressures.

If a choice really had to be made between the evil of slow inflation and the evil of mass unemployment, I would choose the former. But such a choice does not have to be made, and if it did, there is doubt whether the alternative of slow inflation would be open to us for very long.

Despite the imperfections in business competition, the pressures making for price decreases and against price increases are very strong. If dollar wage rates were kept from rising, there is no doubt that the commodity price level would fall and real wages would rise. If wage rates and fringe benefits can be kept from increasing more than 2 percent a year, the increase can be absorbed by increased productivity without price inflation.

A high average level of employment can be achieved without inflation by means of appropriate monetary and fiscal policies if we will: (1) Limit the monopoly powers of unions so that they will not be able to drive up wages faster than productivity, and (2) continue through the antitrust laws to require workable competition in business.

Question 12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy?

Answer. This is a difficult question, and I doubt that anyone can answer it with assurance.

We emerged from World War II with a total private debt lower than in 1929, although gross national product had doubled from 1929 to 1945. Since 1945 private debt has increased much more rapidly than national product, but it still bears a lower ratio to national product than it did in 1929. The rise has been particularly rapid postwar in installment debt and in mortgage debt of consumers.

It is clear that the increase in private debt relative to gross national product cannot continue for long without adverse consequences. It is not clear that the present level of private debt is a threat to the economic stability and vitality of the economy.

Mortgage debt and installment debt facilitate saving and investment in housing, automobiles, and other durable goods. Since in most of the postwar period we were catching up in the accumulation of durable goods, it is not surprising that large increases should have occurred in installment and in mortgage debt.

Increase of debt is a powerful force making for growth and expansion in good times. Liquidation of debt is a powerful force making for contraction and cumulative depression. The danger inherent in the debt structure depends on the ratio of income and asset value to debt that will obtain when a recession in business occurs. Obviously, this will depend on how severe the recession is.

If our economy is inherently more stable than it was 30 years ago (and I believe it is) and if the Federal Reserve System continues to follow anticyclical policies (as I am sure it will), the danger from collapse of the debt structure will be very much less than it was after the twenties. If, in addition, we would adopt temporary tax reduction to combat severe recession (as apparently we are not yet ready to do), the hazards from collapse of the private debt structure as it now exists would be negligible.

Question 13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy?

Answer. Public works should never be used as a major means of coping with depression. Public works take too long to start and too long to stop. Their pump-priming effects begin too late in the depression and continue too long into the ensuing recovery and boom. Moreover, public works undertaken as antidepression measures are less likely to meet proper standards of need, careful planning, and efficient administration. It is desirable to accelerate Government purchases and public works underway if such acceleration can be achieved within a reasonable timespan and without loss of efficiency, but the total possibilities of such acceleration will not add up to enough to provide an important antidote to depression.

Temporary tax reduction is far superior to public works as an antirecession measure. It can take effect quickly, it can be of such magnitude as to reverse any deflation, and it can be stopped quickly. It can be in the form of cancellation for a temporary period of some portion, or all, of personal income taxes. One possibility would be the cancellation of all withheld taxes and the equivalent on income not subject to withholding. This would increase personal incomes by about $2½ billion or 10 percent per month and would end a depression quickly.

A permanent tax cut, together with tax reform, would be highly desirable in depression if, after the cut, a balance in the Federal budget could be foreseen in the ensuing recovery. Such is not the case now. Even with present tax rates, the expansion of military expenditures and the increases in other Government spending recently authorized will probably lead to a deficit in the years immediately ahead unless inflation swells the amount of tax receipts.

A temporary tax reduction should be kept separate from tax reform or permanent tax reduction. This is desirable in the interests of simplicity, avoidance of delays, and public understanding.

The main question, on which there is room for wide differences of opinion, is the timing of major antidepression moves. The reason for these differences of opinion is the dilemma of wage inflation or unemployment posed by the monopoly power of the unions. Any successful moves to end the recession will be the signal for intensified wage demands and accelerated wage inflation. In these circumstances many people oppose strong monetary or fiscal action, preferring less inflation even at the cost of more unemployment. Others make the opposite choice, preferring to end the recession even though it means an acceleration of wage inflation. This is a most unhappy choice, and it will stay with us until we come to grips with the excessive economic power of unions.

If it were not for the threat of wage inflation we could act boldly and safely to end this or any other recession in short order. It would be possible to put into effect a massive temporary tax cut (e. g., the elimination of withheld taxes) when unemployment (seasonally corrected) exceeded 7½ percent of the civilian labor force, reduce the tax cut by half after 3 months, and terminate it at some specified time within 12 months or when unemployment dropped to 5 percent, whichever occurred first. The trigger points for starting and stopping a temporary tax reduction cannot be set much, if any, lower than those indicated without risking serious inflationary effects from such action.

In the world-as-it-is I would recommend that the Federal Reserve System move all the way to ease credit and reduce interest rates and do so more rapidly than it has. Then I would recommend action on temporary tax reduction at the points indicated. These moves will aggravate wage inflation—but I suspect that the prelude to curing wage inflation is to have more of it.

Question 14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

Answer. Deficit spending by the Federal Government since the end of World War II has not been an important factor contributing to or producing inflation. Over the entire postwar period (calendar years 1946–57) the Federal Government had a cash surplus of $11 billion. In only 1 year, 1953, was there a sizable cash deficit. The legislative budget would show a less favorable picture, but it is the cash budget rather than the legislative budget that reflects the impact of Federal receipts and expenditures on the economy.

In special areas Government spending produced inflationary results, for example, payments in support of agricultural prices and concentrated expenditures for defense during the Korean war. On the whole, however, the cash surpluses of the Federal Government during the postwar period had a dampening effect on inflation.

The deficit financing of the Government that occurred during World War II did, however, have a major inflationary effect in the postwar period. The inflation of 1946–48 was primarily a reaction to the excess money and near money that was created by Government borrowing during the war. And the pegging of the Government bond market from 1945 until 1951 made it impossible to take effective monetary action to control inflation during that period.

Question 15. Can full employment goals be attained while maintaining a dollar that has relatively stable purchasing power?

Answer. Given existing institutions, I believe it is not possible to maintain a dollar of relatively stable purchasing power while attempting to attain full-employment goals. In my judgment the force of cost-push inflation, and in particular wage inflation, is so strong that prices will rise and the value of money will depreciate if we attempt to maintain a reasonably high level of employment.

On the other hand, if the power of unions is reduced so that they cannot drive up wages faster than productivity and if workable competition in business is maintained by vigorous antitrust action, it will be possible to maintain a stable dollar and achieve a high level of employment through appropriate monetary and fiscal action. There will be cyclical ups and downs in production, employment and prices, but these can be moderated so that we can have a fairly stable price level and a high level of production and employment.

See also answers to questions 1, 4, 6, 11, and 13.

Question 16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

Answer. Escalator provisions in wage and other contracts are of two types: (1) Those providing for adjustments to compensate for changes in the price level, and (2) those providing other automatic increases, such as the "improvement factor" that was originally intended to approximate the trend of increase in productivity.

Price escalators tend to speed up the transmission of inflationary or deflationary influences to buyers and employers. Unless they make excessive adjustments to compensate for price changes, price escalators do not initiate inflationary or deflationary movements. They only accelerate the spread of such influences throughout the economy, but this acceleration results in greater inflation or deflation than otherwise would occur in the economy.

"Improvement factors" that are limited to 2 percent or even perhaps 2½ percent per annum would not be seriously inflationary if all union demands, including wage increases and fringe benefits, could be contained within this 2 to 2½ percent. In actual practice, the cost of living and "improvement factor" escalators tend to become the base on top of which other demands are piled and from which the bargaining starts.

As a consequence, cost of living and improvement factor "escalators" play a most important role in wage inflation.

Unless and until unions are willing to accept cost of living and "improvement factor" escalation as the total amount available to cover all their demands—unless their other demands are substitutes for and not in addition to such escalation—the escalator provisions will lead to wage inflation and will be incompatible with the achievement of economic stability.

Question 17. List and briefly discuss what you consider the causes of the present recession, and what should be done to terminate it.

Answer. Among the causes of the present recession might be listed:

(1) Completion of "catching up" in the accumulation of producer durable goods and consumer durable goods to make up the shortages inherited from depression and war.

(2) Wage inflation: Wages driven up faster than productivity, leading to higher costs, higher prices and a reduction in profit margins.

(3) The actions of the Federal Reserve System to restrict credit in order to check inflation and moderate the boom.

(4) The failure of the Federal Reserve System to shift quickly enough and far enough from restrictive to expansionary measures.

(5) The reduction in inventories in response to reduced demand. The shift from inventory accumulation to inventory reduction accounted for two-thirds of the decline in gross national product from the third quarter of 1957 to the first quarter of 1958.

(6) The reduction in expenditures for consumer durable goods, especially automobiles, induced by the recession.

(7) The reduction in expenditures for producers' durable equipment induced by the recession.

Important steps have already been taken by the Federal Reserve System to ease credit and increase the money supply. Interest rates on bank loans and long-term borrowings are, however, still considerably above the levels prevailing prior to 1955. In my opinion further steps are needed to increase the money supply and exert additional downward pressure on interest rates.

The recession could be ended quickly by a large-scale temporary tax cut such as was described earlier. Whether such action should be taken depends on value judgments in regard to unemployment versus inflation. If such action is not taken there will be less inflation and more unemployment; if it is taken there will be less unemployment and more inflation.

A permanent tax cut should not be made at this time because of the prospective increase in Government expenditures. The yield from all our present taxes will be needed to balance the budget next year and the year after at high employment. The present 10 percent excise tax on automobiles is, however, so discriminatory and repressive that it should be reduced immediately to no more than 5 percent and the base of the excise broadened to other commodities as of January 1, 1959, to compensate for the loss of revenue.

What is needed most is a reduction in the monopoly power of labor so that monetary and fiscal actions can be taken without fear of cost-push inflation. Wage inflation is the key economic problem of this country. Solving that problem will make possible high employment, price stability, and dynamic economic progress. The resulting benefits to union members will far outweigh any possible gains they might achieve by exercise of union monopoly power.

See also answers to questions 2, 3, 5, 6, 11, 13, and 15.

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