CONCRETE RULES AND FLUID FEDS

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Reviewing
ALLAN H. MELTZER, A HISTORY OF THE FEDERAL RESERVE,
VOLUME 2, BOOKS 1 & 2, 1951-1986
(University of Chicago Press 2009)

THIS SECOND VOLUME OF Allan H. Meltzer's *History of the Federal Reserve* covers the tumultuous era from 1951 to 1986. He begins at the time of a thriving post-war economy and continues through the deficit years of Lyndon Johnson's Great Society program and into Nixon-era wage and price controls. He then tackles the Great Inflation of 1965-1982 and concludes with Paul Volcker's triumph over the inflation beast.

As a new homeowner and entrant to the workforce I have seen the carefree days of graduate school replaced with the sleepless nights of a responsible economic citizen. My free time is riddled with idle fretting over dollars, cents, and interest rates. How much should I save, and where should I invest it, to maintain my standard of living in retirement? Should I buy or rent, and what type of mortgage should I choose? No single institution has more impact on these decisions than the Federal Reserve Board of Governors.

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The machinations of the Federal Reserve (or Fed) are the most arcane and jargon-ridden in the federal government. A basic course in macroeconomics teaches that the Fed controls interest rates to conduct monetary policy. It typically manages the relationship between the money supply and economic growth through buying and selling Treasury bonds. The tight rope it walks is a delicate one, for if the nominal growth of the money supply exceeds the real growth in the economy then inflation rears its ugly head. On the other hand, if the Fed stands by during the doldrums of recession then unemployment persists and politicians get restless. Along the way the Fed regulates the safety of the banks it oversees and is sometimes pressured to bail out banks during times of distress.

The Fed's decision-making process is far more complex than Macro 101 would suggest. Meltzer artfully demonstrates that the Fed is influenced by academic debates that reflect the intellectual and ideological divides in the economics profession. The Fed is not a monolithic institution and its leaders are instead influenced by disparate philosophies leading them to pursue distinct and at times conflicting goals involving unemployment rates, inflation, or growth. Some members, and indeed some Chairmen, seem further influenced by naked ambition and the pursuit of political influence.

Meltzer offers three central themes to decipher the Federal Reserve's inner workings. He chronicles the role that emerging monetary theory played in influencing monetary policy, particularly the rise of the Friedman school of monetarism as an alternative to Keynesian economics. He considers the significance of central bank independence from political interference. He further describes how the great inflation of 1965 to 1982, and Volcker's subsequent strong medicine to combat inflation, upended 50 years of conventional wisdom about the role and responsibilities of central bankers.

Meltzer takes us back to what seem like prehistoric notions. He shows us the days before the Fed distinguished between real and nominal interest rates and when banks labored under interest rate ceilings. He describes the Fed's historical acceptance of the Phillips Curve, a simplistic model arguing a sustained inverse relationship between unemployment and inflation that has since been discredited. Meltzer's method is to pore through minutes and transcripts to offer a meticulous re-creation of meetings of the Federal Reserve Federal Open Market Committee and the Federal Reserve Board of Governors, hearings of the Senate and House Banking and Joint Economic Committees, and statements from key Treasury and White House officials. He also weaves in the dominant macroeconomic theories of the time to demonstrate how academic debates about the velocity of money, currency stabilization, the relationship between unemployment and inflation, the natural rate of unemployment, the role of rational expectations, and other debates influenced the Fed Board and the Fed Staff.

Along the way he also mediates the macroeconomic academic disputes of the period (e.g., 677). Meltzer is an unabashed monetarist and his history is certainly colored by that viewpoint. This volume begins a few short years in advance of Milton Friedman's publication of *Studies in the Quantity Theory of Money*. If it is fair to observe that debates over Keynesian thought continue over the role of fiscal policy, and that they are fairly settled toward the Friedman view in monetary policy,[1] perhaps Meltzer's monetarist bias can be forgiven and ultimately prove essential to the reader. Moreover, though the Fed adamantly rejects use of explicit inflation targeting, in recent years there has been much discussion of their use of *implicit* targeting, which seems like all but a final blow in favor of Friedman.[2]

Meltzer delivers blow after blow to the classic Philips Curve by alternating punches between historical data and theoretical literature questioning the assumption through the 1970s and into the 1980s (284-87, 486-90, 552-54, 856-59). He also convincingly argues that the artificially low estimate of 4% natural unemployment, which prevailed through most of this history, shares some blame for the Great Inflation (though he gives the lion's share of blame to Fed

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[1] *See generally* Milton Friedman and Ann Jacobson Schwartz, A Monetary History of the United States, 1867-1960, Princeton University Press (1971).

[2] *See* Daniel L. Thornton, The Lower and Upper Bounds of the Federal Open Market Committee's Long-Run Inflation Objective, Federal Reserve Bank of St. Louis Review, May/June 2007, available at research.stlouisfed.org/publications/review/07/05/Thornton.pdf.

Chairmen unwilling to stand up to spendthrift Presidents) (672). The reader should keep a critical eye on Meltzer's mediation of the historical scholarly conflicts in which he was actively engaged (see, e.g., 81, 180, 263, 1135, 1210), a result of his prolific work as an economic historian reaching back 40 years. A rare portion of his view of the scholarly battles bears risk of bias, but in any event no sacrifice of academic rigor is apparent in his method.

Meltzer also chronicles an era in which economic models became increasingly technically sophisticated and in which Fed Staff models followed suit. He maintains his argument that the Fed Board still doesn't agree on the fundamental goals of monetary policy and that many governors have failed to articulate a rational basis for their decisions, often going instead with their gut in policy decisions (476). He also notes a persistent failure by the Fed to differentiate between real and nominal interest rates (1006).

He ultimately declares victory over the Keynesians in the role of monetary policy, citing to admissions from leading Keynesian academics like Romer, McCallum, and Modigliani in favor of a generally monetarist worldview for Fed operations (though he admits they do not go so far as to accept his argument in favor of explicit inflation targeting). Meltzer also maintains a critique of the Fed Staff's ability to put prevailing theory to use, bolstering his case with evidence of persistent errors in the Fed's forecasting of inflation, expected inflation, and monetary velocity. The impact of this failing remains uncertain given Meltzer's argument that most Chairmen and Governors rarely relied on the Staff's models in any event.

Meltzer artfully demonstrates that past is prologue when we look at the Fed's struggles to manage monetary growth, political pressure, and the evolving academic understanding of macroeconomics. The repetitive nature of these struggles is also evident on the regulatory side of Fed operations. Meltzer chronicles a debate over regulating interest rate ceilings that serves as an acute example. During the 1970s interest rate ceilings previously legislated in the 1930s were abolished (998). Meltzer observes that new financial entities and transaction forms evolved to arbitrage around the ceilings, as money market funds developed to provide higher returns at the same level of risk and banks found alternative instruments to compete for deposits. Meltzer also notes that the price ceilings resulted in reduced services for bank customers. Versions of these arguments resurfaced in the recent discussion over price ceilings adopted on interchange fees – the fees charged to retailers for using debit cards – in the Dodd-Frank Wall Street Reform Act of 2010.[3]

If the more academic macroeconomic principles are the meat of Meltzer's critical history, then the bones of the work are the tenures and leadership styles of the four Federal Reserve Chairmen who led the Fed during the 27-year span of the volume's focus. Meltzer opens with William McChesney Martin, who served as Fed Chairman from 1951 to 1970. Meltzer gives him credit for reorganizing the Fed and establishing its authority over interest rate policy through an accord negotiated with Treasury in 1951 (251), and for maintaining a fair stance against inflation early in his term, owing in part to support from the Eisenhower administration (257). Martin was responsible for consolidating power in the hands of the Fed Board in Washington and limiting the power of the Regional banks, particularly the New York Fed. He was also responsible for the Fed's "even keel" policy of supporting Treasury bond issues by purchasing bonds, thus enabling loose monetary policy, even if the Treasury's sales interrupted a period of constrictive policy. He also established a strong precedent for coordination with the administration (261). During the Eisenhower administration a disciplined fiscal policy kept the cost of this diminished independence in check.

Heading into the 1960s, more frequent issuances of Treasury debt to finance growing deficits led Martin astray. Meltzer concludes that Martin sacrificed Fed independence in the hopes of gaining a voice in fiscal policy, ultimately a poor trade as he gained little influence to slow deficit spending in the Johnson administration. Meltzer pegs 1965 as the beginning of what he terms the Great Inflation. He doesn't paint Martin as a "radical" Keynesian, and ul-

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3 *See* Todd Zywicki, Will Congress Take Another Swipe at Credit Cards, Wall Street Journal, January 5, 2010, available at online.wsj.com/article/SB10001424052748704905704574622722184163510.html.

timately makes a successful case that Martin was a thrifty financier who lacked the courage to stand up to radical fiscal policy (472). Meltzer criticizes Martin for his lack of technical skill in economic modeling (263) and pokes fun at the irony of Martin's frequent admissions that he neither understood nor trusted economic models (476). Yet Meltzer also critiques the dominant Keynesian thought of Martin's contemporaries. One wonders whether a more technically skilled economist at the helm might have been even less concerned with inflation than Martin.

Meltzer then considers the Chairmanship of Arthur Burns, appointed by Richard Nixon in 1969. Meltzer describes Nixon as particularly obsessed with re-election (838) and focused only on maintaining low unemployment numbers. He describes Burns as eager to accommodate (676). A brief experiment in price controls by the Nixon administration ultimately made the situation worse (839). William Miller briefly chaired the Fed under Jimmy Carter, pursuing a continued expansionary course, and once inflation reached well into the double digits he was replaced with Paul Volcker.

Meltzer offers measured praise of Volcker's tenure, particularly after Volcker found an able ally in Ronald Reagan and after public sentiment turned in favor of bringing inflation back down (1128). Meltzer ends his history at 1986, a time by which he concludes public expectations of inflation had been tamed and the Fed's credibility as an inflation fighter renewed (1131). His ultimate lesson is that inflation expectations are slow to take hold, but also slow to recede, and the credibility of the Fed as willing to contract money growth in response to future inflation is as precious as the trust of a spouse, i.e., solid and stable for long periods but perilously difficult to regain once lost.

Meltzer renders a guilty verdict to the "even keel policy" by which the Fed agreed to support the price of Treasury bonds around the time of their sale regardless of whether the Fed's long-term policy was constrictive at the time. Meltzer argues that the Fed only reversed course when the public became engaged in the issue. Volcker only had the maneuvering room to beat back inflation when public opinion polls began to support the move.

As a sidebar, Meltzer offers a brief solution to the independence problem facing Fed Chairmen (22). He urges that the Federal Reserve Board periodically announce an agreed policy objective for the next two or three years. If the objective is not met, he urges that the President should ask for an explanation or accept a required resignation. Meltzer points to his influence on New Zealand's adoption of this policy as evidence of its advisability. He presents a well-reasoned case for institutional limits on the Fed's ability to maintain sound monetary growth in periods during which political leaders are more focused on unemployment. His alternative approach is, however, unconvincing. The subservient relationship between Burns and the Executive branch that Meltzer criticizes would have been even worse under his proposal. The same forces limiting central bank independence would similarly infect the President's requests for explanations and resignations. Alternatively, the binding targets could be written vaguely, attach to multiple variables, and contain sufficient exemptions to limit accountability.

This history flushes out many of the tensions that have haunted central bankers since the beginning of the Fed in 1917, and further informs the current dilemmas facing the Fed and other global central banks. Central bankers can set firm rules to guide decision-making going forward, an approach recently adopted by the European Central Bank, such as a rule that inflation will always be targeted between 1 and 2%, or that the Fed will bind itself to act to maintain unemployment below 4%. Concrete rules provide predictability and can shape market perceptions about future events, most importantly perceptions about expected future inflation. Merely announcing such a rule is impotent unless markets actually believe the Fed will stick to the policy. Meltzer argues for a fixed-rule policy in which the central bank makes clear what it targets and within what range (1234). Meltzer's advocacy is no doubt in part due to his place at the forefront of the rational expectations literature on Fed policy. He supports the argument with an epilogue about how the most recent Fed Chairmen – Alan Greenspan and Ben Bernanke – have embraced rational expectations with their adoption of a more transparent process through extensive releases and speeches. He makes a successful case for improved transparency, but some room for debate over explicit targeting remains.

Explicit targeting is probably a slam-dunk in a perfect world, where the Fed is fully independent, Warren Buffett manages the federal budget, and junk mail invariably contains slips of gold. It is more difficult to achieve in practice because of the ebbs and flows in the level of independence central banks are afforded by political leaders who have shorter time horizons and a typically greater appetite for inflation (as long as unemployment stays low), as Meltzer himself demonstrates (667). Though the Fed is technically independent of the executive and legislative branches, various forces have encouraged Fed Chairmen to coordinate their policy decisions with the President and Congress (475). Most significantly, Meltzer argues, has been the ever-looming threat of legislation to limit the Fed's range of action – via interest rate ceilings, for example (839). The level of independence Fed Chairmen have asserted has depended on the personal goals of the individuals involved and the level of threat perceived from the executive and legislative branches. Though the reader is tempted by Meltzer's proposed solution, his demonstration of the independence problem is too forceful and plausible to leave us at ease with the oversimplifications in that solution. It might work in the immediate post-Volcker and Greenspan era, in which the public accepts a Fed focus on inflation, but it would lose force as the public and political leaders became more concerned with short-term growth.

Just about any bet in the financial markets includes some estimate of future interest rates (unless one hedges interest rate risk on the transaction, in which case the appropriate cost of the hedge is itself based on an estimate of interest rate risk). Meltzer's history gives useful insight into the institutional forces shaping monetary policy and is therefore a vital resource for all participants in (and students of) financial markets. His history offers a frightening analogue to present day. The year 2011 bears a great many similarities to the calm before the storm that Meltzer observes from 1960-1965, just before the start of the Great Inflation, in which the Fed's focus was almost exclusively unemployment and periods of acceleration in the rate of growth in inflation were dismissed as one-off occurrences in volatile commodities.

Meltzer's opus is without peer, particularly when compared to the other Federal Reserve histories on the market. Other works have sacrificed analytical rigor for personality worship of well-known Chairmen. Some have devolved into conspiracy theory motivated by a theme of class warfare and suspicion of the cognoscenti of a supposed central banking cabal. Still others have suffered from an over-reverence for the power of economic modeling and the central bank. Meltzer strikes the right balance and his work is a useful contribution toward understanding the inner workings of one of the nation's most powerful and least understood institutions.

Meltzer is least credible where he uses the book as an opportunity to referee scholarly debates in which he was a contender and at points the reader wonders whether he has decided to undertake a descriptive or a critical history. Taken as a whole, this tome nonetheless cements Meltzer's position as the master historian of the Federal Reserve and sets the capstone to his academic career. He has stated publicly his intent to retire, leaving the history of the Federal Reserve from 1987 to 2011 for the next generation of economic historians to undertake. Fed buffs may have a long wait for a worthy successor.