



**THE NEED FOR CLEAR THINKING  
IN DEALING WITH INFLATION**

**Address by  
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It is a real pleasure to be with you this evening and to discuss some of the issues currently facing the economy.

As we meet in the good fellowship of another Traffic Club annual dinner, it would be difficult to characterize the present state of the economy in glowing terms. Inflation is raging at double-digit levels. Interest rates are at an all-time high with the prime rate at 20%. Financial markets are in a turmoil with triple-A rated bonds trading at deep discounts and the Dow Jones averages significantly below levels of recent months. While economic activity continues to show strength in some sectors, vital industries such as residential construction and automobiles are in severe slumps.

Most Americans agree that inflation is our most pressing domestic problem, and there is an almost universal determination to "do something" about it. In choosing policy options for remedial action, it is essential that we separate fact from fiction and truth from fantasy as self-delusion complicates, rather than facilitates, our ability to act effectively. With this in mind, I shall direct these remarks toward debunking some prevalent economic misconceptions which stand in the way of effective action against inflation. Among the topics I will discuss are:

- (1) Misconceptions about the real causes of the inflation we are experiencing,
- (2) A mistaken belief that the Federal Reserve is responsible for our present high interest rates,
- (3) The suggestion that the imposition of economic controls offers an effective way to curb inflation, and
- (4) The wishful thought that somehow we can cure inflation in a painless manner without our suffering temporary economic distress in the process.

I would like to consider each of these misconceptions separately.

**First, as to the causes of inflation.**

It is obvious that, just as a doctor cannot effectively treat an illness without identifying its probable causes, neither can policymakers effectively deal with a problem as complex as inflation without understanding what brings it about. A serious obstacle to our ability to come to grips with inflation is the confusion which exists over what really causes it. One day we are told that inflation is the result of the decisions of greedy businessmen arbitrarily to increase the price of goods and services they create. In the next breath, we are told that the real culprit is exorbitant wage demands by power-hungry labor. I recently heard a congressional critic of the Federal Reserve System charge that inflation is caused by high interest rates which add to the costs of production. High wages, high prices and high interest rates are the results of inflation, not its causes.

There are those who, in an attempt to explain away the inflationary effects of past monetary and fiscal policy errors, would like us to believe that our present inflation is largely the result of OPEC-inspired increases in the price of energy. This simply is not true. Energy price increases do contribute in a small and passing way to inflation. But in no way are they responsible for the bulk of the problem. Assuming that inflation, as measured by the GNP price deflator, is currently approximately 10%, the portion of that 10% that is directly attributable to energy price increases is less than 3%. At least three-quarters of our present inflation is the direct result of excessive money growth. To put it somewhat differently, had there been no oil shocks, we would still be experiencing an inflation rate of 7%, as measured by the GNP deflator, or 11% as measured by the consumer price index, due solely to the fact that over the past several years money growth has averaged 7%. The effects of higher energy prices and similar extraneous factors account for only a small part of our present inflation.

The fundamental rate of inflation is determined by one basic factor, the rate at which the money supply is permitted to grow. By money supply, I mean assets that can be easily exchanged for goods and services. Persistent increases in the money supply cause inflation to accelerate; persistent reductions in the rate of growth of the money

supply cause the level of prices to decline.

The Federal Reserve, through purchases and sales of securities on the open market, has direct control over the rate of growth of the money supply. Our present high rate of inflation is a consequence of excessive monetary expansion over the past fifteen years. In the 1940s and 1950s when money grew at a rate consistent with the growth of productivity, inflation was virtually nonexistent. It was only after the mid-1960s, when the Johnson Administration adopted a "guns and butter" policy and the Federal Reserve accommodated deficit spending by expanding the money supply, that inflation became the serious problem that it is.

Last October, the Federal Reserve officially adopted a policy of gradually reducing the growth of the money supply and thus took a giant step forward in coping with inflation. If we are truly concerned with inflation and desirous of combating it in the most effective manner, it is essential that we give our full support to the new policy.

A second common misconception that surfaces too often these days is the charge that Fed policy is responsible for having pushed interest rates to their present high levels. It is true that, since October 1979, when the Fed announced its new measures to control the growth of the money stock, the prime rate has risen from 13.5% to 20%, with the bulk of the increase . . . 4.75% . . . occurring since the end of February. I submit that the Fed had very little to do with these increases.

Interest rates are prices of credit and, like all other prices, are determined by the demand and supply of credit. Demand for credit is the sum of all borrowing in our society, by individuals, businesses and governments. The supply of credit is provided by savers in our economy and by the Fed. The Fed supplies credit through its open market operations. When the Fed buys securities in the open market, it creates additional bank reserves. The banking system uses these new reserves to make loans which, in turn, expand credit and money. When the Fed wants to reduce reserves, it sells securities in the

open market. The Fed can cause a temporary increase in interest rates only by dramatically restricting the growth of bank reserves, and this has not been the case in recent months. If we compare the growth of bank reserves for the six months preceding October with the growth from October to February, we find that the Fed was supplying reserves at a rate of 260 million dollars per week before October and 220 million dollars per week since October. A decrease of only 15% cannot, by any stretch of the imagination, account for the sharp increase in the prime rate.

But if we look at what has happened to credit demand, we find that it has been growing by leaps and bounds. Prior to October, short-term and intermediate credit rose at an average rate of 1.4 billion dollars per week. Since October, it increased by 2.7 billion dollars per week, a whopping increase of 93%. And during January and February, the period which accounts for the steepest increase in the prime rate, credit grew at 3.7 billion dollars per week, a 164% increase over the level of pre-October growth. Clearly, it was not any restrictive policy of the Fed, but rather an enormous appetite for borrowing that brought about the sharp increases in the prime rate. I should note parenthetically that 47% of the borrowing since October was by the U. S. Treasury and other government agencies.

Another misconception is that the Fed causes interest rates to rise when it increases the discount rate. Whenever a discount rate increase occurs, the 6 o'clock news can be expected to announce, "The Fed raised interest rates again today." Let's examine what really happens. Member banks borrow from the Federal Reserve from time to time in order to obtain reserves they need to support some of their loans to their customers. The rate the Fed charges for such loans is known as the discount rate. Actually, loans of this sort by member banks are insignificant when compared to the total lending by banks. Total member bank borrowings through the discount window are currently only 2.5 billion dollars compared to total commercial credit of about 450 billion dollars. Thus, increases or decreases in the discount rate affect only a small segment of total funds used for bank lending.

In general, the idea that the Fed can set interest rates at any level it desires, or even raise or lower them at will, is fallacious. The only real effect the Fed can exert on rates is by expanding or contracting the supply of credit. In times of strong credit demand such as we have recently experienced, if the Fed expands bank reserves by creating more money, in order to keep interest rates from rising, the inflationary implications of such expansionary actions are readily recognized by financial markets, and interest rates will continue to rise in expectation of further inflation. The same thing, but in the opposite direction, results from a restriction in the supply of credit by the Fed. A restriction first raises interest rates, but it also reduces the growth of money. When inflationary anticipations fall, so do interest rates.

A third misleading concept which arises in times of inflation is the belief that controls of one sort or another offer an effective method of dealing with inflation.

Controls, guidelines, quotas . . . call them what you will . . . only serve to redistribute the burden of inflation across the economy. Controls only dam up the flow of the economy, causing it either to seek other channels . . . such as black markets or similar avenues . . . or simply to gather momentum for a new burst of inflation once controls are lifted and the floodgates opened. They have the effect of a pressure cooker. When the lid is removed, the pent-up pressure explodes. To illustrate, in the period immediately prior to 1943 when wartime controls were imposed, consumer prices were rising at a 6.1% annual rate. The year after controls were lifted, prices zoomed upward 14.4%. In 1961, before guidelines were introduced, prices were increasing 1.1%, a figure the economy could live with. In 1967, after the guidelines had failed, prices more than doubled their earlier growth rate. In this decade, the same thing happened. Prices rose 4.3% in 1970 before the Nixon controls were imposed. They shot up 9.1% after controls were lifted. Controls have never been an effective weapon against inflation. There is no reason to believe they would serve a meaningful purpose today.

Finally, there is the erroneous belief that we can somehow break the back of inflation

in a painless manner. Currently, we are seeing an emerging pattern of resistance to the Fed's anti-inflation measures on the part of various interest groups who find themselves economically or socially inconvenienced by what we are attempting to do. Hardly a day passes when someone, be it a farmer, a builder, an automobile dealer, a beneficiary of a publicly-funded social welfare program or other affected individual, does not petition the Federal Reserve for exemption from the anti-inflation program. Inevitably, each group concedes that inflation must be dealt with, but each feels that the burden of sacrifice should be borne by others.

I recognize that it is a natural human impulse to try to protect one's own turf, and most people can rationalize why they particularly should be excluded from the inconvenience of the anti-inflation effort. On the other hand, there is simply no way to break the momentum of an inflation which is the result of nearly two decades of economic self-indulgence without each of us enduring a certain part of the withdrawal pain. We simply can't expect to withdraw from a 15-year economic binge and not suffer a hangover!

The inflation we are experiencing, if allowed to continue, poses a deadly threat, not only to our economic well-being, but to the survival of the political and social institutions which have made our Nation great. The surest way to destroy a democracy is to tolerate runaway inflation. The inflation in Germany after World War I led to Hitler. Hyperinflation in South American countries has led to the establishment of numerous military dictatorships. If we are unwilling to tolerate the temporary discomfort of higher interest rates and perhaps some softening of economic activity as inevitable side-effects of what is necessary to eliminate inflation, we cannot expect to avoid the fate of other countries which have not faced up to the seriousness of the problem.

I have confidence in the wisdom of the American people and in their courage to respond in the face of an emergency. What we are experiencing today is an economic emergency of the worst sort. If the American people are presented with the facts and are not misled by momentary self-interest or by the promise of simple solutions, we can

bring inflation down to tolerable levels. If we opt for the simple and seemingly painless solution, we will merely prolong our present plight. These are the choices we face; I trust that we will choose wisely and persist in what is necessary to restore stability and growth to our economy.