The Fed vs. Prosperity

An Interview with Richard Salsman

By Robert Tracinski

Richard Salsman is Senior Vice President and Senior Economist at H. C. Wainwright & Co. Economics, and author of "The Cross and the Curve," published in the May issue of The Intellectual Activist. *He recently talked with* TIA *Editor Robert Tracinski about how the issues he discussed in that article apply to recent economic events.*

TIA: Acting on the Phillips Curve theory that you discuss in your article, the Fed recently raised interest rates, and is threatening to do so again, in an attempt to "pre-empt" inflation. What do you think will be the effect of such rate increases?

Richard Salsman: Rate hikes will hurt financial markets and the economy. And the greater the hikes, the worse the consequence. Stocks fell 10% in the month after the last rate hike, which was on March 25; bond prices also fell. This meant the destruction of billions of dollars of wealth. Financial markets have responded similarly to rate hikes in the past, especially when a hike implies many more to follow. The last time rates were raised, throughout 1994, the stock market failed to rise at all for over a year and bond prices fell by nearly 15%.

The negative effect of rate hikes on the economy usually takes longer, about a year and a half. Rate increases of 3% or more usually are sufficient to cause a recession, as in 1990 through 1991. The 1994 rate hikes were not large enough to cause a recession, but they did slow the economy in 1995 through 1996.

TIA: Why do rate hikes take so long to affect the economy? Is there no near-term influence?

RS: Production is not instantaneous. Some period of adjustment is required to reflect a new cost of capital, a cost which most critically influences long-term capital spending projects. Ironically, the nearer-term effect of rate hikes is actually bullish. Businessmen tend to speed up spending on capital projects to avoid the expected higher cost of capital. The same phenomenon can be observed when the government announces that income tax rates will rise *next year.* The incentive is to move as much of your income as possible into this year from the next. Activity migrates from the future into the present. To the extent that the Fed is worried about "excessive" economic activity to begin with, its rate hikes

only *heighten* that activity near-term.

TIA: So you expect a vicious circle: The Fed raises rates to slow growth, but short-term activity increases, so it raises rates again, and so on—until it causes a recession.

RS: Yes, that has been its pattern in the past. And when, in the face of a recession, the Fed begins to lower rates, it makes things worse, inducing businessmen to put off economic activity from the present into the future. The recession deepens and the Fed then cuts rates still further. Instead of "smoothing" the business cycle, as most economists allege, the Fed actually accentuates it.

TIA: Expand if you will on the workings of the Federal Reserve. It is usually said that by raising or lowering interest rates, the Fed can contract or expand the money supply and thereby slow or increase inflation. You seem to reject this idea, holding that the only consequence of higher interest rates is restricted growth. Why? Doesn't the Fed control the money supply?

RS: Only to a limited extent. The Fed mostly influences the currency portion of the money supply—Federal Reserve Notes. But currency is only about 15% of the total money supply. The rest of the money supply consists of checkable deposits at banks and mutual funds. Although these deposits are tied in some loose way to bank reserves at the Fed and must conform to Fed-mandated reserve requirements, they still fluctuate to a considerable degree outside the control of the Fed. Loan demand tied to business expansion, for example, can increase deposits without causing inflation. The demand for Fed currency itself fluctuates beyond its control; more than half of it circulates outside the US, in the streets of cities like Moscow and Havana, where local money is distrusted. Even if the Fed controlled 100% of the money supply, the value of money—its purchasing power—would be affected not only by supply but by demand.

Rising interest rates do not "contract" the money supply and "slow" inflation; they *reflect* inflation, as lenders seek compensation for being repaid in cheaper dollars. The error consists in believing that interest rates are the price of money, and then to conclude that a higher price of money is achieved by contracting its supply. But interest rates are the price of *credit*—of savings lent over some period of time. The price or value of money is its purchasing power—what it will buy in terms of tangible goods and services. The price of credit does not *determine* the supply of money; rather it *reflects* the price of money, because lending is conducted in money.

TIA: In your article, you stated that the Fed's "absurd policy of ensuring economic stagnation is even codified into law, in the Humphrey-Hawkins Act of 1978." What is this Act?

RS: Officially, it is the "Full Employment and Balanced Growth Act of 1978," and it extended to the Fed the central planning goals first set out in the Employment Act of 1946. Among other things, these Acts require the President to submit annually a five-year plan for economic growth, employment, and inflation, along with his budget. The 1978 Act requires the Fed to make policy consistent with the President's plans, to maintain low inflation and foster "full employment"—that's defined in the Act as an unemployment rate no higher than 4%, even though that has not happened since 1969. The 1978 Act also requires the Fed to testify before Congress about its designs. Since the Fed follows no objective standards, such testimony causes market turmoil. The Act embodies Phillips Curve theory by requiring the Fed to actively create jobs, allegedly by inflating—and also to tame inflation, allegedly by stunting economic growth and employment.

Fortunately, there are a few congressmen who realize that this Act embodies a false view of inflation and jobs. Since 1995 there have been two Republican congressmen in particular. Senator Connie Mack and Representative Bill Paxon have sponsored a bill, the Economic Growth and Price Stability Act, which would require the Fed to focus only on price stability. The assumption, a reasonable one, is that price stability is a precondition for economic growth and job creation. This bill tells the Fed to stop treating sound money and a sound economy as incompatible. Unfortunately, this is a lame attempt to improve central planning, not dismantle it.

We need to abolish the Fed and allow the re-establishment of free banking and the gold standard. That system embodies individual rights and the rule of law; it's what brought the US falling prices, higher real wages, and prosperity.

TIA: Why are false doctrines still accepted at the Fed today, when its Chairman is Alan Greenspan? He used to know better—he wrote in *The Objectivist* in the 1960s defending free banking and the gold standard. What happened? What are his ideas now?

RS: First, the Fed is not some scientific monetary institute. Central banks are a statist device to finance the welfare state. Second, Mr. Greenspan is the Dr. Robert Stadler of *Atlas Shrugged.* He is fully aware of the truth, in this case about monetary affairs, yet leads and promotes the government agency destructive of objective money.

As to his motivation, I leave that to others who know him personally. For myself, I would not trust even his private pronouncements. What some people call "Potomac Fever," Ayn Rand used to call power lust.

But his public record is very clear. It involves a series of intellectual cave-ins for the sake of maintaining his political standing. He was President Ford's top economic advisor in 1974 and 1975, when the "Whip Inflation Now"

campaign—complete with "WIN" buttons—was launched, blaming inflation on business and labor. He fought Reagan's tax cuts and supported Bush and Clinton's tax hikes. He claims budget deficits should be closed at all costs, even though deficits result from excessive spending, not insufficient taxes. In 1981, he scared Ronald Reagan and his advisors out of returning to the gold standard by resorting to bogus arguments. He headed the Social Security Commission in 1983 and recommended huge hikes in the payroll tax, even though partial privatization options were available. When the banking system collapsed in the late 1980s, he refused to blame the Fed, or regulation, or the socialist deposit insurance system. He always argued for more Fed powers.

His tenure at the Fed has included the 1987 stock-market crash, the banking collapse of 1988 through 1990, the recession in 1990, and huge gyrations in the foreign exchange value of the dollar. He rejects sound stock-market advances as "irrational exuberance," echoing Keynes. And he endorses the Phillips Curve.

His reputation for delivering low inflation exists only because his predecessors were so bad. But inflation rates under Greenspan are still twice as high as they were during the 1960s.

He has become notorious for speaking in a vague and eclectic manner and has himself joked about being proud of it. He promulgates no standards. He is not an Objectivist, but a pragmatist-statist. He is less an economist than he is a bureaucrat. He does not work in a statist government to rationally reform it; he works in it because he prizes the power that it assigns him.

TIA: Current Fed policy takes the anti-inflation side of the Phillips Curve "trade-off." What is the likelihood of a change in policy back to the 1960s and 1970s, to the other side of the coin: the "pro-labor," pro-inflation side?

RS: The likelihood is less as long as the unemployment rate stays low. But when it rises again and the economy slows—an inevitable result of Fed policy—there will be calls again for a "loose" monetary policy. That's the bureaucrat's code word for inflation. And the Fed is increasingly populated by Clinton appointees who prefer inflation.

Until the false alternative of the Phillips Curve theory is eliminated—really, until subjective money is eliminated—there will always be a chance that the planners will flip back to using the other side of the false coin. So we need a real coin—a gold standard operated by free banks. But first and foremost we need its revolutionary philosophic preconditions. Neither the Fed nor Alan Greenspan will be the standard-bearer of that revolution.