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The Importance of an Independent Central Bank

Address by

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It is a pleasure for me to be here on the campus of Jacksonville University to join in honoring this graduating class. I say that most sincerely. Having spent the greater part of my life as a university teacher, I always take satisfaction in the scholastic achievement of young men and women. This is rightfully a proud moment for you, and I very much appreciate being able to share it.

Today, I would like to talk to you about an issue that has been important throughout much of recorded history and which is certain to influence your lives -- for better or worse. I refer to government's management of money -- a function that in our country is lodged by statute with the Federal Reserve System.

No nation whose history I am familiar with has succeeded in managing the stock of money perfectly. Few, indeed, have even managed it well. And those societies that have been least successful have paid dearly for their ineptitude. Debasement of the currency had a great deal to do with the destruction of the Roman Empire. In our own times, excessive creation of money has released powerful inflationary forces in many countries around the globe. And once a nation's money is debauched, economic stagnation and social and political troubles usually follow.

Each of you in this assemblage, whatever your age, has experienced at first hand some of the consequences of monetary stress. For a dozen years now, our Nation has been subjected to a relentless siege of inflation that has conferred undeserved windfall gains on some and undeserved hardships on others. In terms of social well-being, these capricious pluses and minuses by no means cancel out. Young people wanting to buy a home these days know that the price of decent shelter has soared almost out of reach. Parents across the country know the shocking extent to which tuition costs have ballooned. And woe to anyone who has major medical expenses and is not adequately insured.

Those, moreover, are merely among the most readily visible consequences of inflation. There are other less apparent effects that are even more pernicious. Once a nation's economy has been gripped by inflation, it becomes virtually impossible to maintain an environment in which jobs are plentiful and secure. The economic recession of 1974-75, in the course of which unemployment climbed to a level above 8 million persons, would not have been nearly so severe -- and indeed might not have occurred at all -- had it not been for the inflationary distortions of the preceding several years.

That is clear, I think, from the sequence of events. Double-digit inflation severely drained many family pocketbooks, reduced consumer confidence, and led to more cautious consumer spending. Businessmen, however, were slow in responding to the weakening of consumer markets. They seem to have been blinded by the dizzying advance of prices and by the effect of that advance on their nominal profits. They thus continued aggressive programs of inventory expansion and capital-goods expansion longer than was prudent, thereby causing economic imbalances to cumulate to major proportions. By the time the weakening of consumer markets was fully recognized by businessmen, the need to scale back had become enormous. The worst recession in a generation ensued.

The only positive aspect of that traumatic episode is that it finally opened the eyes of many economists and public officials to the fact that inflation and unemployment are not alternatives for our economy. The message is now clear that inflation in time causes serious unemployment. Understanding of that relationship is gradually tending, I believe, to make public policies more sensible.

Some of you in this audience may be wondering, I suspect, whether the Federal Reserve may not have something to do with the inflation we have been experiencing. It may fairly be asked: Has not the Federal Reserve been creating too much money? And may not this be one of the causes of our inflation?

That question is, indeed, often put to me, and I welcome it because of the opportunity it affords to clarify the nature of the dilemma our country faces. Neither I nor, I believe, any of my associates would quarrel with the proposition that money creation and inflation are closely linked and that serious inflation could not long proceed without monetary nourishment. We well know -- as do many others -- that if the Federal Reserve stopped creating new money, or if this activity were slowed drastically, inflation would soon either come to an end or be substantially checked.

Unfortunately, knowing that truth is not as helpful as one might suppose. The catch is that nowadays there are tremendous nonmonetary pressures in our economy that are tending to drive costs and prices higher. This, I should note, applies not only to our country, nor is it anymore just a phenomenon of wars and their aftermath as tended once to be the case. Rather, powerful upward pressures on costs and prices have become worldwide, and they persist tenaciously through peace-time periods as well as wars.

This inflationary bias reflects a wide range of developments that have been evolving over a span of decades in both governmental and private affairs. Foremost among these developments is the commitment of modern governments to full employment, to rapid economic growth, to better housing, improved health, and other dimensions of welfare. These are certainly laudable objectives, but they have too often caused governmental spending to outrun revenues. Other developments -- such as the escalator arrangements that various economic groups have achieved through their efforts to escape the rigors of inflation -- have speeded the transmission of inflationary impulses across the economy. What we as a people, along with other nations, have been tending to do is to subject available resources to increasingly intensive demands; but we at the same time have sought to insure that incomes do not get eroded when excessive pressures on resources generate inflation. This amounts, unfortunately, to creating upward pressures on costs and prices, and then arranging to perpetuate them. That is the awesome combination that fighters against inflation have to try to counter.

Theoretically, the Federal Reserve could thwart the nonmonetary pressures that are tending to drive costs and prices higher by providing substantially less monetary growth than would be needed to accommodate these pressures fully. In practice, such a course would be fraught with major difficulty and considerable risk. Every time our government acts to enlarge the flow of benefits to one group or another the assumption is implicit that the means of financing will be available. A similar tacit assumption is embodied in every pricing decision, wage bargain, or escalator arrangement that is made by private parties or government. The fact that such actions may in combination be wholly incompatible with moderate rates of monetary expansion is seldom considered by those who initiate them. If the Federal Reserve then sought to create a monetary environment that seriously fell short of accommodating the nonmonetary pressures that have become characteristic of our times, severe stresses could be quickly produced in our economy. The inflation rate would probably fall in the process but so, too, would production, jobs, and profits.

The tactics and strategy of the Federal Reserve System -- as of any central bank -- must be attuned to these realities. With sufficient courage and determination, it is nevertheless within our capacity to affect the inflation rate significantly. We may not, as a practical matter, be able to slow monetary growth drastically within any given short time span, but we do have considerable discretion in accommodating the pressures of the marketplace less than fully. We are, indeed, often engaged in probing and testing our capacity to do just that. And, while we must be cautious about moving abruptly, my colleagues and I in the Federal Reserve System are firmly committed to a longer-term effort of gradual reduction in the rate of growth of money -- something that is reflected in the progression of steps we have been taking to lower permissible growth-ranges for the money supply. Slowly undernourishing inflation and thus weakening it seems the most realistic strategy open to us. We believe that such an effort -- especially if Congress becomes less tolerant of budget deficits -- will ultimately create a much healthier environment for the determination of wages and prices.

The capacity of the Federal Reserve to maintain a meaningful anti-inflationary posture is made possible by the considerable degree of independence it enjoys within our government. In most countries around the world, central banks are in effect instrumentalities of the executive branch of government -- carrying out monetary policy according to the wishes of the head of government or the finance ministry. That is not the case in this country because the Congress across the decades has deliberately sought to insulate the Federal Reserve from the kind of political control that is typical abroad. The reason for this insulation is a very practical one, namely, recognition by the Congress that governments throughout history have had a tendency to engage in activities that outstrip the taxes they are willing or able to collect. That tendency has generally led to currency depreciation, achieved by stratagems ranging from clipping of gold or silver coins in earlier times to excessive printing of paper money or to coercing central banks to expand credit unduly in more modern times.

With a view to insuring that the power of money creation would not be similarly abused in our country, the Congress has given our central bank major scope for the independent exercise of its best judgment as to what monetary policy should be. In fact, Congress has not only protected the Federal Reserve System from the influence of the Executive Branch; it also has seen fit to give the System a good deal of protection from transitory political pressures emanating from Congress itself.

Probably the two most important elements making for Federal Reserve independence are the following: First, the seven members of the Federal Reserve Board serve long and staggered terms and can only be removed for "cause." This arrangement severely limits possibilities for any "packing" of the Board and enables members of the Board to act without special concern about falling out of grace politically. Second, the Federal Reserve System finances its activities with internally generated funds and therefore is not subject to the customary appropriations process. This arrangement is intended to assure that the Congressional "power of the purse" will not be used in an effort to induce System officials to pursue policies that they otherwise might consider poorly suited to the Nation's needs.

The Federal Reserve has thus been able to fashion monetary policy in an impartial and objective manner -- free from any sort of partisan or parochial influence. While the long history of the Federal Reserve is not faultless, its policies have consistently been managed by conscientious individuals seeking the Nation's permanent welfare -- rather than today's fleeting benefit. Significantly, this country's record in dealing with inflation -- albeit woefully insufficient -- has been much better generally than the record of countries with weak central banks. Indeed, I would judge it no accident that West Germany and Switzerland, which in recent years also have managed their economy better than most others, happen to have strong and independent monetary authorities like ours.

The degree of independence which Congress has conferred upon the Federal Reserve has been a source of frustration to some government officials since the Federal Reserve Act first became law. Certainly, from the standpoint of the Executive Branch, it would at times -- perhaps often -- be more convenient to instruct the central bank what to do than to reckon with the System's independence. In the end, however, the country would not be as well served. The Federal Reserve, it needs to be emphasized, seeks earnestly to support or to reinforce governmental policies to the maximum extent permitted by its responsibilities. When the System's actions depart, as they occasionally have, from the way in which the Executive Branch would wish it to act, that is generally because the System tends to take a longer-range view of the Nation's welfare. Actually, most of the time, monetary and fiscal policies are well coordinated and mutually reinforcing; in other words, they are the product of continuing and fruitful discussions between members of the Administration and Federal Reserve officials.

Not only is dialogue continuous with the Executive Branch of government, but Federal Reserve officials appear frequently before Congressional Committees -- something that works, on the one hand, to keep Congress informed as to System activities and which, on the other, affords Senators and Congressmen an effective means of registering approval or disapproval of Federal Reserve policy. In practical terms, the economic policy dialogue that is always in process within our government produces a thorough exploration of options. It may fairly be said, I believe, that the System's independence results in a more thorough discussion and thrashing out of public issues than would otherwise occur.

Despite the salutary influence that the Federal Reserve's independence has had on our Nation's economy, legislative proposals that would place the System under tighter rein keep being introduced in Congress. The proposals that have been put forth over the years cover a wide range -- for example, to enlarge the size of the Board, to shorten the terms of its members, to enable the President to remove Board Members at will, to diminish or eliminate the role of Federal Reserve bank directors, and to subject the System to the Congressional appropriations process or to audit by the Government Accounting Office. In recent years, there have also been proposals calling for numerical forecasts of interest rates or other sensitive magnitudes, which if ever undertaken by the Federal Reserve, could unsettle financial markets, besides misleading individuals who lack sophistication in financial matters.

The shortcomings of these individual proposals matter less, however, than what appears to be their common objective, namely, to reduce the Federal Reserve's independence and to restrict its scope for discretionary action. That, I believe, is the real thrust of the diverse efforts to "reform" the Federal Reserve System. It is perhaps of some significance that such proposals not infrequently come from individuals who are basically dissatisfied with what they regard as excessive Federal Reserve concern with battling inflation.

The element of populism in all this is strong -- particularly the preoccupation with maintaining low interest rates. It makes no difference how often Federal Reserve officials repeat that the System's continuing objective is the lowest level of interest rates compatible with sound economic conditions. That is not enough. What is desired is assurance that interest rates will be kept permanently down, or at least not be allowed to rise significantly.

The Federal Reserve cannot, of course, give that kind of assurance. In a period of rising demands for funds, a determined effort by the System to keep interest rates down could quickly turn the Federal Reserve into something akin to the engine of inflation that it was during the early Korean War period when the System unwisely tried to keep interest rates down so that the cost of financing the Federal debt would not escalate. Actually, the consequences now would almost certainly be far worse than they were a quarter century ago because the public has become far more sensitive to inflation.

Long-term interest rates, in particular, tend to respond quickly nowadays to changing inflationary expectations. Once the financial community perceived that the Federal Reserve was pumping massive reserves into commercial banks with a view to creating monetary ease, fears of a new wave of inflation would quickly spread. Potential suppliers of long-term funds would then be inclined to demand higher interest rates as protection against the expected higher rate of inflation. Borrowers, on the other hand, would be more eager to acquire additional funds, since they would expect to repay their loans in still cheaper dollars. In short, heightened inflationary expectations would soon overwhelm markets in today's inflation-conscious environment by actually causing long-term interest rates -- which are generally more important to the economy than short-term rates -- to rise. The policy of seeking lower interest rates by flooding banks with reserves would thus be frustrated. And I need hardly add that adverse effects on production, employment, and the dollar's purchasing power would follow.

The Federal Reserve System, I assure you, will not be deterred by the drumbeat of dubious propositions concerning money and interest rates. We are determined to continue on a path of further gradual unwinding of the inflationary tendencies that have become so deeply embedded in our economic life. We are determined to continue promoting the expansion of our economy and yet control the supply of money so as to prevent a new wave of inflation. Such a policy, I firmly believe, is the only responsible option open to us.

I hope that I have succeeded today in conveying some sense of the importance to you as individuals and to the Nation generally of the Federal Reserve's role in our government. Fortunately, despite the criticism that is not infrequently voiced by some members of Congress, the Congress as a whole has kept the Federal Reserve's role in a clear perspective and has fully protected the essentials of Federal Reserve independence. That will continue to be the case only if you who are graduating today and other citizens develop a full understanding of what is at stake.

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