



**SHOULD MONETARY POLICY BE MADE MORE RESPONSIVE
TO THE POLITICAL PROCESS?**

Address by

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Being invited by a community of distinguished scholars such as this to join in a discussion of Federal Reserve independence is in itself an honor. And this honor is magnified when another participant in the discussion is a national leader of the stature of Senator William Proxmire, distinguished chairman of the Senate Banking, Housing and Urban Affairs Committee.

I am particularly pleased to take part in this program — this community dialogue — because of the subject you have chosen.

The importance of sound monetary policy to the continued prosperity of our nation was eloquently described recently by Arthur Burns, chairman of the Board of Governors of the Federal Reserve System. Dr. Burns said: "Our country is passing through a fateful stage in its history. Economic, social, and political trends of the past several decades have released powerful forces of inflation that threaten the vitality of our economy and the freedom of our people."

"Defeating the forces of inflation requires determined action. Greater discipline is needed in our fiscal affairs, and structural reforms are required to improve the functioning of our labor and product markets. But all such reforms would come to naught in the absence of a prudent course of monetary policy."

I concur in Dr. Burns' assessment. And, I feel the most significant issue relating to the prudent conduct of monetary policy is the question you have made the subject of this dialogue, namely "Should Monetary Policy Be Made More Responsive to the Political Process?"

Concern about the proper relationship between monetary policy and the political process is not new. It dates from the first attempts to establish a currency not tied to some standard of intrinsic value, and it has arisen repeatedly since then.

In 1294, the Il-Khan, the Ruler of Persia, learning of the Chinese invention of paper money, established, by edict, a paper currency in his own country. He then proceeded to maintain personal control of monetary policy, thereby making monetary policy completely responsive to the political process of 13th Century Persia.

The Il-Khan soon discovered that control of the money supply enabled him to

increase the purchasing power of his royal court simply by printing more money, which he did — in large quantities.

Soon he owned all the merchandise from all the shops of his capital, Tabriz.

It didn't take the merchants long to realize that the Il-Khan had used his ability to print paper currency as a means of confiscating their wealth. The Persians dealt with their inflationary problem in a fairly positive manner: they deposed their Ruler and beheaded him.

Let's look at a more modern example of political domination of monetary policy... post-World War I Germany.

Germany had gone off the gold standard prior to World War I.

After the war, when the Weimar Republic was established, the Reichsbank, the Republic's central bank, was required by law to buy government debt instruments at the Treasury's request. Thus, when the government wanted to finance a deficit, it merely had to print some Treasury notes and exchange them for reichsmarks at the Reichsbank.

This arrangement made it impossible for the central bank to impose any restraint on the creation of money and permitted the government to control monetary policy.

The Reichstag was anxious to respond to the desires of the groups that had elected it, and, of course, the last thing the voters wanted was higher taxes. So, the government was only being responsive to the apparent will of the people when it financed its operations by printing money.

The result was the cataclysmic inflation of post-war Germany.

At the height of that inflation, it required thirty papermills working round the clock to deliver paper to the 150 printing plants that employed 2,000 presses to print reichsbanknotes.

Prices rose tenfold in four months. They rose 200% in eleven months. And the inflation had only begun to accelerate. By the end of the 17-month period that began in

July 1922, wholesale prices had risen 750 billion times their original levels.

In an attempt to protect themselves from the declining value of the currency, lenders were charging legal interest rates of 22 percent — per day. Workers received their pay in trillions of reichsmarks. They had to lug their money home in bales and spend it as quickly as possible before further hyperinflation destroyed its buying power.

The middle class virtually disappeared.

Disillusionment with inflation drove Germans away from the moderate center parties which they blamed for causing the inflation and into the two extremist parties, the Communist Party and the National Socialist Party.

We all know what followed.

Fear, confusion and disillusionment inspired riots and attempts to violently overthrow the government. One such disturbance, which began in a Munich beer hall, helped launch the career of Adolph Hitler. The process which had its roots in post-war inflation, culminated in World War II.

A third example of what happens when a central bank loses its independence and monetary policy becomes responsive to the political process is the case of England.

At the end of World War II, the British government took complete control of monetary policy. In the 60's, the government began responding more and more to voter demands for expensive social programs. The cost of providing those programs soon exceeded the amount the government was able or willing to collect by taxation or by borrowing from the public. So, the government of Great Britain began financing its programs by creating money. In the absence of restraint from an independent central bank, the money supply exploded and inflation followed.

In 1968, the United Kingdom's money supply grew 10.3% and consumer prices increased 10.9%. In 1970, Britain's money supply increased 12.7% and consumer prices, 13%. Since 1973, the British money supply has grown at an average annual rate of about 15% and consumer prices, about 20%.

Not only were the British people subjected to the terrible ravages of inflation; the social problems the government sought to solve were not solved. In fact, they've grown progressively worse.

Let's take a look at our own situation. During World War II, the United States, like Great Britain, turned over monetary control to the Treasury Department. The government, in effect, used inflation-creating expansion of the money supply as a means of financing the war. This was both understandable and defensible under conditions of war.

Fortunately, however, this country's monetary history diverged from that of Great Britain after the war. In 1951, at the instigation of Congress, the Federal Reserve System and the Treasury reached an accord that returned to the Federal Reserve substantial independence in the conduct of monetary policy.

In convening the Senate hearings that led to that arrangement, Senator Paul Douglas of Illinois, a fiscal liberal, observed, "We have very little chance of achieving...maximum production, maximum employment, and maximum purchasing power if we cannot maintain an appropriate and relatively stable flow of money and credit."

The best guardian of monetary stability, Congress decided, was a strong central bank. Parenthetically, it is worth noting that after World War II, Germany, likewise, having learned the hard lesson of runaway inflation, granted to its central bank, the Bundesbank, independence in its conduct of monetary policy.

It is no coincidence that, in recent years, of all western nations, Germany and the United States, with independent central banks, have been most successful in resisting inflation. History amply demonstrates that political domination of monetary policy inevitably leads to inflation.

The founders of the Federal Reserve System back in 1913 recognized the importance to this Nation of an independent monetary authority. Senator Carter Glass, Chairman of the House Banking and Currency Committee which helped author the Federal Reserve Act, called for the System to be a "distinctly non-partisan organization whose functions are to be wholly divorced from politics." That view was supported by President Woodrow Wilson, who was extremely careful to avoid White House interference with the newly created monetary authority and thus set a precedent that has been followed by most succeeding presidents.

The present Federal Reserve Act contains provisions specifically designed to insure the independence of the System. Members of the Federal Reserve Board of Governors serve 14-year staggered terms in order to avoid presidential "packing" of the monetary authority. The System is financed from its own internal sources and thus protected from political pressures that might result from a process of Congressional appropriations. Power is diffused among 12 regional Federal Reserve Banks, each of which is an independent corporation headed by a president appointed by a district board of directors. Partisan considerations play no part in the deliberations of the Federal Open Market Committee as it weighs issues of monetary and credit policy from the viewpoint of the public interest and the general welfare.

The wise reasoning that went into the original design of the Federal Reserve as an independent monetary authority still applies today. If Fed independence is lost and monetary policy-making were to become responsive to the political process, accelerated inflation would almost certainly follow. If anything, the safeguards of Federal Reserve independence must be strengthened. Because in our political process, even the best-intentioned elected officials are subject to intense pressures to support inflationary fiscal policies.

For candidates to be elected to public office, they must reflect the legitimate desires of their constituents. If elected, they must strive to fulfill the pledges they have made to those who elected them and this usually involves the expenditure of money by government. The financing of government expenditures and the handling of budgetary deficits entails difficult monetary decisions. Decision-makers must choose between politically tempting, but inflationary, monetization of debt through purchase of Treasury securities by the central bank, or politically unpopular non-inflationary alternatives such as tax increases or higher interest rates.

To place the responsibility for both fiscal and monetary policy-making in the hands of officials who must rely on political support for election is asking a lot. It is easier for an independent monetary authority, insulated from the pressures of elective office, to manage monetary policy objectively in the best long-range interest of the Nation. So I say, our national interest will be best served if the Federal Reserve is permitted to formulate monetary policy decisions independently of political pressures in a manner similar to that enjoyed by the federal court system in judicial decision-making.

This means that the Fed should be responsible to the political process but not necessarily responsive to it. These two adjectives are really the crux of the current debate. To be responsible means to be accountable for actions taken within one's power or authority. To be responsive, on the other hand, means to react to demands and pressures, often of a short-term nature. Monetary policy, to be effective must necessarily be a long-term process by which monetary authorities try to maintain money supply growth which does not generate inflationary or deflationary pressures and expectations. The Fed should have the authority to control this process and be responsible for the results. To be responsive to the vicissitudes of political events would negate authority for long-term policy and greatly reduce the opportunity to assign responsibility for actions taken. As a matter of fact, responsiveness to the political process makes the formulation of a long-term policy, which is the main reason for the existence of monetary authority, almost impossible. And monetary policy which reacts to every unpleasant economic shock has always, as history has shown, resulted in the loss of control over non-inflationary money growth.

No doubt, the Federal Reserve System could be improved. Nothing fashioned by man is perfect. But to make monetary policy a matter of politics would not be an improvement. It would be a terrible mistake.

At this fateful stage in our history, with powerful forces of inflation already threatening us, it is important that we learn the lessons of history and resist the temptation to look for the "easy way out." Deficit budgeting financed by debt monetization is relatively painless in the short-run. Such inflationary policies in the long-run could lead to the downfall of our Republic.

If we are to avoid runaway inflation, each of us must take part in the struggle to preserve fiscal and monetary sanity. We can put an end to spiraling prices; we can stop the growth of government; we can resist the siren song of more and more government spending and more and more government controls. We can, that is, if we are willing to face up to the realities of fiscal and monetary conditions and impose the self-discipline necessary to assure the continued soundness of our economic system.

There are those who say the demise of the American System is inevitable. I don't agree with them. I feel that we have it within our power to preserve the political-economic system which, imperfect as it may be, has served us so well during the past two hundred years.

But to do so, we must allow the Federal Reserve System to function with the independence necessary to assure orderly growth and economic stability.