

Naval War College Review

Volume 2
Number 6 *June*

Article 1

1949

June 1949 Full Issue

The U.S. Naval War College

Follow this and additional works at: <https://digital-commons.usnwc.edu/nwc-review>

Recommended Citation

Naval War College, The U.S. (1949) "June 1949 Full Issue," *Naval War College Review*. Vol. 2 : No. 6 , Article 1.

Available at: <https://digital-commons.usnwc.edu/nwc-review/vol2/iss6/1>

This Full Issue is brought to you for free and open access by the Journals at U.S. Naval War College Digital Commons. It has been accepted for inclusion in Naval War College Review by an authorized editor of U.S. Naval War College Digital Commons. For more information, please contact repository.inquiries@usnwc.edu.

RESTRICTED

CLASSIFIED

ALNAV 59

U.S. NAVAL WAR COLLEGE INFORMATION SERVICE FOR OFFICERS



**INFORMATION SERVICE
FOR OFFICERS**

FOREWORD

This "Information Service" has been initiated and established by the Chief of Naval Personnel for the benefit of officers unable to attend the Naval War College.

Articles selected for publication are considered to be of value to all officers. However, their publication should not be considered as reflecting the opinion of the Naval War College.

CONTENTS

THE RISE OF SOVIET POWER - - - - -	1
<i>Professor Michael Karpovich</i>	
FINANCE IN WAR - - - - -	25
<i>Professor Raymond Rodgers</i>	

Issued Monthly By
The Department of Correspondence Courses
U. S. Naval War College
Newport, R. I.

THE RISE OF SOVIET POWER

A lecture delivered by
Professor Michael Karpovich
at the Naval War College
October 15, 1948

The rise of Soviet power in Russia is not merely an historical question. As I see it, the circumstances under which the Soviet power appeared in Russia have a very direct bearing on the difficulties that we are experiencing today in our relations with the representatives of that government. I think that, unless you know something about the nature of the regime, its aims, its spirit, its technique, you cannot solve the so-called riddle of Russia which perhaps would not have been a riddle had the outside world kept itself informed about this regime.

That brings me to the consideration of the revolution of 1917. What I shall try to do is answer this specific question: "Why was there a revolution in Russia? How did it come about? And why, in this revolution, did the extreme leftists, as represented by the Bolshevik (the present day Communists) come out on top?"

First of all let me refer to a rather widespread opinion that in order to have a revolution in any country you must have a situation of complete impasse. Things go from bad to worse and finally they become so unbearable that the people rise in revolution. I do not think that historical records substantiate this point of view. As a matter of fact, I think one might almost advance another proposition, and that is that revolutions usually happen at a time when there is sufficient improvement in conditions inside of the

Professor Karpovich was born in Russia and was graduated from the University of Moscow. He arrived in this country in June of 1917 with the diplomatic mission of the Russian Provisional Government. Since 1927 he has been with the History Department of Harvard University.

country. A people that is completely down-trodden, and in completely abject misery, usually is not in the spirit of revolution.

Take the French revolution at the end of the 18th century as an example. I think the concensus of opinions of the modern historians is that in many respects France was the most advanced country on the continent at the time. The position of various groups of population, including the intelligensia, was relatively better than the position of similar groups in other countries. It was because there had been a partial improvement, and they tasted this improvement, that they wanted more and felt strong enough to insist on getting it. Paradoxical as it might sound, I think it is true. It is not realized widely that the history of Russia concerns this point of view.

On the basis of my historical study, and my personal impression and recollection, I can say that, in the days before the revolution, Russia was a rapidly progressive country. Progress was going on practically in every direction. Politically it was no longer an autocracy because in 1906, a rather modest constitutional regime, but still a constitutional regime, was introduced. A national assembly, elected by the people, which was given the name of Duma, (an old Russian word for assembly) was invoked. From that time on, strictly speaking, Russia was no longer an autocracy, no longer a limited royal power, because here was an elected legislative assembly, and without the consent of this assembly no new law would become a law.

Simultaneously, a bill of civil liberties was introduced. Everything is relative in this world of ours and certainly it was not the same degree of civil liberties that we enjoy in this country today. Many people will tell you that we do not enjoy complete civil liberties either, but by comparison I think we have a fair degree of them. By comparison with what preceded the constitutional re-

gime in Russia, it was a very, very considerable advancement. I still vividly remember the acceleration of intellectuals and other groups of people in the country that now they could speak and write and assemble much more freely than it ever had been possible before 1906.

By comparison with what followed, the degrees of civil liberties attained at that time, look rather favorable now also. Certainly there was much more civil freedom in Russia between 1906 and 1917 than there has been under any of the so-called totalitarian regimes in our own days. From this point of view we should not be too proud of the period in which we are living. In many respects it is a period of reaction and retrogression, not only in Russia but all over the European countries.

On the economic side it was also a period of progress. Industrialization in Russia did not begin with the revolution. The five year plan was another chapter in Russia's industrialization that had been going on before the revolution. The period immediately before the revolution was one of intense industrialization, very intense in construction among other things. There was an advance also in the status, the living standards or the well-being of the worker class. Better labor legislation was passed. Trade unions were legalized for the first time in Russian history. Until 1905 there were no trade unions in existence but they were made legal by supreme legislation at this time. It could be proven statistically if I had time for statistics, and if I had the papers with me, that there was a natural improvement in the living standards of the workers at that time, not only in nominal wages but in real wages.

The overwhelming majority of the Russian population at that time however, did not consist of the industrial workers, of whom there were no more than three million people out of a total population of one hundred seventy million or so. The overwhelming

RESTRICTED

majority of people were peasants, and the plight of the peasants was perhaps the most crucial problem in the economic and social life of Imperial Russia. There was improvement along these lines too. New governmental legislation actually tried to do something to alleviate this plight, and I must say, in a rather energetic fashion. There was a special peasant land bank established which became very vigorous at that time in trying to help the peasants who had not enough land to prosper or even to make both ends meet. Governmental credit was available to buy land for this purpose.

Another remedy was to sponsor migration of peasants from the congested rural districts of European Russia to Asiatic Russia, in particular to the central belt of Siberia. Contrary to the general opinion that Siberia was a terrible place, fit only for convicts, it is quite a desirable and inhabitable part of the world. The central part of Siberia does not differ much from our own northwestern agricultural states or from parts of Canada. Of course in the upper north is the Arctic region and in the south is the desert, but in the central region there was plenty of room for agricultural progress. And the government at the time made a definite effort to sponsor migration and entice settlers there to relieve the dreary over-population in the center of Russia. Agricultural experts, both governmental and private were available in increasing numbers for helping the peasant to improve his agricultural technique. Above everything else, progressive legislation was introduced which tended to substitute individual farming of our American type for the rather antiquated village commune system under which many Russian peasants still were living, and which in the opinion of many economists (and I agree with this opinion) was a hindrance to agricultural progress and to the improvement of agricultural technique.

Finally, on the cultural side there also was progress. By

this I mean primarily education. Primary education in Russia was lagging behind. There were some secondary schools and universities throughout the 19th century, but since the early 20th century a very real progress was made in this direction. This was the period when Russia really began to overcome illiteracy and this was another very important line of progress during this period immediately before the revolution.

Now I hasten to say that, with all this progress, there still were many elements of instability in Russian life. If there had been no elements of instability probably the revolution would not have happened. So it was not an historical accident; there was a possibility, a probability perhaps, for the revolution to take place because of these elements of instability. These elements of instability were there due to the simple fact that progress was still very recent and still was in its initial stages. One could not overcome, in ten years or even in twenty years, various drawbacks which were the results of centuries of historical development. So, all along the line, this tension still continued.

Political conflict between the government and the opposition continued even after the establishment of the constitutional regime. The opposition was not satisfied by the constitution of 1906 which was won by the revolutionary movement of 1905. This Duma, this representative assembly, was far from being a fully democratic assembly. It was based on a limited franchise for property owning classes and did not represent the peasants and the workers and even the lower middle class to an equal degree. It was also limited in its power, in its functions with regard to the government. It was, as I told you, a real legislative assembly but it had no complete control over finances, over the budget. Everyone who has studied the history of representative institutions in world history knows that the control of the purse is one of the most important weapons in the hands of such an institution. That power was not given to the Duma, it had

RESTRICTED

no legal control whatsoever over the executive. It might exercise moral pressure, but all the legal executive authority remained in the hands of the Emperor. All the Ministers of State were appointed by him and were responsible only to him. No matter what the representative assembly thought of this or that executive policy, it could do nothing but protest, complain, or try to exercise moral pressure; it had no real control over the executive. Because of this, the opposition was not satisfied and political tension continued.

Here I think I should tell you very briefly of what principal groups the political opposition consisted on the eve of the Revolution of 1917. Going from right to left, I shall mention first what might be described as the moderate, non-revolutionary, non-socialist opposition. The Marxist writers, the Soviet writers, would call it the bourgeois parties. These were constitutional democrats. That is, they were prepared to cooperate with the monarchy provided it would become something like the British or constitutional type. They wanted to transform the constitutional regime in Russia into a really democratic constitutional regime with universal suffrage, among other things. They wanted a parliamentary regime in the English sense, in which the executive would be responsible to the legislature. They wanted to achieve these ends, as well as some social reforms, within the framework of the capitalistic society by peaceful, constitutional means. In other words, they were revolutionists but they were not preaching revolution, although they were bitterly and frankly criticizing and attacking the government.

More to the left stood the other so-called moderate socialists. I say so-called because in any other country they would not be considered moderates at all. They went pretty far in their demands but as compared with those who were still more to the left they were moderates in a relative sense. These moderate socialists did not want the monarchy at all. They wanted the Tsarist government, the dynasty, overthrown and a republic established—a democratic

republic of the western type, let us say of the American type; they also wanted much more radical social reforms than the constitutional democrats were prepared to offer. But these moderate socialists were not thinking at the time (I am speaking of the period immediately before 1917) of an immediate transition to socialism, and here lay the fundamental difference between them and those more to the left. They did not contemplate an immediate transition to socialism because they argued, and I think with a great degree of plausibility, that a country like Russia was not prepared for socialism, either on the economic side or on the cultural or psychological side. To this group of moderate socialists belong two parties—the so-called Mensheviks, who were a faction of the same social democratic party to which the Bolsheviks belong, and another party which had the terrifying name of Socialist Revolutionaries, but which in reality was not as revolutionary as the name implies.

Finally I arrive at the last group which eventually triumphed in the revolution, and these were the Bolsheviks, the left wing of the social democrats, who were already at that time under the leadership of Lenin. They wanted destruction of Tsarism by violent revolutionary means and then they were prepared to go over almost immediately, if circumstances permitted, to the introduction of a socialist regime. This idea, that one could pass immediately from the destruction of the Tsarist government to the introduction of a complete socialist society, developed in Lenin's mind gradually. I think that it was not until 1917 that he finally came to that conclusion and saw his chance.

Tension also continued in the field of social relations because no matter how substantial the progress achieved was, it still was not substantial enough to dispel the social discontent that had been accumulating throughout centuries. It did not satisfy, even with this relative improvement. The workers still were not satisfied and,

RESTRICTED

as I said before, the fact that there was an improvement made them impatient for *more* improvements. The fact that the peasants now could get *some* land, made their desire stronger for the *rest* of the land. The same situation prevailed among the workers and that gave the radical socialist parties an opportunity to carry on propaganda among the peasants and the workers. There was considerable response to this propaganda, although it was nothing overwhelming.

Finally there was still what I would describe as the cultural pressure. In spite of all the problems and impatience and the struggle against illiteracy, on the eve of the Revolution, sixty percent of the population of the Russian empire were still illiterate. This, of course, was an appallingly high percentage. Incidentally, here I would like to tell you what I am telling all my audiences and all my students whenever I touch upon this particular point—and that is to warn you against the exaggerated notion (which you can still find in books on the subject, in public speeches and so on) that there were ninety percent illiterate in Russia on the eve of the revolution. Some people up to this day still tell you that, Henry Wallace among them. He has made the statement many times. The figure is fantastic and has no foundation in fact whatsoever. Sixty percent is bad enough; why make it worse by making it ninety percent. The political consequences of that situation are quite obvious. When you have sixty percent illiterates in a nation it is difficult to get real national unity, particularly in a time of crisis. There isn't enough mutual understanding. There isn't enough of a common language. That means that sixty percent of the Russians really did not participate in what might be called the nation's cultural life and therefore could not develop, strictly speaking, national consciousness. It was this cultural gulf, this cultural rift, in Russia between the educated minority and the uneducated majority which turned out to be one of the most dangerous things when the trial of revolution came. This lack of understanding led to mistrust

by the popular masses of the white collar men whom they could not properly understand, even when these white collar men tried to work with them and professed to be quite sincerely their friends.

However, with all these tensions, I am convinced that there was not what the Soviet writers would describe as an immediate revolutionary situation in Russia on the eve of the first world war. The revolution was a possibility, perhaps a probability, but there wasn't anything inevitable in it. I thought at the time, and I think the same thing now on the basis of historical studies, that there were good chances for a gradual, peaceful solution of the country's pressing problems, that it was a question of time and above all it was a question of peaceful time. Peace was needed for that—no involvement in major international conflicts. That was precisely what was *not* given to Russia by the course of historical events. From this point of view, I think the involvement of Russia in the first world war was a fatal thing for the Imperial regime. I don't think that *any* war is ever opportune from the point of view of *any* country, but one might say, without exaggerating, that the war of 1914 came to Russia at the most inopportune time possible because it caught the Russian government and the whole country, in the process of reorganization. A very wise French political scientist, Tocqueville, once said in the middle of the 19th century, "The most dangerous time for a bad government is when it begins to reform". There is a good deal to that because they lose their old stability of habitual wickedness, and they are not yet sufficiently good to be stable again. They are just in a transition period. That is exactly what happened to the Russian Imperial regime.

The war stopped this progress in its initial stages. Everything was being reorganized, changed, adjusted to modern conditions and right at this moment came the terrific shock of a modern war, the magnitude of which nobody anticipated at the time. The duration of the conflict and the magnitude of it came

RESTRICTED

very much as a surprise to the majority of the people in the period. Also of course, the war inevitably intensified all the tensions—the political tensions, the social tensions, the economic tensions, the cultural tensions, and it fatally undermined the prestige of the government.

What, in my interpretation, ultimately brought about the downfall of the Imperial government was primarily the loss of political unity in the country due to the political crisis and the loss of national morale. A great deal has been said of Russia's unpreparedness in the first world war and of the series of defeats suffered by the Russian army during that war. My impression is that the importance of this factor has been over-emphasized and exaggerated. A sober study of the course of events in Russia shows that the military situation was not as desperate as it has been pictured. I am sure that a politically and morally healthy nation could have withstood these blows and survived until the end of the war. Some other writers emphasize the economic difficulties. They certainly were great, but to my way of thinking, they were not fatal. What made the military and economic difficulties fatal was the *political* crisis, which started in the midst of the war in the summer of 1913, and only abated with the collapse of the Imperial regime early in 1917. I believe that the responsibility should be divided between the government and the opposition, but the lion's share, in my opinion, still lies on the shoulders of the Tsarist government which had behaved in an almost suicidal manner. Instead of trying to placate their opposition and preserve national unity by timely concessions, they behaved in a way which finally antagonized everyone, so that when the crisis came, the government really had no active defenders.

This was the background for the first revolution of 1917. One must remember that in 1917, not *one*, but *two* revolutions took place, one after another. The first one was the fall of the Imperial

regime. The second one was the advent to power of the Communist party. It was not called the Communist party at the time; it was referred to usually as the Bolsheviks. The first one of these was the March revolution of 1917. Perhaps a note is in order here. Very often you will find it in books called the "February Revolution." It happened in February—the last days of February by the calendar then in existence in Russia. This was the old Julian calendar which in the twentieth century was thirteen days behind the Gregorian calendar. The same was true later with the Bolshevik revolution. The October revolution happened early in November which creates a minor confusion on the subject; but February means March, and October means November as far as these revolutions are concerned.

This March revolution is a classic example of an unprepared and not planned for revolution, a revolution which one might say "just happened." I was in Russia at the time—not only in Russia but in St. Petersburg where the revolution actually took place and I still remember this very strange psychological phenomena. For a fairly long time before that, everybody would talk about the impending revolution. Everybody would exclaim on occasion, "Well things cannot go on like that any longer, it certainly will end in a revolution." So you might say that all anticipated it and yet when it actually came, nobody recognized it at first and all were taken by surprise. The government was taken by surprise because it did not prepare any adequate measures of defense. The moderates were taken by surprise, as you shall see in a moment, and the revolutionary parties were taken by surprise. They did not organize this revolution, they did not plan for it. It did not happen as they anticipated it would happen, and they only tried to use it later when it was already an accomplished fact. It was a very spontaneous and in a sense an accidental thing.

It all started with food riots in St. Petersburg, which were

RESTRICTED

caused by temporary difficulties in food supplies. St. Petersburg was situated in a very bad part of the country for a capital. Nothing, or almost nothing, grew around it; everything had to be brought in, sometimes from a long distance. Therefore, difficulties with the railroad traffic were felt immediately in the supplies of this capital city which was over-crowded during the war anyhow. As a result of these difficulties a group of people started to protest and they were in their full rights; I've seen some of them myself. This was not a pleasant occurrence but it did not look like a revolution that would overthrow the Tsarist government when it started. It all continued about a week, and from one day to another these disturbances became more and more serious. Then as a last resort the authorities on the spot called out the troops. The troops refused to do anything about it and instead of dispersing the crowds, began to fraternize with them and finally went over to the side of the people. That really decided the issue.

These troops were the troops of the St. Petersburg garrison; not regular troops, but rather raw recruits. In Russia they were called, "Reserve Battalions." They were kept there waiting for their turn to be sent to the front to replace the losses at the front. Discipline among them was low. And it was this military force on the spot which really decided the issue by leaving the authorities within the capital without any armed force whatsoever at the decisive moment. And it was in this way that the revolution happened. There were no barricades. There was nothing that we usually associate with the classical type of revolution.

Let me tell you one thing which I think is rather illuminating from this point of view. I was connected at the time with the War Department. On the day, which is now recorded in all the history text books as the day of the fall of the Imperial regime; I went to my office in the War Department as usual at about eight-thirty and stayed there until six o'clock in the evening as every-

body else did. We worked regularly as we did every day. During the day we began to hear that there was something happening in the other part of the city. Some crowds were moving, some soldiers moving, but nobody knew exactly what was happening. I went home without knowing anything about the historical event that was taking place. I tried to find out what was going on by telephoning in the evening but the telephone was out of order and so I went to bed without knowing what was happening. The next morning when I awoke everything was over and I learned the news that the Imperial government was no longer there and that a new revolutionary regime had started. Now I am convinced that was the experience of nine-tenths of the population of the capital of the Russian Empire, not to speak of the people outside of St. Petersburg where actually nothing happened at all. This I think is a remarkable case of an unplanned, casual revolution.

When that happened the Tsarist government on the spot (the Emperor himself was with the army) simply abdicated. From the moment they heard about the desertion of the soldiers, they became panic stricken and all resigned and disappeared. There was no authority left in the capital in the midst of a war, and it was then that the moderates in the Duma were forced to take upon themselves the exercise of supreme power.

The Duma as I told you was based on a limited franchise. It represented mostly the property classes and some intellectuals. It consisted in an overwhelming majority of people of moderate views who didn't want to be revolutionists. They *had* to become revolutionaries in spite of themselves because there was no other way out of the situation. Here was a vacuum; it had to be filled. Everybody went to the Duma; the soldiers that revolted went there and said, "Here, we are at your disposal." And at first the Duma didn't know what to do with them. When they arrested the former ministers, they would bring them to the Duma and

say "Here are these criminals; do something with them." And the Duma didn't know what to do with them. It was under such conditions that they assumed power.

A committee of the Duma declared that, due to the anarchy in the capital, it took upon itself the functions of the government temporarily. Almost simultaneously another institution appeared and that was the Soviet. Soviet now is a household word throughout the world. Back in 1917 nobody outside of Russia knew what it meant. Originally it simply meant "council."

Back in 1905, during the dress rehearsal revolution to which I referred before, a Soviet of worker's deputies was organized at the time of the general strike and at that time its purpose was to serve as a general staff for the strike. Nobody thought of making it a permanent institution—only a national strike committee. In 1917 some of the Socialists remembered about that experience. "We had this Soviet back in 1905, why not create another one now?" But there was one substantial difference, and that was that at this time they added the soldiers to the workers because the soldiers played such a decisive part in overthrowing the Tsarist government by their desertion. It was felt that now they must have a Soviet of workers and soldiers. They did this in a very hasty fashion but there was no regular election. They just brought together a certain number of factory workers and a certain number of soldiers that they could find at different places, and declared this to be the Soviet of Soldier's and Worker's Deputies. This was, from the beginning, guided by socialists and by more radical members of the opposition. The idea was that this would be an organized control over the Duma which of course represented the property classes and the moderates.

On the basis of an agreement between a Duma committee and the Soviet, the first provisional government was born. This

provisional government subsequently became known as the Kerensky government. It was not a Kerensky government at first because, although Kerensky was in it, he was not the Prime Minister and was not the most influential member. He became Prime Minister later, several months later when the government was reorganized. This provisional government was a temporary government as the name "Provisional" indicates and its function was to bring the country to a constituent assembly which, elected by the people on the basis of universal franchise, was supposed to decide the future form of government in Russia. It was a kind of "caretaker" government for the interim period. Paradoxically its first membership consisted almost entirely of moderates. There was only one socialist there and that was Kerensky, and he was a very very moderate socialist who was looked upon with suspicion by the real radical socialists. He was something like a labor man in England, much nearer Bevin or Atlee, than Lenin, Stalin or Trotsky or any of those men.

Now why was this so? Why did it happen that the moderates had to take power? Well, there were different reasons for that but the principle one is the weakness of the revolutionary parties, including the Bolshevik party, at that moment. First of all, most of their leaders were abroad. Lenin was in Switzerland, Trotsky was in New York, Stalin was not abroad but in exile in Siberia and so were the majority of the revolutionary leaders at the moment when the revolution took place. Only second rate leaders were on the spot. But I think that even if all of the first rate leaders had been on the spot—people like Lenin, Stalin, Trotsky and the rest of them—they would not have dared to take power into their own hands at that time for the very simple reason that they were not nationally known. Do not forget that during the Imperial regime they were underground parties; they never appeared in the limelight until the period of revolution and excitement set in. Before that they acted as underground leaders and I don't think that more than a handful of people in early 1917 knew

the name of Lenin in Russia. That might surprise you, but I think it is a statement of fact. Therefore, a government consisting of nobodies, from the point of view of the country at large, would not command confidence and wouldn't make any appeal. By contrast, the Duma leaders, who were acting in the open and who played a very important part during the war and whose names were known throughout the country and in the army, inspired confidence. The socialists and the radicals permitted the moderates to organize the government at first, because they themselves were not in a position to do so at that time. This provisional government, as I already said, was supposed to remain in power until the constitution of the constituent assembly. Before it could invoke the constituent assembly, it was overthrown by the second revolution. The second revolution brought Lenin and his Bolsheviks into power. The provisional government disappeared early in November of 1917, after eight months of unhappy and rather turbulent existence.

I have no time for a detailed narrative of the events of these eight months. Instead of this, I will summarize the principle reasons for the ultimate failure of the provisional government and for the victory of the Bolsheviks headed by Lenin. First of all perhaps, one should remember what might be called the "usual" or the "general" course of revolutions on the basis of the few major revolutions in European history with which we are familiar. They all seem to follow the same course which in the earlier period of the revolution is more and more to the left. Everywhere it begins with the moderates in control and in each case the radicals replace the moderates. I don't think there is anything mysterious about it. I think it can all be explained on psychological terms. Let us not forget that revolution is primarily a psychological phenomenon. It is something that happens in men's minds or in men's souls. As I see it, what happens is this: Once a revolution starts, all the usual restraints are suddenly removed including among other things the

nature of obedience, which is a very important thing in human society. It is the fact that somehow you have to obey the constitutional authorities and you have to obey the law. Then all of a sudden a sufficiently large group of people don't feel this way any longer. On the contrary they feel that you can take law into your own hands, that you choose to obey or disobey the constitutional authorities. When such a situation arises, then naturally, with no restraints left, the revolutionary passion begins to run its course, and as long as there is enough of it, the tendency is to go to the extreme. The radicals benefit from this because they can ride on the sway of this passion much better than the moderates. So this, I think, happened in Russia too. But with this must be some more specific reasons, some Russian reasons; not general human reasons.

First of all one must consider the whole background of the Russian. What the provisional government tried to do was to stop the revolution at a certain stage and to crystalize the situation in the forms of a traditional western European or an American democracy, which is traditionally a middle of the road policy. Democracy, after all, is the most difficult form of government. It is the one that requires the most intelligence and self restraint and self limitation. There was no training that could prepare the majority of the Russian people for such an exercise of self-restraint because they had very little experience in their past history with self government, either on a local or a national scale. The constitutional regime was ten years old when the revolution broke out. Ten years in the history of a nation is a very very brief period. Then of course there was also the lack of general education and the sixty percent illiterates which I referred to. On top of that you had the specific war-time conditions.

Another tremendously important fact which should not be forgotten, is the fact that the revolution in Russia took place in the midst of the war while the Germans and their allies were still

in Russian territory. Because of this, a double task of almost super-human difficulty was put before the provisional government at the same time: reorganizing a country the size of Russia with its variety of races and nationalities and historical background into complete democratic society overnight while at the same time continuing to fight the war to a victorious conclusion. They refused to conclude a separate peace or think about it. They were still loyal to their allies and to their military obligations. They insisted that the war must go on.

Now either of those two tasks separately would tax the ability and the energy of any country, even under normal conditions. Combined, they became almost super-human tasks. Then there were some weaknesses in the makeup of the government itself. First of all, it was a coalition government and became increasingly a coalition government. In the later period of these eight months there were socialists next to non-socialist liberals and so on, and they did not always agree. The government was undermined by the existence of a parallel authority, because the Soviet also claimed authority and very often issued orders which conflicted with the orders of the provisional government.

The government also had no means of repression in its hands. Now every government, no matter how democratic, needs some means of repression to put an end to disorder and open rebellion. Very few people realize that on the next day after the revolution, after the fall of the Russian Empire, there probably wasn't a single policeman left on his beat throughout the whole extent of the Russian Empire. The old police was associated with the old political regime to such an extent and was so unpopular with the people, that for their own safety and their self protection they discarded their uniforms, pretended they never had been policemen and disappeared. Here was a new government without any police force whatsoever. They tried to improvise some sort of a volunteer militia but it was not very efficient. They had no reliable

military force at their disposal on the spot, because one of the conditions on which the provisional government was permitted to be organized by the Soviets (and they were forced to sign this) was that they would not remove from St. Petersburg the soldiers who took part in the overthrow of the Tsarist government. That, of course, put these soldiers in a privileged position in a sort of praetorial guard, a revolutionary praetorial guard. They knew they could not be sent to the front and they could not be replaced by more reliable troops. It was this very unruly, very independent, military force that the government had at its immediate disposal. When the provisional government fell, what happened was this: These very soldiers, who in March left the Tsarist government and went over to the Duma, now left the Provisional government and went over to Lenin and his crowd. Here again was the decisive military opportunity while there was no time and no opportunity to bring the troops from the front to put down the coup d'etat insurrection.

Finally the democratic idealism and legalism of the provisional government also had something to do with holding it down. Democratic idealism is a very fine thing, but democracy must know how to defend itself and this art they did not possess. Take the case of the constituent assembly for instance. They decided they must first devise a purposeful electoral law on the basis of which this assembly could be elected. They were very honest, very idealistic people, so they convoked a committee consisting of the best specialists on constitutional law. For months and months this committee debated, article by article, the electoral procedure. I'm told by specialists (I'm not a specialist myself) that what they finally produced was the finest electoral law that had ever been devised by human minds. But the only trouble was that by that time the government itself was overthrown and they never could make use of this law. Now obviously, it would have been better to convoke the assembly as soon as possible on the basis of an imperfect electoral law but have some sort of popular back-

RESTRICTED

ing behind their authority, or even to turn over that authority to a permanent government. This was a typical mistake that was made.

Against this you have Lenin, the leader of the Bolsheviks, with his strategy and his tactics. He returned to Russia in April 1917 from Switzerland, after having traveled through Germany with the permission of the German military authorities, with a very definite scheme in his mind. By this time he came to the conclusion that the time had arrived for a universal all out Communist Russian revolution. He didn't call himself Communist as yet. According to his theory, which is undoubtedly familiar to you, capitalism had come into its last phase, the phase of imperialism, and was doomed to an early destruction. War was an opportunity, an introduction to social liberty. Therefore his task was to transform the war that was going on into a social revolution, not only in Europe but everywhere. The fall of Tsarism in Russia gave him a wonderful opportunity. He decided to make Russia a starting point for a world revolution. In order to do that, he had to get rid of the provisional government and of the moderate socialists who did not agree with his scheme and with his problem. He had engaged, since his appearance in Russia, a tremendously well organized, and largely effective, propaganda campaign directed towards these aims—the undermining of the authority of the provisional government and winning over popular support. It is important to remember that during these summer months of 1917 Communism, as such, was not an issue. Lenin never advanced any of the specific proposals that we now associate with the Communist regime in Russia. Nobody in Russia in 1917 heard of collective farms or five year plans or any of these specific features of the present day Communist regime in Russia. He addressed himself to the more immediate needs and aspirations, and offered very simple slogans. People were tired of war so he insisted on immediate peace at any price. Russian peasants had always wanted land, so he insisted on

the immediate seizure of land by the peasants and so on. That put the provisional government in a very disadvantageous position.

Take these two crucial issues, the war and land questions. On the question of war the provisional government said, "Yes, we too want peace but we want a general democratic peace in alliance with our western allies. We are negotiating about the conditions, about the terms of such peace but meanwhile wait and continue to fight." Lenin came and said, "Well, if these western allies, these western capitalists want to fight, it's their business. Why should the Russian soldier shed his blood for western capitalists. Let's start fraternizing with the enemy and conclude peace at any price and as soon as possible." A similar situation existed with regard to the land question. No one in Russia, at the time, objected to the transfer of land to the peasants. It was so obvious that it had to be done that even the landlords were resigned. But the provisional government's condition was "This is a complicated economical question and it cannot be done in a haphazard economical fashion. So we will appoint a committee, this committee will prepare a bill, this bill will be admitted to the constituent assembly and the constituent assembly will pass a law. Then, legally and in an orderly fashion, you will get your piece of land." As opposed to that was Lenin's propaganda "Don't wait for any constituent assembly; you have the right to this land. Go in and seize it and divide it among yourselves as you see fit." Now you can easily see how in this situation it was rather difficult to combat this sort of propaganda. The amazing thing about this is that it did not win enough support until the very last moment.

Throughout most of this period the Russian people exhibited remarkable resistance to Bolshevik propaganda. It was only late in September that the Bolsheviks got a majority in the Soviet. As to the country at large, they had no majority (I'll tell you in a moment why I think so) even at the time when they actually seized power.

RESTRICTED

The power was seized not so much by a popular uprising or a popular revolution as by means of, what I would call, a coup d'état. In contrast to the March revolution, the November revolution of 1917 was carefully planned, carefully prepared, and carefully organized by the Bolshevik party led by Lenin. It was really a coup d'état effected by a small group of professional revolutionaries. The actual events again were limited to St. Petersburg, not the country at large, and the number of participants was very small. Again there were no large scale battles; there was no popular uprising in the actual sense of the word. What happened was that a group of people under the leadership of Lenin and Trotsky seized all the strategical positions in the capital at a designated time and, as the Provisional government did not have sufficient military force on the spot to forestall it, they were forced to capitulate. Then the rest of the country simply accepted the change, some perhaps with enthusiasm, but I am sure these were in the minority. The majority took it with a spirit of passive resignation. There wasn't anything to be done about it. "This new government is there, let's see what it is going to do."

The reason why I insist that, at that moment, they did not have a majority of the people behind them is very simple. A few weeks after this coup d'état, that is, after the new Soviet government headed by Lenin and his Bolsheviks was already established, they permitted the scheduled elections to the constituent assembly to take place. These elections were, and still are, the first and the only free democratic elections that ever had been held in Russian history. They really were free elections and they really were democratic. The results were this: the Bolshevik party gained one third of the votes, while two thirds went to the parties which they had overthrown. That happened several weeks after they had established their government.

When Lenin learned about these results he made a very

interesting comment, which can be found in his collective writings and which to me is very illuminating. He admitted the fact and he said, "Yes, our opponents have the majority, but see how the votes are distributed. We got the majority in the strategic points which really matter. The industrial workers, the large industrial centers voted for us, and so did the soldiers and the sailors in important strategic places. In other words, the vote was for us in those groups which have real power in their hands. Our opponents have a majority, but this is the majority of peasants dispersed throughout the country, not organized and therefore they really don't matter from the point of view of the struggle for power." This is a very familiar argument; that is, it has become familiar since. This is the way the Communists now argue in the satellite countries which are under Russian influence. They don't care about what they call electoral arithmetic. What they want is to seize strategic points. The background for that is already back there in Russia in 1917 in the Russian revolution. It proved to be a realistic calculation, because it permitted them to establish their power even in the face of the fact that two thirds voted against them. The other parties won the votes but lost power. The Bolsheviks lost the election but retained power and power in the mind of Lenin was the important thing.

It seems to me that this explains a good deal in the subsequent course of events in Russia and in particular the nature of the Soviet government. You have here a case of a determined group of Bolsheviks which tried to impose on the country, using favorable circumstances of course, a blue print of their own political and social program at the moment when the country was not prepared for socialism either materially or spiritually. Because of this, because they had to act from that time on in hostile surroundings, this government could be only a dictatorial government. In the interest of self preservation, in the interest of perpetuating its pol-

RESTRICTED

itical control, this government could not relinquish the dictatorial principle. It has to remain a dictatorship and today, more than thirty years after its coming into power, it is more centralized, more dictatorial and has a tighter control over the country than it had in the beginning.

Then of course, the dictatorial nature of this government also shows in its foreign relations because they inevitably transfer into the field of international relations the experience they had inside their country: the fears, the suspicions, the spirit that has been generated by the struggle inside of the country goes into their relations with foreign powers. They cannot tolerate, as the example of Czechoslovakia has shown very well, even the semblance of a democratic government on their borders because in that they see a threat, not to the national interests of Russia which is a different proposition, but to the political interests of the regime.

The historical background and the story of how this regime came into power helps us to understand the nature of the difficulties with which we have to contend in the present day international crisis.

FINANCE IN WAR

A lecture delivered by
Professor Raymond Rodgers
at the Naval War College
March 2, 1949

The subject I am going to talk about today is a great mystery to most people. Yet most people use credit and that is largely what I am going to deal with. It is very much as the colored boy down south viewed the problem of a mule that he had bought. He was bringing this mule home when he ran into a friend of his and the friend asked, "How much money did you pay for him?" He replied, "O, I didn't pay no money. I got him on credit. I gave my note." The other fellow said, "You sure got him cheap." Now that is the problem that we have to keep in mind going through here. You can do wonders with credit if you don't overdo it. You can stretch a thing just so far, and with credit you don't know how far you can stretch it until it is too late.

This whole question of financing war, as it is done nowadays, is not fully understood. In bygone days it had to be done by inflating the currency, and before that by hoarding up treasure or hoarding up actual gold value of one sort or another. Nowadays we have a different system, and in some sense a much better system but, as I intimated a moment ago, it is a system that works so wonderfully that there is always the danger of saying, "Well, if we did two hundred fifty billion, why not do five hundred billion?" After all, that is only another one hundred per cent. We went from fifty to two hundred and fifty, that's five hundred per cent so why not go again and so on, and that's what we have got to watch.

The actual cost of war cannot be put off, in an economic

Professor Rodgers is Professor of Banking at New York University. He has written and lectured extensively on financial subjects and has held a number of positions in the field of business finance.

RESTRICTED

sense. You cannot postpone it; everyone suffers in time of war. The ships, the planes, the guns, everything that is destroyed has to be produced in time of war and it has to come out of the economy. Civilians have to do without things. These sacrifices cannot be postponed. Finance cannot shift the economic burden. It can, however, shift the burden as between classes of the population, so we start out here at the beginning with a very encouraging note for you professional gentlemen!

No modern war has ever been lost because of finance, that is, if you have a modern banking system, and we certainly have one in the United States. (Maybe it is a little too modern!) There is no excuse for losing a war because of the financial side. (We could go ahead and talk about how a modern war involves mobilization of our resources and so on, but I don't think that is necessary for it must be an old story to you officers by now.)

Now the first and simplest way to finance a war is by taxation, and, by all means, it is the best. Then there is no fooling around about it. You have the economic burden and the financial burden right at the same time. Prices don't get out of order, nothing gets out of line, and the purchasing power of the people does not increase. Everybody knows right where he stands. However, you can't do that in a democracy. You can't even do it in an autocracy, and certainly you couldn't do it in America. You have to hold a carrot out in front of the mule, as they say in England. You have to give the boys a little extra overtime pay. You have to give labor a little incentive to produce extraordinarily. Of course, patriotism is a great help, but something in the pay envelope also comes in handy! So we can't, especially in America, get away with financing a war by taxation no matter how sound it may be in theory.

Now let us see why it is so sound in theory. You have no increase in the public debt. You don't have any back-log of pur-

chasing power built up. You don't have the American people holding two hundred billion dollars of liquid assets and no place to spend it—nothing to buy with it. Financing war by taxation would mean you wouldn't need the OPA; you wouldn't need price control. You wouldn't need such regimentation if you financed by taxation.

As a matter of fact, gentlemen, if you financed by taxation, instead of war creating inflation, it would actually create deflation, because you would not increase your purchasing power. Every increased dollar would be taken right back by the government. You know, the Lord gives and the Lord takes, meaning the sovereign, so it will be taken right back. You hand it to the boys and you take it away from them Saturday night, or at least at the end of the month. But I say, you can't get away with it. The Congress wouldn't like it, the voters wouldn't like it and, no nation, not even Stalin with his Politburo can get away with financing a war in that fashion.

Now the next best method is to borrow the amount that you do not raise by taxation. The question is who to borrow from. Well, obviously the best place to borrow is from the real investor, the fellow who has real capital, and from the earner by payroll deduction—that's the real McCoy! Take back that purchasing power—that's the idea. Borrow from the investors, borrow from the insurance companies because they get premium income continually. They get real capital, the largest source of new real capital in this country. Their investment capital each year is the premiums that are paid in on the life insurance policies. It runs around three and one half to four billion dollars a year, and that means that someone has done without something. That means that people have paid that purchasing power to an insurance company instead of going out and buying the things they could have bought. There is no credit expansion there. As I said before, it is the real McCoy. It is simply a shifting of purchasing power from the man who has

RESTRICTED

the insurance policy to the insurance company, which in turn shifts it to the government through the purchase of bonds.

Now, the same thing is true of the payroll deduction plan. You gentlemen, who contributed so nobly by having bond deductions made from your pay, gave real purchasing power to the government. There was no indirection about that. There was no hocus-pocus; it was the real thing. If you had not done that, you could have gone out and spent the money for something. Don't worry, we won't go into the matter of what you might have spent it for, but you could have!

We call that the ultimate investor where you just have a transfer of purchasing power and not a creation of new purchasing power; the ultimate investor, where people give up part of their own purchasing power and turn it over to the government, partly as a patriotic gesture and partly because they have coupons on that green paper that you get from the government and you get paid a little thing called interest!

Borrowing from ultimate investors really means from every source from which the government gets money, every source to which they sell bonds except the commercial banks and the Federal Reserve banks. Those two groups of institutions have what we call "credit expansion power." They can take what *you* might call *nothing* and make *something* out of it. They can give you a deposit on their books and you can go and buy things with it, and that goes for your Uncle Samuel, too. They can credit Uncle Sam on the books and Uncle Sam can buy things with it. As a matter of fact, that *is* the way the government does it. But please note: what I am saying does not go for the savings banks. In theory and in practice they are as far removed from the commercial banks as possible. It is only the commercial banks and the twelve Federal

Reserve Banks which have this expansion power. They can make an entry in an account on their books, called a deposit account, and then you draw chits on that—that is, pieces of paper called checks. And you can pay debts; you can buy things. You can make the wheels go around with that.

Now *you* can't do it. If *you* set up an account and try it, *you* go to jail, but the bank has a "system" and you pay interest for the use of the system and what you pay is very well worth it. Don't misunderstand me. This is another one of those instances where a little knowledge is a dangerous thing. I don't want you to get the idea that bankers sit down in a back room and through some hocus-pocus eventually come up with something that was never seen on land or sea and shouldn't have been seen anyway! It is not like that at all. There is a system to it. Its creation is something that is real and substantial. If it is not done properly, the bubble bursts and every man for himself!

So when you borrow from the ultimate investor it is very sound. However, you do put off the day of reckoning in one sense. It means that you have to pay the interest through an increase of the tax burden. It does effect the budget immediately where taxation didn't. It means that government expenses go up; but it is not inflation.

Our whole problem under this modern system of financing war is to prevent inflation. Inflation is the greatest economic and social curse known to man and I mean exactly that. It impoverishes the wrong people. It puts money in the hands of the wrong people. We can say that it is also the greatest curse of war because that is when you usually have your inflation—at least the most serious inflation, but not always.

If you finance by selling these bonds to the ultimate investors, you create a cushion of purchasing power which can be

RESTRICTED

used at the end of the war and thus help in the reconversion period. It helps bridge the gap of greatly stimulated production for war purposes over to the lower peacetime production. We got over it better this time than we were entitled to. We did not have the eight million unemployed as the bureaucrats insisted we were going to have visited upon us. We did right well, thanks again to the miracle of American industry.

I don't get paid a dime by the Association of Manufacturers for telling you that either. Another thing, I don't want you to misunderstand my politics. I am not sent here by the Republican National Committee. I was born in Kentucky, a Democrat, and they don't come any worse than that!

In this country we didn't sell as many bonds to the ultimate investors as they did in Canada or as they did in Great Britain. We can't be too proud of ourselves about it. On the other hand, we did get away with it and we did win the war, so let's not lament too much about what they did in Canada and what they did in Britain.

We now come to the sixty-four dollar question—borrowing from the commercial banks. Here is where you are liable to be hit twice by that terrible two-edged sword of economics. In economics practically anything is liable to hit you going and coming, and it's bad when you get that. So, let's watch this very carefully. As a matter of fact, it wouldn't be necessary for me to come up here today if it was not to elucidate this point, and it is a point that isn't understood even by some bankers. They have a system, as I told you before, and it is chiefly that system which I want to talk about to you today.

When the government borrows from the banks it causes an increase in bank deposits and this is the way it is done. I want

to give you the actual mechanics. A bank can buy a bond from the government in two ways. One is to hand a messenger some cash and say, "Take this cash over to the Federal Reserve and get us a bond." Gentlemen, that would be very crude. They have a much better arrangement than that. That's what we call exchanging assets—buying them for cash. Now any banker who did much of that would be out of the banking business before the messenger got back. It is like going home with the blue chips. It can't be done—not and keep the game going right!

No, the way to do it is this: They send those dollars over to the Federal Reserve Bank for what the banker calls "reserves". The banker has to have a reserve over at the Federal, depending on whether it is a bank in New York City or Chicago. There, at the moment they have to have twenty-six per cent—in the war they had to have less—about twenty-two per cent. In the next group of banks, the next category of reserve cities, the banks have to have a lesser reserve, and then you come down to the country banks where they are permitted to have a still smaller reserve. During the war the banks had to have, at the Federal, about fifteen per cent of their deposits in their reserve balance. In other words, if a country bank had a hundred thousand dollars of deposits, they had to have a fifteen thousand dollar reserve account also. You may ask where did they get those deposits? In the next thing here, the hand is quicker than the eye—if I lose you here, you *will* be lost; you will be in the wilderness when I finish. First thing, you must think of these deposits as in a commercial bank account. When I say bank, I mean only commercial banks. You probably think that people come to the window and hand that pale, young man back of the wicket a dollar and say, "I want to deposit a buck before I spend it." No, that's not the way it is done. That's largely window dressing and not even very good window dressing. The dollar that is brought in over the window is put into the reserve deposit account

by the banker and he credits several times that amount to the account of some borrowing customer.

Let us digress for an instance. You go to the bank and borrow a hundred thousand dollars. Happy thought! What does the banker do? You sign a piece of paper called a note and he adds it to loans and discounts. That's the debit; that's on the left hand side of the balance sheet. The banker writes a hundred thousand dollars on the right hand side of an account called "John Q. Public—\$100,000"; that's a deposit account. To the bankers that's a liability. To you it is an asset, but to the bankers it is a liability—\$100,000. Now where did that deposit come from? Did anybody sacrifice? Did anybody do without anything? They did not. The banker made a double entry. He had to enter on both sides of the books or they would send him to jail. Like the Navy, they have to balance things. When the banker increased loans and discounts he had to increase deposits—his liability. Now those deposits did not come from *without* the bank; they came from *within* the bank.

One of the questions we frequently ask our doctoral candidates—"Do deposits come from loans or loans come from deposits?" Some ninety-five per cent of them will answer that they come from deposits—that the banker lends out money that he has, which is not the case at all. The deposits come from the loans. If you have ever (and I hope you have not) sweated over a bank deposit ledger as I have, you would know that for every dollar that the teller sent up to you, the Loan and Discount and the Investment Departments send up tickets to credit accounts for ten or maybe even twelve dollars, and thus the deposits actually come from *within* the bank!

This loan expansion you may call it, is really *deposit expansion* power. In order to expand your deposits you have to have that reserve with the Federal—you must get it over there in some way. So whenever anyone brings a dollar in at the window

the banker sends that in to the Federal to his fifteen per cent reserve. Then he can buy five or six dollars worth of government bonds or make loans to an equivalent amount.

We are going through it again now, using bonds. The way the banks buy bonds is by means of using an account that was started in World War I. The title of the account is "War Loan Account, Treasurer of the U. S." That was set up at the beginning of World War I, and has been going ever since, and if one of your shades should come back to referee a World War two hundred generations hence, you would probably find the same account right on the books!

Here is what happens. One day the banker gets a letter from the Fiscal Agent for the government saying, "The Treasury is offering, as of such and such a date, fifteen billion dollars of which so many billion dollars will be eligible for bank purchase. We invite you to subscribe up to a maximum of _____." They will give as a maximum a certain percentage of capital and surplus. Why do they put a maximum? Because the banks want more. So would you if you could *write* on both sides of an account and get one or two per cent! You wouldn't mind. You would want more. So they notify the Federal. And in due time the banks are notified that as of a certain day they can make the entry, and as of that day what does each bank do? They make this entry I am talking to you about. Suppose a bank was told that they could have one hundred thousand dollars worth of "Governments". As of the authorized day, they *debit* government investments, and *credit* "War Loan Account, Treasurer of the U. S."—\$100,000.

Now the government does not draw checks on commercial banks. The government used to do that fifty or sixty years ago, but charges of politics were made and presidents had trouble and things of that sort, so the government plays it safe now. As you

RESTRICTED

gentlemen know, they draw checks only on the Treasury but they are payable at the Federal so the government, by telegram, transfers this balance in War Loan Account to the Federal, pays it out and it comes back to the commercial bank—but all of that has nothing to do with what I am explaining this morning. That's merely because of the auditing practices of the government.

Eventually, the plane manufacturer or the munition manufacturer gets a check from the government on the government's account at the Federal. What does that munitions manufacturer do? He doesn't have an account at the Federal, but he does have an account at the State Street Trust Company or the Chase National Bank, or some other good bank so he takes that check in to them. His account is credited, so the government's account—the War Loan Account which went to the Federal—is debited and ends up in the account of the manufacturer at the commercial bank. In other words, all we have there is a transfer via the Federal, from the account of Uncle Sam to the account of "John Q. Public." That's the way it happens. They keep repeating that process over and over.

Here is the thing to keep your eye on; watch the ball now! Each time the government sells a billion dollars worth of bonds to the banks in this way, it results first in an increase in War Loan Account of a billion dollars and then, as the government sends the money over to the Federal and it comes back, it results in an increase of a billion dollars in the deposit accounts of the American people—money which they can spend and buy things—ordinary deposit accounts. It is just as good as if they had taken actual money down and left it with the teller. It is just as good as if they had borrowed it themselves. The only difference is that the government borrowed it for them. In this way we have had an expansion of deposits.

Now here is the ball I told you to watch—that expansion of deposits can then be used by the public, *over, and over again*, to buy more government bonds or to buy whoopee or anything the public wants to buy with it. It is their money. It has been transferred from the government's account to "John Q. Public".

In sharp contrast, when a member of the public buys a government bond, all you have is a shift from one deposit account to another. He draws a check on his own account (That's the way you pay for it) and what does the government do with that check? The bank debits the deposit account of the bond purchaser so that his deposit goes down, and they credit the deposit account of Uncle Sam. This does not go into the War Loan Account. This is not credit expansion. This is a *transfer* of purchasing power. It is no increase—only a transfer and thus not inflationary.

During the war our commercial banks reached a total investment of some eighty-eight billion dollars worth of government bonds. Thus the government borrowed more than eighty billion dollars from the banks through this process which I have just described. Let us see what that means. It means that each time they borrowed, the total of deposit accounts, first, of the government went up, and then later, of the American people. In plain English it means, at the moment, that the American people have sixty-three billion dollars of deposit accounts that they would not have had if the government had not sold sixty-three billion of bonds to the banks and if they had not held them. We thus have that purchasing power which would not have been in existence. You may ask how long it will be there? The answer is: *It will be there as long as the bonds are on the asset side of the balance sheet!* So long as the banks have sixty-three billion dollars worth of government bonds, they have to have sixty-three billion dollars worth of bank deposits. It may not be in the same bank; it may

RESTRICTED

move from bank to bank, but it has got to be in the system. It can't exist any place else. As you know, if you have the debit, you have to have the credit.

It is very difficult for many to see the impact of this—to see its importance. Since the government began to borrow from the banks in 1934 there have been many wrong guesses as to how much can be borrowed in this way. I don't know what the upper limit is, as it is a case where "you furnish your music as you go along." Every time the deposits in the banks went up a billion dollars, a billion dollars was put in the hands of the people with which they could be patriotic and they, in the next bond drive, could give up a billion dollars in checks to the government. Their accounts would go down a billion and the government's account would go up a billion, and then what would the government do? It would spend a billion to pay for military services or supplies or whatever they spend the money for, and the deposit would then move out of the government account, back into the individual's account, over and over again, until the end of time, or until those bonds come off the asset side of the balance sheets of the banks. Gentlemen, don't try to make something mysterious out of this or something difficult. It is the simplest thing in the world.

With all of this borrowing by the government and by business, why are interest rates so low? Prices are higher than they were before the war; also there is more business activity than ever before. There is more demand for credit. Why then is money so very easy? The answer is simple: *We have sixty three billion dollars of credit—sixty three billion dollars of purchasing power in the banks* because of the method of financing the war through the banks. It is not folding money but it will do until the folding money comes along. It is sixty-three billion of purchasing power that is being used, over and over again, week after week. This is the main answer as to why interest rates are so low.

There is one more thing I want to call to your attention. In America, we can borrow our reserves. Of course that is subject to the limitation of the total of gold. We have to have a certain amount of gold back of those reserve balances. But we have had, since World War I, which made us the unwilling recipient of the gold of the world, too much gold in this country. We have had no problem on gold back of our reserves. A lot of people, particularly professors, have been trying to make a problem of this, but we really had no problem on it. We can get the gold we want, any time we want, as long as we have the military power, the economic power, the industrial might. We can get gold; that is no problem at all. If, however, in time of war, our gold reserve (which was legally 25% during this war) falls below or shows that it is going to fall below, all we need to do is reduce the reserve requirement and we will get away with it. We used to have thirty-five per cent of gold back of those deposits. We cut it to twenty-five per cent but nobody worried about it.

During the war, the Federal held twenty-three billion dollars worth of government bonds. How did the Federal get those bonds? They bought them by crediting the account of the government. Thus to make it easier for the commercial banks to buy government bonds, the Federal Reserve Banks created twenty-three billion dollars of reserve, right on the barrel head. All during the war there was never any shortage of reserves. No bank had to send over any consequential amount of its government bonds to borrow to create its reserves; the government beat them to it. The Federal Reserve bought bonds and created the reserve account. On the basis of their reserve accounts the banks can create deposits. The member banks can then buy bonds and credit the government in the special deposit account called "War Loan Account", as explained before, and from there the purchasing power is transferred to the deposit accounts of the American people.

RESTRICTED

That is modern banking; that is the one thing that our commercial banking system does that no other part of our economic system can do. It is a remarkable service that they perform for us. It is really a wonderful thing. *However*, to make the system work we have to have public confidence and I am sure I do not have to tell you boys where you fit in that picture. *As long as the public has confidence* in that system, there seems to be no limit to it. After the war we ran the debt up to 276 billion dollars. Unfortunately, it now appears that there are some “boys” in Washington who think there is no limit. Now there is a limit even though we don’t know exactly where it is.

I want to conclude by saying that the role of finance has declined in importance under modern warfare. To say this is probably unwise. As you know the customary thing to do is to tell you that finance is the most important thing in the world, and to listen very carefully or you are going to miss the boat and all that sort of thing. Well, that is a lot of nonsense. As I told you at the very beginning, you boys don’t have to worry about it too much. I don’t mean that you should go hay-wire or anything like that, but I do mean that with our modern banking system, the problem of financing war is greatly simplified. This was especially true during World War II. During the past war we did a much better job than we did in World War I.

The banks in this war did a good deal of financing for one-third of one per cent per annum on Treasury bills. Now ponder that. If anyone tells you that the banks profiteered, remember, as bookkeepers they have to get *something*, and one-third of one per cent isn’t much. They are entitled to something for working out such a system. They got eighty seven and one half hundredths of one per cent on Certificates of Indebtedness. In addition, the banks were able also, to buy long term bonds, on which they got less than two per cent, after taxes. All in all, they did a magnificent job.

So, in conclusion, I want to say that we financed this war very nicely, very neatly. There are lots of things that were done in Washington that I could criticize, but everything considered, the boys did a grand job.

During the war, and since, they have done a magnificent job of managing the public debt. We have a public debt now, as you know, of a quarter of a trillion dollars, and some people say the problem is whether we are going to pay it off, manage it, or repudiate it, or what not. Certainly we are not going to repudiate it, and in my humble opinion and *within this room*, there is no real need for us to pay it off. We will, of course, pay off some of it, but, as a matter of fact, I don't think the American people want it paid off. We are going to manage it, because if we don't manage it, gentlemen, it will manage us. The way the Federal Reserve authorities and the Treasury have fought inflation with one hand by raising the reserve requirements, raising interest rates, and with the other hand bought government securities and kept up the price of government bonds until they finally passed the crucial test has really been magnificent. When you can push up with one hand and push down with the other and get away with it, you are pretty darn good. As I said, they did that and I believe in giving credit where credit is due. I had no hand in it; moreover I have never gotten a dime from the Treasury or the monetary authorities for defending them. I did get \$15.60 a month in World War I from the government as an enlisted man in the Navy. I earned it; the officers saw to that. My conscience doesn't bother me one bit. So I want to make it clear that I don't come here as an apologist for anything that I had anything to do with and I don't come here to whitewash anybody.

Clearly, *the way we financed this war is the way we will finance the next one*. I do hope we will finance more of the next

RESTRICTED

one by means of taxation although the taxes were high enough in this one for me. When a college professor has to pay fifty cents out of an income dollar as income taxes, taxes are certainly high. Nonetheless, we do have to recognize that taxation right up to the breaking point, but not beyond it, is the soundest way to finance war. Any additional amounts needed can be supplied through credit expansion by our marvelous banking system.

That concludes my story, and thank you very much for your close attention.