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INFLATION AND FEDERAL RESERVE INDEPENDENCE

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Approximately nine months ago I left the world of commercial banking to become President of the Federal Reserve Bank of St. Louis. I did so, not only because of the challenge of being part of the Fed System which plays such an important role in the financial affairs of the United States and the Free World. Rather, I joined the Fed because I'm sincerely concerned about the future of our way of life. I am convinced that the greatest threat to the survival of our free society is runaway inflation. . .and I believe that the best chance we have of avoiding a return to double-digit inflation is through a sound monetary policy formulated by an independent Federal Reserve System.

We might begin by asking ourselves, "Is inflation really such a threat? Can it actually destroy us? Now that the double-digit figures of a couple of years ago have declined to an annual rate of 5–6%, is runaway inflation still such a problem?" I know that there are some economists who go so far as to say that we should tolerate a certain amount of inflation in order to create jobs and to keep the economy going; that the great problems of unemployment, shortages in housing and social inequity can be solved only by massive injections of money, deficit budgeting and expansion of the national debt; and that a little inflation isn't bad. It reminds me of the young lady who thought that being just a little bit pregnant wasn't a problem! Is inflation bad? You'd better believe it is.

The consequences of inflation should be well-known by now. You know what happens to the economy in periods of uncontrolled inflation. The real value of savings deposits, pensions, and life insurance policies are reduced. Inflation creates havoc in financial markets as interest rates are driven up. Funds for mortgage lending diminish, and business encounters difficulty in raising funds needed for capital expansion. In short, inflation destroys confidence in the future and blunts the driving forces of economic expansion.

Inflation has other serious side effects. In addition to its economic costs, it takes its toll politically and socially. Runaway inflation tears at the very fabric of a free society. Solid citizens, who in their desire to be self-reliant have set aside funds for the education of their children or for their own retirement, suddenly find that the value of their savings has evaporated. . .that their carefully laid retirement plans have been destroyed and their years of toil have gone for naught. In their frustration, they lose confidence in traditional political institutions and in desperation may listen to demagogues who offer the "easy solution."

In recent years, governments have been toppled in Argentina, Chile and other countries—largely because the citizens of those countries lost confidence in the ability of their leaders to cope with the problems of inflation. Here in America, the distortions, injustices, and hardships wrought by inflation have contributed in no small measure to the current distrust of government officials and of government policies, and to a serious loss of confidence in our free enterprise system. When citizens lose confidence in the ability of their leaders to cope with inflation, economic and political freedoms give way to hopelessness. In frustration, people turn to tyranny and dictatorship. This has happened in other Nations and other societies; it could well happen here.

So much for the damaging consequences of inflation. If we agree that it poses a threat to our future, the next step is to consider what to do about it. Now, for a doctor to treat an illness, it is helpful if he knows what's causing the trouble. While I don't profess to be a professional economist, I do know that economists differ greatly in their opinions of the causes and cures of inflation. However, in nine months of association with a highly knowledgeable staff of economists in our Federal Reserve Bank, I've learned a few things that I believe have a real bearing on inflation. One is that the trend of growth of the money stock has a direct and real effect on price levels. When the money grows faster than the output of goods and services, prices tend to increase; conversely, when the money supply growth declines, prices do likewise. If output grows at about 3 per cent a year, which has been the average growth rate throughout the history of the United States, then the economy can absorb a 3 per cent annual growth in the money supply with no appreciable change in price levels. This was the case in the postwar period from 1947 to 1962 when output grew at roughly the same rate as the money supply. During that period, except for the Korean War, the minor increase in money supply was easily absorbed and prices remained relatively stable. For as long as money supply and economic growth increase at the same rate, prices do not rise.

The problem occurs when the government starts creating money and thereby expands the money supply at a rate faster than the ability of the economy to increase the supply of goods and services. How does the government do this?

As you know, the government can finance its increased spending in one of <u>three</u> ways. It can do it by raising <u>taxes.</u> When government spending is financed through increased taxes, the result is not inflationary. However, tax increases are not very popular with politicians for the simple reason that elected officials who support tax increases usually don't last very long in office. A second noninflationary alternative is for the government to borrow through the sale of bonds to the private sector of the economy. Absorption of government debt by the private sector normally leads to higher interest rates. Like higher taxes, higher interest rates are politically unpopular. Furthermore, the stimulative effect of such action is usually lost, since the additional spendable money available to government is offset by a reduction in spendable funds in the hands of private investors who bought the bonds. And increased interest rates are in themselves counter stimulative because they tend to put a damper on private spending.

Unfortunately, there is still a third way to skin the cat. And that is for the central bank -- in this country, the Federal Reserve Banks -- to monetize the debt in order to keep interest rates from rising. This happens when the Fed buys up government securities in the open market. But when the Fed buys securities, then commercial bank reserves rise dollar for dollar and the money stock rises 2.5 dollars for every dollar's worth of bonds purchased. The government gets to spend more, the private sector seems to have as much money as ever to spend, and interest rates do not rise, at least initially. Sounds good. . .but is it really?

The answer is No. For an increase in the money supply means that more money is chasing the same amount of available goods. And that results in inflation.

And here is where the independence of the Federal Reserve System becomes so important.

History is full of examples where fluctuations in money supply have caused fluctuations in prices. Since our money is not attached to any outside standard such as gold, silver or holdings of foreign exchange, the Federal Reserve has the power in effect to create and destroy money at will. This is done through the Fed's Open Market Committee. When the Federal Open Market Committee decides to stimulate the economy, it directs the money desk at the New York Federal Reserve Bank to purchase government securities. It pays for its purchases by writing checks on itself and thereby increases bank reserves and pumps money into the economy. Conversely, the sale of securities by the Fed siphons money from the economy and has a restrictive effect on economic activity.

The ability of the Federal Reserve to perform its monetary functions in the best interests of the Nation, independent from political pressures, is the key to this Nation's ability to control inflation.

The founders of the Federal Reserve System back in 1913 recognized the importance of an independent monetary authority. Senator Carter Glass, Chairman of the House Banking and Currency Committee which helped write the Federal Reserve Act, called for the System to be a "distinctly nonpartisan organization whose functions are to be wholly divorced from politics." That view was supported by President Woodrow Wilson, who was extremely careful to avoid any suggestion of 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 specific provisions 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.

Yet there are those who for philosophical or political reasons would like to circumscribe the independence of the Fed. These are individuals who sincerely believe that the best means of assuring full employment and economic prosperity is through deficit spending and easy money. They believe that the Federal Reserve should be made to accommodate those goals if called upon to do so by Congress or the President. They feel that inflation is a small price to pay for immediate and short-lived prosperity.

In the last session of the Congress, a whole series of bills were introduced which would have had the effect of placing the Fed increasingly under the control of the executive and legislative branches of the federal government. Fortunately, these proposals were not enacted into law, but it is a safe bet that they, and similar measures designed to lessen the independence of the Fed, will be revived in the 95th Congress.

These are the kinds of pressures the Federal Reserve faces in today's world. It is essential that they be resisted and hopefully overcome.

All we need do is to look at what has happened elsewhere to see the significance of an independent monetary authority. Since World War II, West Germany and the United States have had the greatest relative — albeit insufficient — success in resisting inflationary pressures of the major industrial powers. It is no accident that both countries have strong central banks.

Conversely, there is the example of Great Britain where political domination of the central bank has wrought devastating results. Britain's experience is an almost classic example of what happens when a central monetary authority loses its independence. As you know, soon after World War II, Britain embarked upon a number of expensive social welfare programs. Initially, the programs were financed by increased taxation, and inflation was avoided for a time. Serious inflation did not really begin in postwar Britain until the early 70s when, in order to counteract increasing unemployment, the Bank of England was forced to monetize the national debt. The rest you know. . .inflation sky-rocketed to almost 20 per cent a year. . .the value of the pound dropped and so did the British standard of living. A once strong central bank caved in to government pressure and, once again, inflation has brought a once proud nation to its economic knees.

As I said earlier, I believe that the survival of the American System is in the balance. . that the greatest threat to our future is inflation. If we are to avoid runaway inflation, each of us must take part in the struggle to preserve fiscal and monetary sanity. We <u>can</u> put an end to spiraling prices; we <u>can</u> stop the growth of government; we <u>can</u> resist the siren song of more and more government spending and more and more government controls. But it means that we must be prepared to stand up for the principles that have made America great.

The hour is late. It has become quite fashionable in some circles to proclaim the inevitability of the demise of our system. Such a philosophy is a convenient escape. For if there is not hope, we are not obligated to do anything.

I do not share this pessimism. We have human talents on our side. We have economic strength on our side, and most important, we have history on our side. We have, in the American free enterprise system, the most successful economic system in the world. It has elevated us from a powerless nation, 90 per cent of whose citizens were in poverty at the time of the Revolution, into the greatest agricultural and industrial power on earth. So successful is our system and so high are the aspirations of the American people that we define poverty at an income level that is higher than the average income level of the world's second most powerful nation, the Soviet Union.

I believe that we can maintain the progress we have made and build upon it. What we need today, more than any time in the history of the United States, is the commitment of well-meaning and well-informed men and women who are willing to speak out on issues of major importance and who are willing to forego the simple solutions of the moment for the long-term benefit of future generations. In the struggle for the survival of the American experiment, I urge you as civic leaders to speak out for what you know is right. By doing so, and only by doing so, can we secure the future of our generation and the prosperity of generations of Americans to follow. I thank you.