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Inflation and the Federal Reserve

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No term in the "dismal science" of economics is more misunderstood than "inflation." The word means "rising prices," but is used at different times by different people to describe totally different phenomena.

The most predominant type of inflation is natural and occurs as raw materials are used up and must be replenished. It's akin to the law of diminishing returns, or entropy, and is overcome by technological innovation. Another type of inflation is expressed through constantly changing conditions of supply and demand, including the fluctuating cost of labor. Yet another type results from the predatory pricing practices of monopolies such as the worldwide oil cartel which has jacked up the cost of petroleum to over $80 a barrel.

Of an entirely different order are the inflation induced by central banks such as the Federal Reserve in creating financial bubbles or by the federal government in taking inflationary actions such as annually compounded increases in government employee salaries to reduce the real cost of servicing its astronomical debt. These instances might actually be viewed as "high crimes and misdemeanors" which violate the due process clause of the Constitution by unlawfully destroying the value of citizens' property.

In any case, inflation is a fact of life that is almost impossible to control, let alone understand in all its complexities and details. This article focuses on inflation as it is treated by the official monetary system.

So let's talk about money. Money is obviously an indispensable component of our economic system. If it is properly constituted and managed, it has the ability not only to command goods and services produced and traded within the system, but also to encourage and call forth new types and quantities of production. The presence or absence of sufficient quantities of money, how it is created and introduced into circulation, how its value is established and maintained, and how it is used or not used to further the ideals of society are critical issues that properly should fall within the purview of political debate.

Unfortunately, these issues are not debated at all within the American political system, which is thereby failing in some of its most fundamental responsibilities.

These issues are not debated because people make the mistake of believing that money is, or should be, a thing of value in-and-of itself, or that this value is created by "market forces," so is somehow a "given."

Many also believe that monetary policy is a technical subject understandable only to experts, so should be immune from political oversight.

But history shows that money serves its socially-beneficial purposes only when it is regarded as an instrument of law and an economic medium-of-exchange and when it is regulated by a government which can responsibly direct its benefits to the common welfare of all citizens. Such is not the case with the U.S. and other Western nations today.

That the Founding Fathers held a progressive view of money is proven by the fact that the Constitution gave Congress the power "To coin Money, regulate the Value thereof, and of foreign Coin, and fix the Standard of Weights and Measures." During the nineteenth century, the Supreme Court confirmed in cases involving the famous Greenbacks that this authority includes the issuance of paper money.

Through much of our history, the monetary power has been implemented through a variety of methods, though since the creation of the privately-owned Federal Reserve System in 1913, it has been exercised primarily by the private banking system which lends credit into circulation and charges interest for its use.

Today it is the political power of the banks and financiers that prevents monetary matters from being examined and debated the way they should be. This power is also the basis of our retention of a medieval relic in the destructive and corrosive system of fractional reserve banking.

Fractional reserve banking under a privately-owned central bank is not ordained by our Constitution. It is an extralegal construction resulting from abdication by Congress of its own lawful prerogatives. This system has resulted in a condition of growing debt slavery fixed upon our population which is afflicted with a chronic shortage of purchasing power sufficient to absorb our national production.

If examined closely, this system could likely be declared unconstitutional, as indicated above. A system which forces citizens into ruinous debt is clearly in violation of the Constitutional guarantees of due process and equal protection under the laws and might even be found to violate the Thirteenth Amendment, which states that, "Neither slavery nor involuntary servitude…shall exist within the United States."

Philosophically, the way money is viewed in the eyes of the banking system is to confuse it with "wealth." "Wealth" to them means cash or bank deposits. "Wealth" is regarded as belonging to private individuals, not the government. Granted, the government has the power to commandeer private wealth through taxation, or borrow it through the sale of bonds and other securities. Also, the government holds the title to certain assets, including land, buildings, equipment, etc.

But the government does not, in this view, originate wealth. Therefore, money, viewed primitively as a commodity with intrinsic value, not as an instrument of exchange created by law, cannot be created or originated by the government. This is the presumption on which today's bank-oriented monetary system is based, which is why it is so inadequate to meet the needs of society.

Present dogmas overlook the fact that at critical periods of our history, such as during colonial times, the Revolutionary War, and during and after the Civil War with the issuance of the Greenbacks, the government did in fact directly issue its own money without resort either to debt instruments marketed to banks and/or the public or to collection of taxes as backing for the currency. That is to say, the government exercised the power at these times to utilize its sovereign prerogative to create "wealth" on behalf of the public from which it derived its authority. It then used this wealth to meet legitimate public objectives, such as to wage the war that won our independence or the one that preserved the Union. The fact that this wealth was “real” was reflected in the ability of the government to receive such monetary tokens as payment-in-full of taxes.

Also, the government has circulated wealth in the form of metallic coinage, though its monetary value has been virtually eliminated by inflation of the Federal Reserve Notes which, since their introduction, have destroyed ninety-five percent of the value of the dollar.

An even broader view of wealth sees it as the total productivity of the nation’s economy, both present and potential. This includes the skills and ability of the people who produce that wealth, as well as the laws, institutions, and traditions which serve to unlock their creative potential. Money is then a mere token used to facilitate exchange within this complex of factors. Under this definition, the “wealth” of the United States includes our Declaration of Independence and Constitution, including the Bill of Rights.

Unfortunately, the present course of affairs as defined by the current Federal Reserve System which oversees our monetary system falls short of these rightful uses of money. With the participation of the financial industry, the Federal Reserve mainly assures as its first priority that the wealth held by the banks will never be relinquished by them and, if possible, will not be diminished.

Rather this wealth will perpetually increase through the interest charged for its use. Of course money borrowed from the banks may be used by debtors to create new assets or may simply be spent on consumer goods. But the wealth of the banks themselves must never be compromised.

Thus the banks have become the primary focus of power within our nation. This is implied whenever the word “stability” is used with reference to the financial system. Businesses, households, and individuals may be subjected to the “creative destruction” of market forces, but not the banks. Also, given compound interest, a monetary system based on lending must result in the migration of all a nation’s wealth into the hands of the lenders within a few generations. This is what is happening in the U.S. today.

The current crisis dates to 1979 when the Federal Reserve initiated a severe recession in order to fight the inflation which had built up in the aftermath of the Vietnam War and by the 1971 removal of the gold peg for international currency transactions. The situation was similar to what happened during the run-up to the Great Depression, starting well before the 1929 stock market crash.

Since the recession of 1979-83, the concentration of wealth in the hands of the nation’s upper income groups, i.e., those with money to lend or invest, has been increasing, all the way through the economic resurgence of the mid- to late-1990s up to today. Claims during this period by the Federal Reserve that inflation has been brought under control are called into question by everyday experience, during which individuals and families have seen large increases in prices for such necessities as housing, utilities, fuel, health care, education, insurance, etc.

In fact, an examination of the Consumer Price Index (CPI) published by the Bureau of Labor Statistics indicates a record of relentless and unabated price inflation since 1965. The rate of increase slowed somewhat during 1979-81, when the Fed-induced recession began, but it resumed its climb and has continued upwards since then. In fact, prices have been virtually out-of-control for the last thirty-eight years despite official disclaimers to the contrary. For this the Federal Reserve has offered no explanation.

The question of why this inflation has occurred is one that requires intensive study. There is a disconnect in the policy of the Federal Reserve through its assumption that the inflation it did not necessarily seem to have caused could be corrected by its periodic actions in raising interest rates and so contracting the currency. In fact, the Fed has never had any reason to believe it could regulate the economy through interest rates—the essence of monetarism—except through the most simplistic interpretation of its role. In fact, it seems to have been a kind of hubris for it to think it could solve a problem which it obviously has never fully understood.

As stated in its own 1994 publication, "The Federal Reserve System: Purpose and Functions," the first duty of the Fed is "conducting the nation's monetary policy by influencing the money and credit conditions in the economy in pursuit of full employment and stable prices."

What does it mean that since the Fed came into existence, neither of these two objectives has ever been achieved? Can it be that given the way our monetary system under the Fed is constituted, the two goals of full employment and stable prices are contradictory? Might some even say that the chief method the Federal Reserve uses to reach for price stability has been to create, or at least tolerate, un- and underemployment? In fact the Fed in its actual operations, at least since 1979, has treated full employment and price stability as being mutually exclusive. Otherwise it would not have created a major recession at that time, where unemployment increased by sixty-five percent and many businesses and even some major industries were decimated or destroyed.

In fact, the ability of the Fed to act so destructively is one of the bedrock principles of monetarism. The Fed attacks inflation by constricting consumer demand through reducing pressure on prices from potential wage and salary escalation. Therefore it is the workers of the nation who are unwittingly and without their consent the foot-soldiers in the Fed's price stability battle strategy.

The Fed exercises its powers by expanding and contracting the currency through the three tools of buying and selling U.S. Treasury securities through open market operations, operating the discount window at the Federal Reserve Bank of New York, and establishing reserve requirements for financial institutions which are engaged in fractional reserve lending.

The Federal Reserve says that by altering the quantity of currency in circulation it is not creating or eliminating wealth. Rather it says it is merely affecting the amount of "liquidity" available to meet current economic needs. It does this, it says, by moving money from stored wealth; i.e., interest-bearing forms such as savings accounts, to cash and checking accounts used to meet immediate financial requirements.

Admittedly, the ability of the Fed to control the amount of money in circulation and to influence economic outcomes is limited. Even though investors believe that the key to a sound investment strategy is to gauge accurately the effect of the Fed's actions on the economy, expectations should never be raised too high. The Fed cannot directly dictate such measures as how much unemployment should be tolerated. And while the tools at its disposal are powerful and effective and have been honed through decades of practice, they are still awkward and difficult to manipulate in order to prevent undesirable or even catastrophic effects. But these effects have nevertheless taken place.

Returning to 1979 when the Fed sought to squeeze out the inflation from the economy that had built up during the years following the Vietnam War—partly through the loose money policies of Arthur Burns, Chairman of the Fed under President Nixon—it did so by raising the federal funds rate for borrowing by member banks. Under Chairman Paul Volcker, who was appointed in 1976 by President Jimmy Carter, interest rates soared at times to above twenty percent over the next several years, rates unprecedented in the nation's history.

These actions had only a slight impact on reducing inflation, but at a terrible cost to the American economy and to American workers, farmers, and small businesspeople. Also devastated were the poorer areas of America's cities which had been steadily climbing out of poverty. Examples were the destruction wrought in places such as Baltimore or Detroit, where huge sections turned into "death zones."

Since that time, the U.S. economy has not recovered. These were the actions that wrecked our manufacturing industries and produced the so-called "service economy." The nation languished in this condition as sub-par economic conditions lingered through the Reagan years and into the term of President George H.W. Bush. Continuing poor economic conditions contributed to Bush's defeat by Bill Clinton in 1992, with relief coming later through the boom of the mid- to late-1990s, during the so-called dot.com bubble.

At this time, huge amounts of investment capital, particularly from abroad, went into building the technology firms that were leading the microcomputer and internet revolutions. But with the recession triggered by the crash of the stock market in 2000, this presumed prosperity was exposed as an illusion. Today we find ourselves again in a serious stage of economic stagnation, marked by rising un- and under-employment and massive increases in consumer, business, and government debt. And inflation marches on.

Faced with such circumstances, the Federal Reserve does not seem to know what to do. By its own admission, it lacks measures and targets by which to regulate the currency. During the early 1980s, the Fed went through a period where it tried to set interest rates based on quantitative monetary targets. Under the influence of the monetarists, the Fed tried to gauge the amount or money needed in the economy from such measures as M1, M2, and M3. This policy failed, so that today, no one, including leading economists, pays any serious attention to the "Ms" as a guide to monetary policy.

A major reason for this failure was the proliferation of different types of financial accounts resulting from financial institution deregulation. This proliferation was made possible by the growth in electronic funds transfer, where money became a mere electronic blip, rather than a check, cash, or some other paper instrument. Using computer processing, the money supply changes abruptly every night through the use of cash management tools such as "repos," or repurchase agreements.

The growth in complexity through electronics has also made possible many new types of crime, including electronic theft, diversion of funds, and money-laundering. Also complicating the situation was the widespread use of corporate stock as money through such actions as mergers, leveraged buyouts, and payment of compensation with stock options.

While the Federal Reserve has a general sense that the money supply must be kept sufficient to meet the needs of the economy, it finds it difficult to compare the growth of the two or define how they relate to each other. So rather than watching monetary targets, the Fed says it is steering by what it calls an interest rate "smoothing" policy. It says it chooses a currency level consistent with economic growth with the intent of supplying enough money to fuel the economy. Thus the Fed claims that it wants to get the price of money right for the economy at any given time, though the target is elusive.

In other words, the Fed doesn't know what it is doing. What it mainly seems to do is to watch the same economic indicators everyone else does, and if it thinks the economy is "overheating" it raises interest rates. When liquidity contractions appear to be too destructive and the screams from individuals and businesses get too loud, it will then lower them. Unless of course foreign investors start screaming, when the Fed will raise rates again or leave them steady.

Unable to quantify either the money supply or actual economic activity, the Fed supposedly uses inflation as a surrogate. Unable even to gauge inflation accurately, it uses worker wages as a surrogate for that. So if individual earnings go up, the lid on the economy comes crashing down, as though people who work for a living have been caught with their hands in the cookie jar.

After starting to raise interest rates around 1994 to slow down the economy during the dot.com boom which had been engendered by a "strong dollar" policy by the U.S. Treasury to attract foreign investment, the Fed later began to lower them in an attempt to revive the economy when recession began in 2001. But this never really produced the hoped-for recovery.

In particular, housing mortgage rates were lowered to the lowest rates in four decades, thereby increasing available cash to consumers through refinancing of existing mortgages and through new home equity loans. These actions maintained activity in an economy which now relies for three-quarters of the value of its transactions on consumer spending. Of course such an economy is highly susceptible to variations in consumer confidence, which was why, after the stock market plunge following the terrorist attacks of September 11, 2001, President George W. Bush told the public to go shopping.

As the deflating housing bubble has made clear, even this rare bright spot in the declining U.S. economy scarcely improved the employment picture except through low-paying service jobs. Meanwhile, the ability of consumers to support the economy has been weakened by the further decline of manufacturing due to NAFTA, free trade policies, and the globalization of industry. The strong dollar of the 1990s led to massive increases in the trade deficit and even more reliance on foreign purchase in the U.S. bond, stock, and Treasury markets. Now with the value of the dollar falling, purchase by foreigners of securities is also slipping.

But again, inflation when gauged by the long-term CPI is not low—its cumulative effect since 1965 has been devastating. Yet by trying to target inflation as its chief measure of success, the Fed is clinging to what can only be described as a fetish of "price stability." Nor is Congress taking any action to challenge this interpretation of the proper goals of monetary policy. Indeed, Congress seems totally passive in the face of the Fed's own confusion.

Congress's commitment to so-called price stability was shown by a series of analyses produced in the late 1990s by the staff of its Joint Economic Committee (JEC) and by the absence of any attempt by anyone in Congress to challenge the Fed's policies. What Congress should be addressing is that in order to achieve price stability, un- and under-employment has become the tool of choice both of the money managers at the Fed and of their supporters in Congress. Price stability is in fact a tool of "class warfare" directed by the moneyed interests from the nation's banks, as well as by the Fed itself, against the workers, farmers, and responsible businesspeople of the nation. The dichotomy between price stability and unemployment is another relic of the Dark Ages out of which our system of central banking has emerged.

These points show that the goal of monetary policy should be neither price stability nor full employment. Not only are the two goals contradictory, but they both postulate a static state of the economy where change simply does not occur. Such a state, however, can never be truly realized, except perhaps in death. As said by Heraclitus, "There is nothing constant but change." Nothing alive is without change, as everyone knows. And a nation's economy is undoubtedly alive.

This leads in turn to an assessment of what really should be the goal of monetary policy. Given the irrefutable presence in life of ceaseless change, price stability as an anchor which by itself can remove uncertainty is an illusion. Of course, price stability is only a surrogate for what the Fed is really trying to achieve, which is stable profits for those who lend money at interest, whether institutions or individuals. As stated earlier, money itself is thus viewed as a commodity and a mathematical constant. This philosophy of rigidity raises money to the status of a heathen idol to which all other economic values, and all human beings as well, should be sacrificed.

In actuality, money is, or should be, also as stated at the outset, an instrument created by law to act as a medium of exchange in facilitating the legitimate trading of goods and services within the economy. The Federal Reserve and the financiers do not view money this way. The term of art for a commodity definition of money is "store of value." It implies that money is essentially the same whether it is being used or not. But this can never be.

Returning to price stability, it is clear that such a state is also unattainable due to the laws of physics. Rather prices must continuously tend to rise, unless restrained by unnatural force, due to a) the physical principle of entropy, or the law of diminishing returns; and b) the consumption of resources devoted to production. This will happen until technological breakthroughs are achieved which improve productivity through the application of human intellect and creativity. Such breakthroughs create efficiency and productivity gains, and, in many cases, quantum changes through entirely new product lines and industries. So prices must always fluctuate.

This happened, for instance, through Edison's harnessing of electricity, Henry Ford's mass production of automobiles, the development of airplanes and air travel, and the creation of a microcomputer industry through the manned space program. Indeed, the example of quantum physics is instructive, as it postulates a universe of endless creativity in contrast to the medieval dogma of scarcity and struggle between social classes for the right to exist. The more optimistic view of human possibilities exemplified by modern science has produced the explosion of world economic development starting with the discoveries of the European Renaissance beginning about 1450 A.D.

This discussion also raises some philosophical questions about the nature of man. From this standpoint, all ideologies associated with the concepts of Social Darwinism, for instance, must be viewed as an assumption of an essentially animalistic level of consciousness, as expressed historically through the barbarism of the European Dark Ages. According to this ideology, which may have given rise to both the current banking system and the laissez-faire school of economics, people are animals who fight over finite resources like half-starved dogs.

But if it's the biggest, baddest, meanest dogs that survive; i.e., "the fittest," mankind must of necessity be on a downward evolutionary spiral. This, however, is contrary to human experience, where a progressive trend can clearly be discerned through a long-range survey of human history. Mankind does seem to be learning something, though it often seems like we learn the hard way and that for every step forward we take a half-step back. In contrast to ideologies based on human savagery—and any ideology which sees man's potential as less than infinite falls into that category—a quantum approach to economics defines a world that is truly human by looking to the endless possibilities expressed in the material environment for creativity, imagination, and evolution. A monetary system worthy of support must therefore facilitate these characteristics.

A humanistic approach to economic development does not mean that full employment should then become a graven image for worship, replacing price stability. Full employment can never be attained, as all economists know, because jobs will constantly become obsolete, also due to the same forces of change. Thus a certain level of "structural unemployment" has proven acceptable as a practical matter. This is only common sense. But it also leads to a social obligation to support displaced workers until they can be retrained or relocated to work at new locations using improved tools and processes.

It also means that the aim of monetary and economic policy must be shifted from the present paradigm based first and foremost on the profits of lenders to one that can facilitate adaptation to change and overcoming of entropy by supporting the human needs of the workforce. It may also mean reforms so that people can finally begin to enjoy the leisure dividend that should result from technological development and will not be obligated to work all the time.

How can this be done? Precisely through the methods implied or set forth in the founding documents of American culture, such as the Declaration of Independence, drafted by Thomas Jefferson, which says, "All men are created equal." Therefore all must be given an equal opportunity to live, grow, and adapt to change and to do so without trespassing on the rights of others to do the same.

Further, the Preamble to the Constitution sets forth the principle of the general welfare, not only for existing society, but for posterity. Therefore the government is required by law and conscience to provide the means for such attainment. Through experience we can clearly see that this includes a decent education, access to water and sanitation facilities, a clean and wholesome place to live, access to energy resources, adequate health care, transportation, etc. It is the responsibility of adult individuals to contribute to making all this available, not only to themselves and their families, but to the entire society.

These elements of social infrastructure thereby become a requirement of common life and are the duty of representative government at all levels to provide. People can then build the economic life they are entitled to enjoy through the competitive system of private enterprise which helps to define the American economy. Any successful modern nation has a combination of robust public infrastructure and a dynamic private sector, not one based on increasing "privatization" of public services.

It is the duty of those in charge of monetary and economic policies to facilitate the development of such a society. But today, neither the Federal Reserve, nor other authorities such as Congress, the Treasury Department, or the Executive Office of the President are doing the job they should be doing. Instead, they are operating the monetary system to the advantage and benefit of private banks and the private financial markets. This is wrong, and it must be changed.

We might look at the inflation issue from another angle, in that economists have pointed out that periods of inflation seem to coincide with those of war. The causes of this confluence appear complex and may include price gouging by those who sell to the government, fear and panic which cause people to inflate prices to secure their economic position, a premium built into prices to compensate for a general atmosphere of economic uncertainty, or the sudden influx of new money due to precipitate government borrowing. Probably all these factors play a role. If we look again at the history of price inflation since 1915, we discern a pronounced increase in prices during the periods of World War I and World War II. This would tend to confirm the hypothesis of a link with inflation.

But what about the wave of higher inflation since 1965? What is unique about this period is that the nation has been in a state of permanent war mobilization since the Vietnam conflict. A considerable amount of economic research would be needed to test the hypothesis that the high level of defense spending has in fact caused the high inflation, but such a study would be worthwhile.

Another hypothesis might be added which would be difficult to measure but which should also be considered. This is that money spent on permanent war mobilization is essentially non-productive in terms of producing goods and services of value to the larger civilian economy; i.e., it has a relatively low multiplier effect. Wartime spending may also be less able to call forth the type of scientific research and development needed to improve the economy in most aspects of everyday life. We never got the "peace dividend" we were told would result from the end of the Cold War. Instead, the military-industrial complex pressed forward without missing a heartbeat until now the War on Terror and possible future wars against Iran and other nations offer new justification for perpetual war mobilization.

The economic question is whether a society permanently at war or always preparing for war has the ability to overcome the natural entropy that will make its production processes less efficient over time. If it cannot, then no amount of reform can solve its problems. We know that no culture in history which has had warfare as its main preoccupation has long survived, unless and until it has seen the error of its ways and changed, or unless it simply was destroyed.

Ancient Greece never really recovered after the Peloponnesian Wars. The debt-riddled, socially-stratified Roman Empire exhausted itself in a blaze of military conflict, then saw defeat and dissolution. The British Empire went bankrupt in a single generation from 1914 to 1945. The U.S. is teetering on the edge of a major financial collapse right now. In fact, those with money are quietly trying to secure their wealth while the unfortunate ones who are heavily mortgaged or locked into inflexible retirement accounts may be left holding the bag. Can the American Empire survive the economic forces that doomed the empires of the past?

Or will what some call the “New American Century” turn into the “No American Century”?

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