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# The Federal Reserve and the Problem of Inflation

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I am delighted that we could arrange to have a cross-section of bankers, business executives, and other professional leaders in the San Francisco area meet with us today. As you were informed, this is the occasion of the Annual Joint Board Meeting of the Federal Reserve Bank of San Francisco and its four branches.

Chairman Wilson, as the historian in our group, has reminded us of the historic forces which preceded the establishment of the Federal Reserve and which brought it into existence over 60 years ago. He has also introduced the Boards of Directors of this Bank and its branches, which represent important elements in the structure of the Federal Reserve System.

Today, I would like to describe some of the current forces operating on the Federal Reserve, and then examine the causes and possible cures for the dangerous inflationary spiral we are now witnessing. However, before getting to these topics, I think that it would be appropriate to say a few words for our guests about the role of a Federal Reserve Bank and its directors in the context of today's problems. For I am often asked, "Just what does a Federal Reserve Bank do? And what is the authority and responsibility of your directors?" It happens that

the Federal Reserve System has a policy of rotating its directors after a certain period of service. It is likely, therefore, that some of our guests today might be approached in the future and asked to consider serving as a director. If so, I hope you would give it favorable consideration.

## **Role of the Directors**

The Board of Directors of a Federal Reserve Bank has a unique function in that it combines some of the traditional responsibilities of directors in a private corporation with the special responsibilities of contributing to the formulation of public policy. This dual role has evolved from the unique structure of the Federal Reserve itself—i.e., part government and part private, guided by a central authority in Washington, but with twelve semi-autonomous Federal Reserve Banks.

As the nation's central bank, the Federal Reserve System's basic responsibilities fall into three basic categories: (1) to regulate the flow of money and credit in a manner that contributes to economic growth without inflation; (2) to supervise and examine those commercial banks which are members of the System, to regulate bank holding companies, and to oversee the foreign activities of U.S. banks; and (3) to provide numerous "wholesale"

central banking services, such as provision of currency and coin, operation of a check collection system, and service as fiscal agent for the U.S. Treasury.

The central policy-making body in the Federal Reserve System is the Board of Governors, appointed by the President and confirmed by the Senate. The twelve regional Federal Reserve Banks share certain of the responsibilities relating to monetary policy with the Board of Governors, administer various regulations, and provide the "wholesale" banking services noted earlier. Thus, the Federal Reserve System is characterized by coordinated control through the Board of Governors and by decentralized administration through the Reserve Banks.

The affairs of each Reserve Bank are conducted under the supervision and control of its Board of Directors, subject to general supervision by the Board of Governors. The Board of Directors of each head office of a Reserve Bank consists of nine members, three of whom (including the Chairman and Deputy Chairman) are appointed by the Board of Governors as representatives of the general public. The public members may not be officers, directors, employees or stockholders of any bank. The re-

maining six directors at each Head Office are elected by the member banks, which own all the stock in the Federal Reserve Bank. Of these six, three are representatives of the member banks and are usually actively engaged in banking; and the other three must be actively engaged in commerce, industry, or agriculture, and may not be officers, directors, or employees of any bank.

Similarly, for each branch of a Federal Reserve Bank, the Board of Governors appoints certain directors as representatives of the public interest, while the majority of the branch directors are appointed by the Head Office Board. The affairs of each Branch office are conducted under the control of its Board of Directors, subject to general supervision by the Head Office Board.

Thus, a Federal Reserve Bank is a privately-owned institution with a public purpose. Except for a dividend on member-bank stock, which is limited by statute to 6%, the great bulk of our earnings is paid over to the U.S. Treasury. A Reserve Bank has a certain degree of regional autonomy, but it is also part of a national system.

The Federal Reserve System is a unique blend of public interest and private representation of "grass roots" interests. In meaningful ways, it reflects the traditional belief in this country in a system of checks and balances. This type of organization has served the country well, in my opinion.

Our directors are successful men in many fields of endeavor—business, finance, agriculture and universities, to name a few. They provide counsel and advice to ensure that the Bank has clearly-defined goals and objectives, and programs for reaching them, and they have the responsibility for overseeing the efficiency of operation and quality of management.

In the area of economic intelligence, our directors provide us with information on the economy weeks or even months before developments are reflected in national economic data. At other times their first-hand information reminds us that ours is a diverse economy in which developments in many industries and regions of a country can run counter to nation-wide trends.

Our directors also provide information and insights on the proper course for public policy, and they can add substance to their views by recommending changes in the Federal Reserve discount rate.

This is the rate which the Federal Reserve Bank charges for loans to its member commercial banks, and it is one of the tools of monetary policy. Although the Board of Governors in Washington has the ultimate authority to approve or disapprove a proposed change in the discount rate, it is strongly influenced by the "grass-roots" reaction expressed by the directors, especially if the directors of a number of Federal Reserve Banks make the same recommendation.

One of the major strengths of the decentralization of the Federal Reserve System is its ability to draw on the best talent in various regions of the economy to serve as directors with the foregoing responsibilities.

#### **Role of the Federal Reserve**

The unique structure of the Fed, which I believe gives it unusual strength in performing its job, also subjects it to criticisms by those who do not appreciate its role and its structure.

The Federal Reserve has at least two elements which make it institutionally unique. First, it is independent within, but certainly not from, the Federal Government.

More specifically, it is an independent agency but with ultimate responsibility to the Congress, and it is not a part of the Executive Branch. Second, the decision-making process within the Federal Reserve System is decentralized in the sense that it is shared by the Board of Governors in Washington with the twelve regional Federal Reserve Banks. I'd like to say a few words about each of these functions.

When Congress and the Administration established the Federal Reserve in 1913, it was deliberately made an independent institution within Government, in order to free it from day-to-day political influence. Senator Carter Glass, the architect of the original Federal Reserve Act, hoped that the System would act as a "Supreme Court of Finance." That hope has been at least partly fulfilled over the decades. The establishment of the Federal Reserve System as the central bank indicated that Congress believed that monetary policy was too important to leave to private bankers. On the other hand, the fact that Congress, over the years, has specified 14-year terms for members of the Board of Governors in Washington, and 5-year appointments for Presidents of the regional Reserve Banks, indicates that monetary policy also is too important to be left to the

day-to-day pressures from the political arena. The goal was to establish a Federal Reserve System which is responsive to the long-term economic needs of the nation in an objective and non-partisan way.

Over the years there have been a number of attempts to erode the independence of the Fed. There have been repeated legislative proposals to retire the capital stock of the Reserve Banks, to eliminate their directors, to centralize all powers of the Fed in Washington, and to make the System more directly amenable to influence by the Congress.

A current example is a bill scheduled for vote in the House of Representatives in the near future, which would provide for a full-scale audit and review by the General Accounting Office of the finances, operations and monetary policy actions of the Federal Reserve System. Although we are completely in favor of audits in the traditional sense, we are opposed to the bill for several reasons. With respect to financial transactions, the Federal Reserve Board is already thoroughly audited by a nationally-known CPA firm, and the results are reported to Congress. In turn the Board performs exhaustive examinations of the Federal Reserve Banks, in addition to the work of

the resident auditing staff at each Bank which reports directly to the Board of Directors. Secondly, the Federal Reserve System, both at the Board of Governors and at the Reserve Banks, has in place effective and hard-hitting programs aimed at operational efficiency. Thus a financial audit and an "efficiency" audit by the GAO would merely duplicate effective programs already in place.

The really serious objection, however, has to do with the proposed policy review by the GAO. In our view, this could be an entering wedge for direct Congressional control over monetary policy—with consequent adverse effects on the economy if such control were to be influenced by partisan goals and political pressures. Forty years ago, the Congress wisely decided to remove the Federal Reserve System from the scope of the GAO, in order to provide for independence of judgment on the part of the System in carrying out the responsibilities delegated to it by Congress. We believe that it would be unwise to change that arrangement.

A second unique feature of the Federal Reserve is the decentralization of policy making. The Federal Open Market Committee (FOMC), one of the two major policy-making bodies of the Fed-

eral Reserve, meets once a month in Washington to decide on the course of open market operations, the most important instrument of monetary policy. The majority of the FOMC consists of the seven members of the Board of Governors. The remaining five members are drawn from the twelve Reserve Bank Presidents, on a rotating basis. But those Presidents who are not currently voting members have an opportunity to attend the meetings and express their views. Thus, the formulation of monetary policy benefits from regional inputs and from a variety of viewpoints.

#### **Role of the San Francisco Bank**

The advantages of a decentralized Federal Reserve System extend beyond strictly policy-related issues. Let me describe some of those that I am most familiar with, using the experiences of the San Francisco Bank.

Until very recently, banking structure in the Twelfth Reserve District, with its state-wide branch banking, was relatively unique in the nation. The Federal Reserve Bank of San Francisco has brought these special institutional factors to the attention of the Board of Governors, and in most cases obtained regulatory treatment which is suitable to this particular bank structure.

The Reserve Bank in San Francisco also has taken an active interest in developing the West Coast as an international financial center. It has encouraged a legal and regulatory environment favorable to international banking operations, and has attempted to get government and financial institutions to consider the longer-run developmental interest of our financial markets. The Bank itself is in the process of strengthening its own research capability with regard to the Pacific Basin area and will assist in the growing financial integration of trading partners in this region.

Over 90 percent of the budget of the Federal Reserve Bank of San Francisco is expended to provide payments mechanism services, currency and coin, fiscal agency, and other services to government, banks, and to the economy in general. In my view, the decentralized organization of the Federal Reserve System promotes efficiencies in these operations because the System's semi-autonomous Reserve Banks can adjust their procedures to local conditions; they can innovate in improving the quality and reducing the cost of service; and they can recruit and challenge better staff.

Two examples may illustrate this point. The Federal Reserve Banks issue virtually all new currency in circulation and are responsible for retiring and destroying unfit currency. More currency is issued and destroyed in the Twelfth District than anywhere else in the nation. To do this job more efficiently, the Bank is experimenting with a number of methods, including some automated ones, for verifying and destroying worn-out currency. Another example is in the area of improving the payments mechanism. The San Francisco Reserve Bank operated the first automated clearing house in the nation, and electronic funds transfers were first processed by a Reserve Bank computer in the Twelfth District. We expect to continue to take a leading role in this field and to support commercial bank efforts to reduce the flow of paper checks.

### **Perspectives on Inflation**

I would now like to turn to the major economic problem facing the nation today—namely, rampant inflation that is occurring even in the face of a softening in economic activity. It may be helpful to put this problem in historical perspective, before attempting to assess the possible cures.

*Effect of Budget Deficits.* During the first half of the 1960's, the United States enjoyed a period of sustained and stable economic growth, with very little inflation. The origins of our current problems seem to lie in the major escalation of the Vietnam war starting about mid-1965.

Government deficits increased at an alarming rate in the Vietnam build-up period of 1965-68, when the economy was at, or near, full employment. President Johnson perceived a lack of popular support for the war and was fearful that his "Great Society" spending programs might get scuttled if he asked Congress for a tax increase. He therefore elected initially to finance expanded military commitments in South Asia with government debt. The deficits which resulted from this decision were temporarily relieved by the belated income-tax surcharge in mid-1968, and by a leveling off in military expenditures at about the same time. However, the fiscal situation deteriorated further in 1969-70 when outlays for civilian programs outstripped recession-reduced revenues, and became still worse in the 1971-72 period when recovery from the recession got underway.

The persistence of substantial government deficits regardless of the phase of the business cycle

has been a major source of the inflation that is now built into the U.S. economy, in my view.

*Monetary Policy Undermined.* It can be argued that a tighter monetary policy ought to be able to offset the inflationary effects of large, sustained deficit financing. In theory this may be true, but in practice the opposite tends to occur. When huge Federal credit demands are added to those of a fully-employed private sector, interest rates tend to escalate. There are some sectors of the economy, such as housing construction and programs financed with municipal bonds, that are especially sensitive to such a development because they depend heavily on long-term credit. When these sectors are confronted with high interest rates, demands for relief are quickly heard. Moreover, the U.S. Treasury itself has a natural desire to finance its deficits at the lowest feasible cost.

In short, large-scale deficit financing by the Government tends to bring great pressures on the central bank to keep interest rates from rising to "unreasonable," "unacceptable," or "dangerous" levels. You may recall that about a year ago there was a serious threat in the Congress to freeze interest rates, or even roll them back to the level of January 1, 1973.

Obviously, the only way that mounting credit demands can be satisfied without an increase in interest rates is for the Federal Reserve to accelerate the growth of money and credit. If done for too long, or to an excessive degree, such action can generate inflationary pressures which may persist for a lengthy period.

It has been my observation that large and persistent Federal deficits are a leading factor in pulling monetary policy off course, in the direction of excessive monetary expansion, as the central bank attempts to cope with the conflicting pressures that develop from such a situation. Too often in practice, therefore, an expansionary fiscal policy tends to generate excessive expansion in money and credit.

*Priority of Employment Goal.* A second factor which tends to inhibit the use of monetary policy in combatting inflation is an unresolved conflict in national goals as between full employment and stable prices. Since the early 1960's in the U.S., achievement of the "full employment" goal has usually contemplated an unemployment rate of 4% or less. Such a rate was regarded by many as a practical minimum, in view of normal shifting of workers between jobs and the lack of marketable skills of some job-

seekers. However, present evidence suggests that structural shifts in the labor force during the last decade would now make the "practical minimum" about 4.5% or 5%, especially in view of the increase in the labor force represented by teen-agers and other new entrants into the labor force who often lack marketable skills.

In my view, there has not been enough refined analysis of the employment and unemployment data, concentrating on the "hard core" of our labor force—i.e., heads of households or "breadwinners"—for whom the social and economic costs of unemployment are highest. Among this group, the unemployment rate in January of this year was only 2.8%, in contrast to the conventional or aggregate unemployment rate of 5.2%.

Studies by the Brookings Institution indicate that the conventional unemployment rate seriously understates the tightness of labor markets. Similarly, studies by our Bank indicate that it takes a higher rate of inflation now to achieve a 4 percent unemployment rate than it did ten years ago. This is due to two factors: first, the changing structure of the labor force has brought higher participation rates for workers with marginal skills; second, increased inflation expectations

have caused labor to demand larger wage increases even at times when the unemployment rate is relatively high. If we should now attempt to follow a monetary policy aimed at reducing unemployment to 4%, the likely consequence would be to exacerbate present inflationary pressures, which have already reached dangerous levels.

For whatever reason, there has been a tendency for the goal of "full employment" to take priority over stable prices, in view of actions in recent years by the Administration and Congress—whose job it is to determine national priorities. Not enough attention seems to have been paid to the trade-off—i.e., the additional inflation that must be accepted to get a lower unemployment rate. In essence, my argument is that we have both a faulty diagnosis as well as the wrong medicine for the unemployment goal. First we need a more meaningful "target rate" for unemployment, as I've explained. Secondly, we need new perceptions and new remedies for unemployment. Rather than imposing inflation on everyone, by attempting to reach our employment goal through expansive monetary and fiscal policies, our aim should be a more vigorous use of selective measures to deal with the problem. These measures

could include low-interest educational loans to youth and minority groups, retraining programs directed toward skills where job vacancies are high, and steps to facilitate worker mobility.

*Lags in Monetary Policy Impact.* A third factor which tends to inhibit the use of monetary policy in combatting inflation, and to call for its use by the Administration or the Congress to provide short-term stimulus to the economy, is a technical one. This factor has to do with the lags in the impact of a change in monetary policy on production, employment, profits and prices. While the technical reasons are complicated and while our knowledge in this area is imperfect, it seems reasonably clear that the lags are longer for an impact on prices than for the impact on the other measures noted.

Thus, the "good news" about easy money appears first—i.e., favorable effect on production, employment, and profits; while the "bad news" comes later—i.e., inflation. Conversely, if a tight money policy is adopted, the bad news comes first—i.e., unfavorable effects on production, employment, and profits; whereas the good news is delayed—i.e., a reduced rate of inflation. Under these circumstances, it is not surprising that

elected officials who must face the voters at a given time would prefer to see easy money.

*Has Monetary Policy Been Too Expansive?* Thus, it may be asked, has monetary policy been a principal cause of our inflation problem, and is there a simple cure in the form of tight money? In recent testimony before the Congress, the Chairman of the Board of Governors, Arthur F. Burns, acknowledged that, with the benefit of hindsight, monetary policy may have been overly-expansive in 1972. Some of our critics, such as Professor Milton Friedman, would go much further—alleging that the money supply has grown too fast since about 1970, and that this played a major role in producing the current inflation.

Such criticism, whether or not justified, is easy enough to make, based both on monetary theory and statistical studies. But it seems to me to ignore real problems in the real world. No central bank can be or should be wholly independent of Government. The elected representatives of the people of the U.S., both the Congress and Administration, must have the ultimate responsibility for economic policy, and that includes monetary policy. In today's world, a central bank that consistently defied its government on major issues would quickly be taken over by the government.

I have been attempting to convey an understanding of some of the forces that impinge on the freedom of action of the Federal Reserve System in using tight money to combat inflation. Whether by accident or design, our Federal budget has been characterized by large deficits in most recent years, giving rise to very large financing needs and to higher interest rates, to a point where serious damage was threatened in some sectors of the economy and where many members of Congress were in a mood to freeze interest rates. Also, whether based on a faulty analysis or a misplaced emphasis, those elected officials with ultimate responsibility for economic policy have placed a high priority on the "full employment" goal, even at the expense of stable prices. Central banks cannot completely ignore such imperatives—even against their better judgment.

It seems to me that our best hope lies in a better understanding of the long-run inflationary damage done to our economy by excessive monetary and fiscal stimulus and by over-emphasis on employment targets, whatever the short-run benefits. It is vital that this matter be thoroughly appreciated not only by the Congress and the Administration, but also by the business and financial community and the general public. It is only



in this way that we can get support for the belt-tightening measures needed to overcome the corrosive problem of rampant inflation.

*Price Controls—Hidden Inflation.* In completing the analysis of the basic causes of inflation in recent years, I would note that the problem was compounded by price controls. The “new economic policy” implemented by the Administration in August of 1971 had some favorable price effects in its initial two phases because excess capacity existed in the economy and because the inflationary pressures were largely of the cost-push variety in 1971 and early 1972. However, by late 1972 and early 1973, the economy was at virtually full employment, and continued wage-price controls led mainly to a misdirection of resources and to artificial shortages. Further, the illusion of stable prices tended to conceal for a while the effects of continued expansionary economic programs. This illusion was rather rudely shattered by the price freeze experience last summer when, for example, certain agricultural sectors quite literally began to shut down. By now, popular support for wage-price controls has declined to a point where they probably will be dropped almost entirely this year.

*Special Causes of Inflation, 1972-73.* In addition to fiscal problems and the nation’s misadventure with wage-price controls, three other factors deserve special mention in analyzing the origins of our present inflation problem. The first is the unprecedented world-wide grain crop failure in 1972 that sent agricultural prices through the roof. The second is the fact that the business cycle in virtually all industrial countries was in a coincident boom phase in 1973, which placed extreme pressure on the supplies and prices of internationally traded goods. The third factor, of course, was the unanticipated imposition of the Arab oil embargo last fall. Inappropriate fiscal policies and overstaying the usefulness of wage-price controls would have created difficult price problems in any case—but these policy mistakes in conjunction with the special factors I’ve noted produced an inflation problem of epic dimensions.

#### **Inflation and the Current Outlook**

How do we get out of the apparent box we have gotten ourselves into? The first thing to remember is that at this time our main economic problem is a shortage of oil, not money. The current rise in unemployment and the cutbacks in production to this point have resulted primarily from supply problems which

cannot be solved with monetary policy. Even if a deficiency in aggregate demand develops from the supply-induced slowdown in the economy, monetary policy could do little to relieve the situation this year because of the lags in its impact on the economy, which I mentioned earlier. In these circumstances, monetary policy should be directed towards 1975 and beyond when the policies we adopt now will have their major impact.

If we wish to overcome inflation, it is going to be a long, hard uphill battle, and our monetary-economic time horizon must be expanded to at least three years to see the success of our actions. Also, since there is a trade-off between inflation and unemployment, we must be prepared to accept at least a temporary rise in the unemployment rate—even after the energy problem is solved—and to use special programs to ease the plight of those affected. Such programs could include liberalization of welfare payments, increased unemployment benefits, and more public employment. Whatever is done in this regard, it is vital that we not try to solve the unemployment problem of the few, by imposing inflation on everybody through expansionary fiscal and monetary measures.

In the final analysis, it will not be possible to solve our inflation problem without fiscal and monetary restraint. For that reason, I found it encouraging to note the recent testimony before Congress by the Secretary of the Treasury. He warned against broad-based increases in spending programs or tax cuts as means of pumping purchasing power into the economy at this time. One can only hope that his point of view will prevail over that of an official of the Office of Management and Budget who was widely quoted recently to the effect that the Administration would "bust the budget," if necessary, to combat unemployment and any downturn in the economy in the months ahead.

One can also hope that the budget reform bill which has passed the House will be enacted. Under present procedures, a large number of appropriations bills are considered separately, without regard to an overall expenditure target, any assigning of priorities, or sources of financing. The budget reform bill would, for the first time, give members of Congress a chance to vote on fiscal policy. Until such a measure is passed, the balance between expenditures and revenues will continue to be a "happening" rather than a policy—and with a high likelihood of chronic deficits.

Similarly, if we are to overcome inflation, the Federal Reserve System must be free to pursue a non-inflationary growth target for money and credit—even if higher interest rates are necessary in the short run, as inflationary forces are wrung out of the economy. It is particularly vital that we not be pulled off course toward excessive credit ease by the two major forces that have done so in the past—i.e., the necessity to finance large-scale budget deficits, and the tendency to call for easy money to solve unemployment problems that could be handled better through selective measures.

### **Conclusion**

The fight against inflation this year and in the years immediately ahead will not be easy, but it is absolutely essential. As Chairman Burns stated in recent testimony before Congress, continued inflation will "reduce the dollar's strength in foreign exchange markets—destroy the gains we have recently made in strengthening our competitive position in world markets— . . . undermine confidence . . . send interest rates soaring and wreck our chances of gaining a stable and broadly based prosperity in the near future."

We are now on the verge of Latin-American style inflation, measured in two digits. We must bite the bullet now, because it will be much harder to fight inflation the longer we wait. This effort will require less expansionary monetary and fiscal policies than we have been following in recent years. If we are not prepared to take these actions, we will be faced with turmoil, uncertainty and economic instability for years ahead. I am confident that the people of this country, and its leaders, have better sense.