ASSET INFLATION
& AN INDEPENDENT FEDERAL RESERVE

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July 7, 1999

On December 5, 1996, Alan Greenspan delivered his "irrational exuberance" speech at the American Enterprise Institute. In it he reviewed the history of the Federal Reserve and brilliantly outlined the intellectual argument for why an independent Fed had the authority and responsibility to deal with all forms of inflation, including inflation of financial assets. His speech was consistent with an article he wrote in The Objectivist in July 1966.

"The excess credit which the Fed pumped into the economy spilled over: into the stock market-triggering a fantastic speculative boom. Belatedly, Federal Reserve officials attempted to sop-up the excess reserves and finally succeeded in braking the boom. But it was too late: By 1929 the speculative imbalances had become so overwhelming that the attempt precipitated a sharp retrenching and a consequent demoralizing of business confidence. As a result, the American economy collapsed…"

Alan Greenspan has savaged the Fed of the late twenties for not understanding or correctly responding to the challenges of asset inflation.

Jerry Jordan, the President of the Cleveland Fed, recently issued his 1998 annual report and also referred to the financial circumstances of the late 1920's and the similarities with today. In his highly commendable report titled Beyond Price Stability: A Reconsideration Of Monetary Policy in A Period Of Low Inflation, he discusses "the potential pitfalls of our current environment of benign price pressures, rapid asset appreciation and substantial liquidity." He reminds the reader that many famous economists, who analyzed the great contraction of the 1930's, "concluded that the absence of consumer price inflation in the 1920's sent false signals about financial and economic stability". In recent times, "as Japan and several other Asian countries are now demonstrating, severe economic contractions can result from financial system imbalances that are not clearly signaled by consumer price inflation." In an environment of increasing productivity, monetary authorities who do not wish to see prices fall, allow monetary growth to accelerate. As in the 1920's, this money growth has supported a domestic "spending frenzy". Over the past five years, this "torrid monetary expansion" has also been a major contributor to the asset inflation that we are currently experiencing.

In late 1996, the Fed was focused on asset inflation and hinted at raising rates just a token quarter point. The outcry in the financial press was surprisingly overwhelming and the Fed quickly abandoned its well thought out position. Now, two plus years later, we have a financial bubble that, even with a miracle, will be difficult to prick without resulting in serious economic pain. Of course, the bubble could be allowed to grow even larger and burst on its own, but at what cost? Those of us who are now benefiting from this paper gain have only to look anywhere in the world for signs of the inherent imbalances. We cherish the independence of our Federal Reserve Bank. It is our hope that our monetary institution is insulated from undue political interference. Even when we don't like it, most will recognize the merits of central bank intervention before economic disequilibrium gets so severe that a serious recession or even worse may result.

Today, the Fed sits on the horns of a dilemma that it should have avoided by acting on its instincts back in 1996. It could, as former Fed Chairman, William McChesney Martin, said when referring to Central Bank tightening, "take away the punch bowl." In this case, the Fed would be blamed for the wealth loss and subsequent recession that could result as now grossly overvalued assets deflate. Its other option is to cautiously follow the market by gradually ratcheting rates higher, but only as the more limited consumer price definition of the inflation threat presents itself. In this way, the asset markets would continue to feed on themselves and reach even more dangerously fantastic heights. However, when the inevitable break finally does come, the Fed would not be blamed as the perpetrator. Maybe, just maybe, the Fed would be able to preserve its status as an, independent institution.

Perhaps, at this late cycle stage, the Fed believes their choice is between the lesser of two evils. First, do the right thing by counterbalancing asset inflation and risk losing its precious and tenuous political independence, or second, do little to confront asset inflation and risk an even more serious and later economic meltdown, thereby deflecting the blame and preserving its independence. To this issue, I have one observation and one question. The observation is, as my own criticism indicates, that the Fed will be blamed anyway and the blame will start with Alan Greenspan's own writings. If its decision is being influenced by a concern for self preservation as an independent institution, it will backfire. The question is, what good is it to have an independent Central Bank if it does not act independently? By only ratcheting rates higher, the Fed has seemingly decided that asset inflation is not a serious threat (which I don't think is the case), or lost its nerve (which I hope is not the case) or has sadly made a mistake by choosing the greater of two evils. It's time for the Fed to act independently and to stop pretending that it is fighting inflation, the broader interpretation of inflation that Alan Greenspan so correctly and officially defined in December 1996.