



ACCOMMODATION AND INFLATION

Address by

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This afternoon I would like to discuss just what happens when increased pressure is brought to bear upon the Federal Reserve to accommodate federal deficits. By accommodation, I mean monetization of the federal debt by the Federal Reserve. If such accommodation were to become a permanent feature of government financing, our economic and political institutions would be in deep trouble.

The problem starts with individual wants. . .the understandable desire of people for a greater share in the goods and services produced by society. These individual wants are conglomerated into group wants, and groups in turn express their desires politically by demanding the fulfillment of their desires as the price of their voting support for candidates for public office. We have the farm vote, the labor vote, the business vote, the consumer vote, etc., all of which are conglomerates of individuals seeking to apply pressure for the satisfaction of their special desires.

Political candidates, in order to be elected, must make promises to these groups, and when elected they must strive to keep those promises. But, keeping such promises, or even appearing to do so, almost always means more expenditure by government.

How does the government go about raising money?

The federal government can raise money in one of three ways. The first and most obvious way is through the collection of taxes. Paying for increased expenditures by raising taxes avoids inflation, but does create problems for elected officials because increased taxes tend to displease voters, and displeased voters tend to vote elected officials out of office.

A second way government can raise money is by borrowing from the private sector. The federal government borrows money by selling government securities. When the Treasury borrows from the private sector by selling bonds to the general public, it must compete with all other borrowers for available credit dollars. Such competition for available credit usually causes interest rates to rise. And high interest rates, like high taxes, are politically unpopular.

There's still a third way to satisfy the spending demands of the public. . .a method which on the surface would seem to provide the government with more money to pay for its "goodies" while at the same time giving the appearance that there is no additional cost

to the taxpayer. It involves a sort of financial sleight-of-hand and works like this: The Treasury offers bonds on the open market. The Federal Reserve accommodates the needs of the Treasury by purchasing the securities in the same market. For every bond the Fed buys, the Treasury has more money to spend and the private sector hasn't had to contribute a cent. Something has been created from nothing. It is a scheme that would have made Merlin the Magician proud.

Unfortunately, as with all magic, when the magician's secrets are revealed, the audience finds that only the magician's dexterity is amazing. The secret of this particular trick is that it's really only a sophisticated version of the old printing press trick: The government needs some money; so the government prints itself some money.

The only refinement in the new version is that when the Federal Reserve buys Treasury securities, money is created not in the form of dollar bills but as reserves of commercial banks. Thus, the cumbersome printing press is disposed of.

But the result is exactly the same. The total stock of money expands. And, if the total stock of money grows more rapidly than the total quantity of goods and services available for purchases, we have inflation.

Now, a basic goal of the Federal Reserve System is to keep the nation's stock of money growing fast enough to keep up with the increasing monetary needs of an expanding economy, but not so fast as to cause inflation.

Left to its own devices and knowing what we do about the relationship of the rate of money growth to the rate of change in the price level, the Federal Reserve has the ability and the authority to avoid excessive inflation. Unfortunately, the Fed is not always permitted the independence of action originally contemplated by the framers of the Federal Reserve Act.

The political pressure groups I have referred to often feel expenditures for their programs are justified even if they require an increase in the Federal budgetary deficit. When the federal deficit increases, the Treasury must increase its borrowings and the Federal Reserve is frequently called upon to monetize the additional debt. If the Fed balks at buying up the Treasury debt, it is often accused of refusing to cooperate with the objectives of the executive or legislative branches of the government.

In the face of such pressure, it is sometimes difficult for the Fed to operate as it would if left entirely to its own devices. Over recent years, the amount of government debt held by the Federal Reserve System has risen rapidly. Back in the 1950's, the Fed consistently held about \$25 billion in government debt. Today that figure is nearly \$100 billion and the percentage of the total federal debt held by the System has nearly doubled.

Serious inflation has been inevitable result, and further inflation is to be expected if an overly accommodative monetary policy is forced upon the Fed in the future.

"So," you say, "we end up with inflation. That may not be good, but is it really such a serious threat to our national well-being?"

And I say, "You better know it is!"

Inflation is harmful to us as a nation; it hurts us as individuals.

Inflation penalizes productive members of society. It discourages people from traditional habits of saving and encourages the use of resources for protection against price rises. Inflation diminishes the value of money and robs society of the incentive to increase productivity and to enhance the general welfare.

Thus, inflation diminishes the rewards our economic system traditionally has offered for its two most prized virtues--productivity and thrift.

An essential element of our free enterprise system is the courage to assume risk. Inflation hinders the risk-taker, the entrepreneur because, when the exact rate of inflation is difficult to anticipate, the risk of changes in the rate of inflation is a disincentive to the commitment of venture capital.

Our private enterprise system cannot survive if the reward for risk is eliminated. Jobs for an expanding population cannot be provided if the incentive for capital investment is stifled.

Thus, from many points of view, continued rapid inflation poses an awesome threat to our national well-being.

But there is still another danger in Federal Reserve accommodation of deficit financing. And that is a lessening of public control of government spending. When the federal government raises money through taxation, each of us personally feels the burden of government spending through the increased taxes we pay. Even when the deficit is financed through a sale of bonds to the public, we feel the cost in the form of higher interest rates.

But when government expenditures are financed by the indirect sale of bonds to the central bank, the costs are hidden and citizen awareness of government expenditures is diminished. When citizens are not aware of government expenditures, they are being denied information they need to exercise effective control of government.

In our own history, and in other countries where central banks have lost independence, inflation has inevitably resulted and citizen control of the government has declined.

There are those who say this process has already made the demise of the American System 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 economic stability.

We must never be led to believe government can give us anything without requiring someone, sometime to pay for it.

We must not let words like "cooperation" and "accommodation" force us into actions for which we may have to pay dearly. In some contexts they may be warm-sounding words loaded with positive connotations. But when we hear them applied as an excuse for the erosion of Federal Reserve independence in the formulation of monetary policy, they should signal danger. And, they should lead us to ask, what will be the benefits of such accommodation, and what will be the costs?

Only when we have clearly answered these questions are we truly prepared to decide which is preferable: a Federal Reserve System that is cooperative and accommodative; or, a Federal Reserve System that is a strong, independent guardian of our money supply.