THE FEDERAL RESERVE: BETWEEN A ROCK AND A HARD PLACE.*


The purpose of this article is to argue that we must better understand our economy before we can hope to resolve the present situation of inflation and financial disarray. The author believes that we must go beyond monetary perceptions of the economy and understand the linkages between immunity to deep depressions and susceptibility to accelerating inflation.

One bright spot of the entire post-World War II economy continues to hold: namely, no severe depression has occurred. Today's economy seems immune to the financial crises and deep depressions of the past. Simultaneously, however, the structure of the economy makes it susceptible to accelerating inflation. The author's point is that these two phenomena are linked and, if we are to do better in the 1980's than in the 1970's, we need to understand this linkage.

Comparing 1979 to 1929, we find the American economy very different. About the only ratio relatively unchanged is that of investment to GNP (relative to GNP, the author contends that the U.S. is investing at about the same rate as before). The ratio of consumption to GNP has declined during the past 50 years, while the government expenditure ratio has risen sharply. The impact on profits of a decline in investment (which implies a decline in income and employment) can be offset by an increase in the government deficit. This occurred in 1974-1975, in striking contrast to 1929-1930. Furthermore, the Fed acted as a lender of last resort in 1973-1975, thus preventing failures of some institutions that would have led to an interactive collapse.

The author asserts that the Federal Reserve was not created to manage the money supply in order to control the rate of growth of money income. The Fed was created to be a lender of last resort with the intent to prevent financial crises from recurring by preventing the debt deflations. Since the end of WWII, debt deflation has been avoided. For the first 20 years of this 35-year period, the Federal Reserve did not have to intervene to maintain the financial system; however, three times since 1966, the Federal Reserve has acted as a lender of last resort.

The Federal Reserve performs a second function, that of operator of monetary policy. Given these two functions, the Fed is in a dilemma. To break the inflationary process, the Fed creates conditions that bring about bankruptcies. To prevent widespread failures, the Fed then has to intervene as lender of last resort. If such intervention is not accompanied by regulations and reforms that restrict financial market practices, it sets the stage for a subsequent inflationary expansion.

According to the author, the control of money is not sufficient to stop this dismal cycle and reforms are needed. He suggests several reforms, including a smaller government, reform of the transfer payment system, break-up of the private market power of large corporations, and public ownership and operation of capital-intensive industries such as railroads and nuclear power.

In summary, the author believes that in order to do better in the 1980's, we must understand our economy. In effect, those in policymaking positions do not understand American capitalism.

We should so live and labor in our time that what came to us as seed may go to the next generation as blossom, and what came to us as blossom may go to them as fruit. This is what we mean by progress.

— Henry Ward Beecher