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THE POLITICS OF MONETARY POLICY:. Part I,

by Bruce Poyer.

In "Secrets of the Temple" (*New Yorker*, November 9, 16, and 23, 1987; later published by Simon & Schuster, 1988), William Greider defines and analyzes the chief political function of the Federal Reserve System—to mediate a continuing conflict which the government, Republican or Democratic, does not care to confront. The conflict arises particularly in inflationary times, and it requires a choice between mutually exclusive policies: either to enhance the economic prospects of the many, or to safeguard the accumulated wealth of the few. The Fed's monetary policies, Greider argues, concern primarily the politics of the rich vs. the poor. Throughout our nation's history, the issue in every inflationary period has been which economic class will suffer, creditors or debtors, and which will benefit: people who derive their incomes primarily from their accumulated financial wealth, or people who still earn their living by the sweat of their brow.

Greider's analysis couldn't be more important to labor, or more timely. The chief victims of monetary policies to control inflation and safeguard the wealth of the few have indeed been those full employment policies which enhance the prospects of the many. The most recent illustration of the conflict involved came in 1981-1982, when the Fed under Paul Volcker forced both interest rates and unemployment rates to unprecedented highs to control inflation. The chief domestic problem confronting the next President is likely to involve the same issues that led to Volcker's policies.

Greider would argue that the 1988 Presidential candidates should recognize that our conflicts over "the money question" are political in nature, and must be solved in political arenas. He telescopes the economic history of the past two decades in these terms: In the late 1960s, the government allowed a runaway inflation of prices to grow, in the 1970s, into a serious destabilization of commerce and public confidence. In the 1980s, the Fed, with the approval of the rest of the government, pushed the economy to the other extreme. In both cases, excess created disorder, and the country was faced with bad choices and new risks. It is the money question which has been tearing things apart—first by the extreme swing of inflation, and then by the opposite extreme, capitulation to the anxieties of capital. Human livelihoods and valuable enterprises alike are dampened by these violent swings in money values.

The author concludes that the federal government, no matter which party controls it, cannot hope to manage the world's most powerful economy through two separate and independent agencies—its elected representatives on the one hand, and a central bank on the other—particularly when these agencies are not even required to coordinate their actions. On the bank's side of it, he thinks that "some remote technicians, working in obscurity," cannot be expected to resolve the deepest political divisions within the American system. On the government's side of it, he reminds us that "the awesome powers of the Federal Reserve have accumulated mainly because, in this regard, representative democracy abdicated its responsibility."

The Historical Documentation

Greider fleshes out this skeleton thesis by tracing the economic history of our nation's six major inflationary periods, beginning with the Revolutionary War and concluding in 1966-1979. In the process, he does not present a balanced view of inflation and its control, since the fiscal policies of these periods do not get equal treatment. His concern is to show that "the money question" is the bedrock political choice.

Demands of the populists for federal regulation of the banking system became pronounced in Texas in the late 1880s. The goal was inflationist; populists wanted elected representatives of the

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people to control the money supply—not an oligarchy of financiers. What Congress finally enacted in 1913 was what the bankers wanted: a Federal Reserve system with vague instructions, and a Board of Governors "that ever since has been content to be ambiguous and evasive, and to hide behind platitudes." Inducing its first recession in 1920 (by raising discount rates and nearly doubling the price of money), the Fed's actions took commodity prices down by about 50%, reduced general business activity by 33%, and increased unemployment by five times, to 11.9%. Thus an additional four million people were forced out of work. The Fed's pattern was set; declining prices were the goal, not the problem; high unemployment did not hurt, it helped. A surplus of labor forced wages down generally, and falling wages led to moderated inflation. One Federal Reserve Board member explained in April 1921 that the economy would not be safe and sound until the contraction produced "what is called liquidation of labor." The phrase, he conceded, "sounded a little offensive."

Not only the Fed, but three Republican administrations gave economic prescriptions for the 1920s that are remarkably similar to the 1980s: tax credits, refunds and abatements to benefit private corporations; four major reductions in income tax rates, skewed to benefit the upper-income brackets; a "trickle down" theory that everyone would eventually benefit as the wealthy devoted their tax savings to capital investment and created new jobs in the process. Unfortunately, the farmers' share of national income declined from 15% to 9% (1920 to 1928); unions lost 30% of their members; workers got longer hours for the same wages; and unemployment estimates varied from 5.2% to 13%.

After the 1929 crash, the Fed did nothing, and Hoover's Treasury Secretary Mellon gave the new economic prescription:

> "Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate .... It will purge the rottenness out of the system. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people."

The upshot was that as the Democrats came to power in 1932, the national economy lay ruined and the American banking system lay ruined with it. Also destroyed was the reputation of the Federal Reserve System.

Reform of the Fed in legislation of 1935 gave more power to the Board of Governors (vis-a-vis the Reserve Banks), and further insulated the Board from political control. The Fed was pulled closer to the financial manipulators and the world of government notes and bonds, and became more distant from the needs of commerce and industry in the productive sectors of the economy.

During Eisenhower's presidency, the Fed directly created at least two of the three recessions, when conservative Republicans shared the Fed's anxiety about "sound money," and supported higher interest rates. Congressman Wright Patman observed th "the period has been marked by a continual shift of income to banks, other major financial institutions, and individuals with significant interest income. The rest of the country provided this income."

In the Kennedy-Johnson years, monetary policy took a back seat to activist fiscal policy:

> "For a hundred and six months, from February of 1961 to December of 1969, the nation enjoyed its longest era of uninterrupted economic expansion. Stocks soared in a long bull market, driven by rising corporate profits, and workers enjoyed steady real growth in personal income, and declining unemployment. In a generous mood, the national government expanded its commitment to help those who were left out of capitalism's growing bounty—the poor, the elderly, and racial minorities."

Economist Arthur Okun thought that "recessions are now generally considered fundamentally preventable." But the economic managers were over-confident. By 1968, they had already waited too long to raise taxes or reduce spending—their own Keynesian prescriptions for dampening aggregate demand and avoiding an overheated economy.

President Nixon appointed Arthur Burns to chair the Fed in 1970, and Burns obliged the President's request for lower interest rates and a 20% expansion in the money supply, timed for Nixon's re-election campaign in 1972. The fulcrum for this stimulative fiscal policy was Nixon's wage and price control legislation of 1971. But the inflation rate in 1973 became 8.8% (doubling the 1972 rate); it went to 12% in 1974, and unemployment went to 9% in 1975. In the midst of this spiral, in 1973, the devalued dollar became too weak to guarantee order and stability in international trade and finance, and the era of floating exchange rates began. Six months later, OPEC quadrupled the price of crude oil, which was traded worldwide in dollars. The dollar had lost 25% of its value in the first three years of the 1970s.

It remained for Paul Volcker in 1981 to inflict the "pure" monetarist formula on the economy, following the prescription developed by Milton Friedman: let interest rates rise or fall automatically in reaction to a fixed formula for control of the money supply. Interest rates indeed rose beyond anyone's prediction. In the tidal wave that followed, millions of Americans lost jobs, homes, farms, family savings, and hope. Nearly every American was directly affected.

Greider's account of these losses will continue in LCR next month, along with an evaluation of the current significance of "money politics" and Federal Reserve policy.