

op. 3

**SECURITIES AND
EXCHANGE COMMISSION
LIBRARY**

THE ARMY INDUSTRIAL COLLEGE
Washington, D.C.

Course 1939-1940

IN TIME OF WAR PREPARE FOR PEACE

by

Mr. Jerome N. Frank,
Chairman, Securities and Exchange Commission

April 8, 1940

AIC 235 (4/15/40) 14 h

43783

IN TIME OF WAR PREPARE FOR PEACE

I am very glad to be here today, not because I think I can say anything that you do not already know, but because I think it of the utmost importance that, in peace time persons in the civilian branch of the government should, as best they can, cooperate with those of you who are in the armed forces.

Eternal peace is a noble dream and one which, of course, every intelligent man wants to see realized as soon as possible. Many dreams -- such as that men could fly -- have been realized. It is, therefore, folly to sneer at dreams. But it is even more unwise to confuse dreams or hopes -- even if they may be realizable in the future -- with present realities.

I am definitely not war-mongering. All sane men hate war and fervently pray that our country will never engage again in armed conflict. But, as old Thomas Hobbes said in 1651, "Warre consisteth not in Battell only, or the act of fighting; but in a tract of time wherein the Will to contend by Battell is sufficiently known. . . As the nature of Foule weather lyeth not in a shower or two of rain, but in an inclination thereto of many dayes together, so the nature of War, consisteth not in actual fighting, but in the known disposition thereto, during all the time there is no assurance to the contrary. All other time is Peacc." In that sense, we seldom know a time of absolute peace. We have an admixture of the two, with the peace ingredient usually, and fortunately, the dominant.

Altogether too much of civilian thinking ignores the fact of war, actual or potential. In a world in which wars are almost constantly going on somewhere, economists still nonsensically write as if wars were "abnormalities" or "interferences" with the "normal" course of world events. To think in those terms is the equivalent of thinking of a universe in which everybody always has perfect health and no one ever dies; a physician who would think in those terms would be a fool. And yet many economists and other civilians indulge in just that kind of thinking.

That was not always true. Adam Smith in his "Wealth of Nations," published in 1776, devoted a chapter to military defense as an integral part of the subject of political economy.

Since the institutions of a country may be overturned by defeat in war, with the result that the essential nature of its economy may become drastically different, and since military expenditures are a necessary part of the budget of any sane government in the sort of world in which we live, any intelligent study of our economy must take into account the activities of the military branch of the government.

Conversely, it would seem to me -- who knows very little about it -- that military men should be vastly concerned with the kind of economy they are asked to defend and with the fiscal, economic, and political aspects of the government of which they are a part.

And so, before I begin my brief discussion of the subject about which you have asked me to talk, I want to say that I, for one, have very little patience with the attitude towards our armed forces depicted in Kipling's "Tommy Atkins." The men in the army and navy are among the most devoted of our public servants. I sincerely hope that the kind of meeting we are having today will lead to closer relations between the civilian and armed forces in government, and that you who are in the armed forces will more freely tell the rest of us what you think of our activities, after learning, through closer contact with us, just what we are doing and why. For you and we are both engaged in preserving the American profit system and American democracy.

Economists, I am told, like to discuss the economics of war, because such a discussion often enables them to simplify their studies by stripping off certain of the complicated problems of money and finance which are brute facts of daily life in peacetime. Such discussion, however, rarely gets down to the blueprint stage. Those, on the other hand, who are faced with the task of drafting actual plans, are often inclined to give too much attention to the mere mechanism of administration and not enough to the purposes which the machine is designed to achieve. Under peacetime conditions, our economic and administrative organizations can well be left to develop largely as actual needs arise. But, to meet the requirements of war, we need a more carefully planned machine -- one that will be ready to function, so to speak, after a few 'phone calls.

While I readily concede, therefore, the need for careful war planning, not only of the methods to be pursued but of the number and nature of organizations which will be required, I intend to say very little about the latter -- for two reasons: First, I think it is essential, before deciding what new agencies

will be required or what existing agencies can be adapted to war needs, to have a clear conception of what functions war finance will be required to perform besides the raising of money for guns and ammunition. Second, I believe that once we have clearly in mind the elements of control necessary to shift suddenly from a peacetime economy to one of war, the types, requirements and composition of the various agencies will become fairly well indicated by the nature of the job to be done. As Abraham Lincoln said, in another context, "If we could first know where we are, and whither we are tending, we could better judge what to do and how to do it."

Clearly, there can be no one single war plan. All wars are not alike. The next war in which we engage may or may not require the same extensive activity as did the last. There should not therefore be a war plan, but many war plans, each being dependent on the character and magnitude of the war to be waged, on whether it is likely to be short or long in duration, and whether it is to be fought primarily on land or sea. Accordingly, there must be several plans, with a recognition, too, that, as a war develops, it may shift its character.

But, whatever the nature of the war, I take it that its purpose will be to preserve our capitalistic or profit economy inside our democracy. Wherefore, all war plans should be so devised as to continue, as far as possible, even in war time, on a free enterprise or capitalistic basis. That means that the effort should be to see to it that the economic machinery will continue to be directed, basically, by the mechanism of prices; that, so far as possible, it will not be directed by government orders. Of course, some direct governmental controls will be necessary, as they were in our last war. But the amount of such direct governmental management of the economy should be no greater than the nature of any particular war (or a particular phase of a particular war) makes indispensable.

The methods of war finance adopted should, then, be required, first, to perform the job with the least disturbance to the ordinary financial life of the community compatible with the supreme aim of winning the war; and second, to perform the job with a minimum of undesirable after-effects. In practical terms, that means that the war burden should be apportioned in as equitable a manner as possible, in order that no group in the community should be permitted to gain at the expense of others. The war should not yield an economic victory for some particular domestic groups.

It is often said that in time of peace we should prepare for war. I suggest this also: In time of war, we should prepare for peace.

The basic fact of war finance is, simply, that the cost of conducting a major war absorbs a considerable proportion of the nation's income, or, more correctly, a considerable portion of the output of the nation's labor force, natural resources, and capital equipment. The essence of war, in the economic sense, is that a portion of productive resources is utilized during war-time in different ways than it is utilized in peace-time; namely, to produce war supplies instead of civilian goods. It is the task of war finance to make possible and to facilitate this shift in the productive effort of the nation. The scope of war finance, therefore, cannot be restricted to the sphere of money or finance proper. We must always be aware that we are dealing, basically, with a problem of shifts in the uses of resources.

Consumption (and I refer, of course, to the consumption by civilians of the everyday articles of peace-time living, especially articles of the inessential variety) must be curtailed below what it would otherwise be with the same level of industrial activity; and production must be stimulated and directed on some adequate basis, in order that any plan of finance decided upon shall be equal to the task of providing the Government with the vast masses of goods and services it will require. In short, assuming any level of national income, during time of war the civilian population must consume less than it would on the same level in peace-time, so that what we save in civilian consumption we can expend in war effort. This, in simplest terms, is the formula of war finance.

If we assume that we are not to employ the direct (totalitarian) method of war finance -- complete industrial conscription and rationing of consumption -- as generally not compatible with the system of capitalistic enterprise, we are left with four main methods of war finance. These are

- (1) Taxation,
- (2) Forced loans,
- (3) Voluntary loans, and
- (4) The issue of currency, including both paper money and bank deposit money.

All theoretical discussions of war finance very soon come back to an evaluation of the relative efficiency,

desirability and after-effects of those four methods. The discussion has such a long history and is spread over so large a literature that I can scarcely attempt here to touch upon all the essentials of this quadrivium of war finance. In a practical sense, however, it is largely a question as to what combination of these methods will best serve our purpose.

It must be remembered, too, that each method may be expected to perform more than the single function of supplying funds for the purchase of war supplies. Taxes, for instance, are useful not only in raising revenue but as a means of curtailing consumption of non-essentials -- which is an important factor in our formula of war finance. Similarly, forced loans or deferred payment schemes are not only revenue raisers but powerful agents in bringing about shifts in the uses of productive resources.

It makes an essential difference in the evaluation of the different methods, whether our reasoning is applied to an economy with full employment of productive resources or to one with underemployment of the factors of production -- reflected most clearly in the unemployment of part of the labor force. Until the stage of full employment of resources is reached, we should give preference to those methods of war finance which induce a net increase in production, not merely a shift in production. In that period, as I see it, we should not, therefore, seek to cover the cost of armament by new taxes or forced loans, but mainly by borrowing, primarily from the banks and from the idle reserves of individuals. Under such conditions, it is even conceivable that we might finance part of the cost of armaments by issuing additional currency without inducing more than a moderate rise in the level of prices -- a most important consideration as I shall presently indicate.

The situation is quite different, however, once the level of practically fully productive capacity is reached. Then, armament expenditure should be financed largely through taxes or through loans placed outside of the banking system, if we are to avoid a rise in the price level. A rise in prices in such a situation obviously would not lead to a further increase in production. The cost of living would most likely rise at a faster rate than the level of wages and salaries. Such a movement would, it is true, forcibly reduce the real volume of consumption and thus set free additional factors of production for the production of armaments. The social iniquities arising from such methods, however, are too well known to require additional comment.

In order to apply some of these generalized theories to our own economy and to discuss the problem in more concrete terms, it is necessary, of course, to fix our ideas in terms of the amounts involved -- the order of magnitude of probable armament expenditures and the sources from which such funds may be derived. I wish to emphasize that such figures as I am about to use are, at best, rough approximations and are to be, in the main, illustrative.

I shall assume that we would have to spend at least \$15 billion a year more on armaments -- including all goods and services needed by the army and navy in prosecuting the war -- than what we are spending now. That is about the amount we spent for a full year in the World War (including loans to our then allies). While the price level now is only about half as high as it was then, armaments have become so much more costly that I understand the expenditure of one billion dollars now means no more, from a military point of view, than did the same amount in 1917 and 1918.

Solely for the sake of discussion, let us assume that, when war came, our national income would be what it was in 1937 -- somewhat over \$70 billion. Our participation in any extensive war would almost surely eliminate, within a relatively short time much of the unemployment now existing. On the other hand, we must take into consideration the reduction in efficiency that necessarily will follow from the replacement of several million experienced workmen by the presently unemployed, by over and under-age males and by women workers. On that basis the maximum national income reasonably to be expected in war time may perhaps be estimated at approximately \$80 billion, in terms of present prices. As calculations of national income do not include the goods used to make up for depreciation of plant and equipment in business, the value of our current output of goods and services would, under the foregoing assumptions, be somewhere near \$90 billion. On that basis, the problem of war finance, then, is (1) to raise an additional \$15 billion per year and (2) to reduce civilian consumption and capital expenditures by the same amount -- so that \$15 billion worth of the output of productive resources will be shifted from civilian to military uses.

Of these two problems, obviously the basic one concerns the ways and means of reducing civilian expenditures by the cost of armaments, and of reducing them, as far as possible,

in step, in time and in kind, with the rise of armament expenditures. We must, accordingly, look to types of civilian expenditure for consumer goods or capital goods which can be reduced without impairing the efficiency of the factors of production and -- in accordance with the principles we have laid down in the beginning -- with the least disturbance to our economic mechanism and with a minimum of undesirable after-effects.

We must begin with a preliminary question: How would the population normally -- in peace time -- spend a national income of \$80 billion. According to calculations made by the National Resources Planning Board, consumers' expenditures on non-durable goods would, in peace time, amount to about \$45 billion on the basis of a national income of \$80 billion. Such expenses go mainly for food, clothing, household operation, and personal care. Since the bulk of these expenditures is made by people of moderate income, I do not think that the allowable and intelligent margin of curtailment is very large, especially if we are to keep the labor force at maximum efficiency and do not want to retrograde too much socially.

It seems permissible, however, to assume that not less than about \$3 billion could be cut out of \$45 billion of consumers' expenditures on non-durable goods. Even after that reduction, consumers' total expenditure on non-durable goods will be about as large, both in money and in real terms, as their comparable expenditure would be at the present time, when national income aggregates about \$70 billion. In other words, on the foregoing assumption, the average civilian might be equally well off in war time with respect to his current consumption as he is today in peace time.

Our great reserve, indeed, lies not in a possible tightening of the belts of individual consumers -- though our midriffs are fairly bulky by international comparison -- but in reducing the expenditures which are usually made both by consumers and by business for durable goods. Or, rather, it lies in the large stock of durable goods which we have accumulated over the years and which we can afford to use, for some time, without making up for accruing depreciation that may be restored after the war is ended.

Among durable consumers' goods, probably the greatest reduction in civilian purchases without a decrease in efficiency and without much hardship can be effected in the purchase and up-keep of passenger automobiles. The National Resources

