The Political Economy of Central Banking in the United States or Quis Custodiet Ipsos Custodes

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The fact that monetary policy can be strongly influenced by political considerations has long been recognized. The topic has increased in importance with the rise of monetarism. Theories that attach great importance to money supply require some explanation of changes in money supply. Gold flows and institutional changes provide easy explanations for some noteworthy historical episodes but they cannot explain the behavior of those central banks that can control the money supply. Hence the emphasis on politics. The movements of money supply can be explained in terms of political events and provide an exogenous driving force for the system. A whole literature on electoral cycles has begun to develop. In this paper I shall argue that central bank policy in the United States is indeed influenced by political considerations. In Section I, I have sketched out the ways in which the Federal Reserve System is exposed to political forces. I have also indicated some of the intellectual, ideological and economic interest forces which work through those channels.

In Section II, I have argued that postwar Federal Reserve policy has to be interpreted in terms of modes of operation developed to conserve the System's power to influence events when it is important to do so. Much of the System's behavior can be understood as defense against attacks by populists and monetarists. In my view, simple election buying has played a minor role. In Section III, I review some recent proposals for the use of new monetary aggregates. I argue that those proposals make more political than economic sense.

I.

Central banks play an ambiguous role in almost any political system. Many of them—the Bank of England in particular—originated as private or quasi-private institutions. When the Federal Reserve System was founded, it was given the form of a set of private corporations.

The quasi-private form reflected, among other things, the public's dissatisfaction with treasury currency which had often been associated with war and inflation. Moreover, the notion that the central bank should play

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an important role in the government's macroeconomic policy is a relatively recent one. Indeed, the notion that a government *should have* a macroeconomic policy is a relatively recent one. If a central bank's principal task is to maintain currency convertibility and act as lender of last resort, the government may have no need to worry about it. That is especially true if the government is not accustomed to take praise or blame for the inscrutable mysteries of the business cycle.

Since the great depression of the 1930s, and the second world war, governments have taken on responsibility for maintaining prosperity and "full employment," together with price stability. They expect to receive praise for prosperity and blame for recession, unemployment, or inflation. Since they have accepted these often conflicting responsibilities, governments need all the help they can get. Nothing can be more galling than to be blamed for the results of actions taken by an independent central bank. It might not be so bad if the bank could be given responsibility and made to take any blame connected with the often unpleasant tasks of monetary management. But if the blame cannot be avoided anyway, governments feel that they might as well make the decisions that will affect their ability to survive the next election.

In many countries, then, the desire of governments to control central banks has been in conflict with the established traditions of independence in the case of the older central banks and with more general notions that central bank independence helps to insure a "sound currency," prevent inflation, and sometimes to insure convertibility and stable exchange rates.

The result is a spectrum of arrangements. At one end are central banks that are in essentially the same position as any other government department. The governor may have freedom to carry out routine operations but the prime minister and cabinet make the major policy decisions. More commonly some form of compromise arrangement has been worked out. The Finance Minister may have veto power over central bank decisions, or it may be easy for the government to remove the governor from office. At the other end of the spectrum the central bank is said to be "independent" of the government. As in other cases the form is not the whole story. Whatever the formal arrangement, political forces are at work that can make a formally independent bank subservient to the government in power, or conversely give great power and influence to a central bank management that is controlled by the cabinet.

The Federal Reserve System is a case in point. It has an elaborate structure intended to make it "independent of political influence." The Governors are appointed for long terms (14 years). The Chairman has only a four-year term but it is not coterminous with the presidential term. The System is financed from the profits on its own operations. To the vexation of some congressmen the System cannot be coerced by the power of the purse. The elaborate regional System, though conceived for other reasons, has proved to be a valuable political aid. The use of local boards of directors keeps the presidents and governors in touch with local business opin-

ion. Counting branches, there are over two hundred directors at any time. Since most of them have been selected as leading citizens, their influence in support of System policy can be considerable. Moreover, past directors constitute a body of local alumni who can be expected to support the System's independence and to be sympathetic to its policies.

Finally, of course, the Fed has the support of large industrial and trade firms. Among the managerial class the Fed is regarded as a defense against the spendthrift tendencies of government. The idea that the power to print money should be put into the hands of those who love to spend it is repugnant to them and they support the Fed's independence even when it hurts.

Nonetheless, the Fed is vulnerable to attack from many directions. It may be useful to consider first the levers that may be used to control or influence Federal Reserve policy without regard to the purposes for which those levers may be used. We can then consider the substance of the "political" issues facing the Fed.

At first glance the appointment process seems to be the point at which Federal Reserve policy can be influenced. The President can appoint Federal Reserve Governors (subject to Senate approval). Counting regular appointments at the end of Governors' terms, as well as replacements for resignations, a President has the opportunity to appoint two to four Governors in a presidential term. A two-term President may, by the end of his second term, have appointed most of the Board.

Moreover, it may be supposed that some governors concerned with reappointment will adjust their views to suit those of the President. In fact, the appointment process seems to influence the System only in a very general way. Presidents, very naturally, tend to appoint governors whose views are consistent with their own. The result is that the Board is philosophically a kind of moving average of the last three administrations. But there is not much indication that appointments have been made to gain short-run political advantage for the President. Two considerations limit that possibility. First, the visibility of the Board and the confirmation process make it difficult for the President to use Federal Reserve appointments to reward his friends and supporters. When monetary policy is not controversial, some nonentities have been appointed to the Board, but in the last two decades that has seldom occurred. The Board has been accorded enough importance to prevent the appointment of "political hacks." At the same time presidents have not appointed governors on account of their views on specific issues. The political disadvantages of appearing to try to "pack the Board" have apparently outweighed any gain from moving one vote in a Board of seven and an FOMC of twelve.

If one cannot reward friends or exert significant short-run influence on Federal Reserve decisions, one might as well take the high road and make appointments which look respectable. That may explain why a number of Federal Reserve staff members and other economists have been appointed in the last couple of decades.

The President's power to appoint the Chairman is a different matter.

Since the Chairman can carry much more weight than the other Board members, he will be important to the President. Any President will want to have a Chairman sympathetic to his views. President Truman refused to reappoint Chairman Eccles, a man of considerable stature within the government. Eccles, it may be noted, remained on the Board and continued to campaign for more flexible interest rates. Chairman McCabe, who succeeded Eccles, departed in the dispute over interest rate policy. His successor, William MacChesney Martin, managed to build his own prestige while adjusting his views in such a way as to serve with five presidents over a period of 20 years. I will discuss Martin's policies later on.

At this point we need only note that Martin gave great prestige to the Chairman's role in international as well as domestic financial matters. By doing so, he narrowed the President's options in the appointment of a chairman. The President is constrained to appoint someone who is, first of all, a person of considerable stature in some way, in government, or as a banker, or business manager. Moreover, there must be some basis for the claim that he has some experience with the problems before the Federal Reserve. Of the last three chairmen, two have been economists with very substantial experience in government. The third, William Miller, was well-known as an outstanding business executive. He would not, however, have been eligible except for the fact that he had studied Federal Reserve problems under President Morris.

The fact that President Carter did not wish to reappoint Arthur Burns for reasons of political economic incompatibility indicates that the Chairmanship is a focus of political influence on the Federal Reserve. The fact that Carter appointed Chairman Volcker when Miller moved to the Treasury indicates the limitations on the President's freedom. Chairman Volcker had served in both the Kennedy and Nixon administrations and was President of the Federal Reserve Bank of New York. Those credentials representing high technical capacity, political neutrality, and "sound judgment" are exactly the ones that make for an acceptable nominee for Federal Reserve Chairman. The President may have to choose between someone he will like and someone that the congressional committees and the financial community will like.

The appointment process is a lever by which the President may influence federal policy. The power of the purse is usually the major weapon of the Congress in influencing government agencies. Many congressmen are annoyed by the fact that the Fed pays its operating expenses out of the earnings on its portfolio of government bonds. Expenditures of funds that come from the Treasury in the guise of interest payments, without a congressional vote, are bound to annoy the Congress. The Congress has been reduced to harrassment tactics such as verbal abuse or foot-dragging on technical issues or limiting the Fed's power to erect new buildings. The congressional committees spend a great deal of time and use a great deal of Federal Reserve governors' time without contributing much to monetary policy. The Congressmen alternate between using the hearings for speeches

for home consumption and asking questions of the "Answer yes or no, do you still beat your wife?" type. The Federal Reserve people deliver bland pronouncements designed to reveal as little as possible. The whole process could be written off as a ridiculous combat of low politics against defensive bureaucrats except for the fact that some communication takes place.

Congressmen always think that agencies, especially those with great power and budgetary independence, ought to be brought under control and made "accountable" to either the President or the Congress. That feeling is even stronger when the Congressman in question dislikes what the agency does or feels that his constituents will blame him for the consequences. As long as the Congress disagrees about the alternative, the Fed is fairly safe, but if the hearing process indicates widespread dislike for the Fed's activities, it is time to be cautious. The whole committee process may be like John Connally's comment on the late Wright Patman—"He is like a cross-eyed discus thrower. He doesn't set any records but he sure keeps the crowd on its toes."

Petty harrassment about audits, buildings, and other minor matters is merely an outlet for congressional frustration but a more serious threat is always in the background. The Federal Reserve Act is, as congressmen never tire of pointing out, an act of the Congress. What the Congress has created, it can destroy. If it wishes to do so, the Congress can put monetary control in the hands of the Treasury or create an entirely new agency.

So drastic a change in our monetary constitution could be brought about only under very special, probably disastrous, circumstances. But the Congress can curtail the independence of the Fed in a variety of other ways. It could require Congressional authorization for Federal Reserve expenditures. Such requirements already exist for FSLIC, another self-financed agency. Alternatively, the Secretary of the Treasury could be given a vote, or more than one, on the Board. The regional system could be replaced with a more centralized one, thus wiping out one of the Fed's political assets.

An alternative approach is to require "coordination between monetary and fiscal policy." That idea appeals to many Congressmen because they see in it an opportunity for the Congress to get into the act. Not every one feels that increasing executive power is to be desired.

I do not propose to discuss the substance of these proposals at this point. For the moment, I merely wish to note that the Congress has many ways to reduce the Fed's power, if enough members are unhappy with Fed policy. Of course, the administration can exert influence by supporting attacks on the Fed or threatening to do so. Alternatively, they may support the Fed or promise to do so in return for cooperation.

So far I have only considered the ways in which the other branches of government can exert influence or pressure on the Fed. That is, of course, a narrow view for two reasons. It would be going too far to assert that the other branches will use the power I have described only to carry out the "will of the people" if they can find out what it is. But it can be said that

neither the Congress nor the executive is likely to attack an agency with a powerful constituency and great prestige unless they can see another powerful constituency anxious to make changes in the System and willing to give strong support to those who do.

Persons who speak of political influences on the Fed seem most concerned with those influences that are directly concerned with electoral politics. Accordingly, I will deal with them first even though I believe that other types of political concerns may be more important. The simplest kind of political analysis asserts that the Fed stimulates the economy just before election in order to help the incumbents (President or Congress) get reelected. If the Board and FOMC were all appointed by the incumbent, that would be plausible. But given the process described above, it is a proposition that can only apply to the Chairman. Even then, the Chairman must induce the members of the Board and the FOMC to go along. One can readily believe that a chairman friendly to the incumbent president may talk himself and his colleagues into a somewhat more expansive policy than would otherwise be the case. But given the structure of the System I can see room for little more without open conflict which would probably be counterproductive for the candidate.

At the moment I content myself with that observation. Later on I shall comment on some of the "election cycle" theories. Meanwhile, we need to consider the special influence of the housing and home finance lobbies or what might be called the "real estate connection." In the United States questions relating to housing finance have played a major role in monetary politics for many years. Residential construction makes up about 4 percent of GNP and employs directly and indirectly millions of people. It is, of course, spread throughout the country. A high proportion of Americans own their own homes and in a country with high mobility several million homes are sold every year. The availability and cost of credit are therefore matters of interest to much of the population. Much of the credit for home finance has been provided by thrift institutions.

Anyone connected with construction or real estate sales or development must take an interest in political affairs. The problems connected with building codes, zoning, and taxation constantly arise. Those considerations have resulted in the development of powerful lobbies representing the interests of the housing industry and the thrift institutions. They have strengthened their hand as well as generated some business by supporting the cause of low-income housing (so long as it results in new building). By identifying all housing with housing for the poor, the housing lobby has enlisted the support of liberal politicians who might otherwise not be interested. At the same time it happens that this politically powerful industry, dependent on a steady supply of mortgage credit, has suffered more from variations in credit rationing than any other. Monetary restraint has been very largely housing restraint. One might expect a type of investment which is so heavily dependent on credit to be especially vulnerable to fluctuations in real interest rates. But until after 1979, real interest rates in the United

States did not move very much. Mortgage rates hardly kept pace with changes in inflation so that the net movements in real rates were small. Sharp increases in short-term interest rates did cause disintermediation and reduced residential construction in each of the credit crunches.

The pressures of electoral politics and the politics of housing finance are easy to understand. Ideological politics are uncommon in the United States but money is an exception. Paper or deposit monies seem to involve making something out of nothing. Usury is a controversial question through much of the world. Even Freud wrote an essay on "The Love of Gold."

In the United States, controversy between the populists and the sound money men has been a feature of political life almost since the founding of the Republic. In earlier times the gold standard versus silver was the focus of controversy. For a time the convertibility of greenbacks was the big question. The structure of the Federal Reserve reflects, in part, populist fears of financial power concentrated in New York, together with sound money fears of direct government control, especially by Democrats.

Populism is not easy to define but it reflects a fear of the power of big business as well as big government. Indeed, populists are often, not without some reason, fearful of an alliance between the two. Since populism is mainly a movement of small farmers and small businessmen, the availability of cheap credit is a major concern. It has been a southern and western movement and had its greatest strength when congressional seniority gave great power to otherwise undistinguished Congressmen from the one party in the south. They had great influence at the end of World War II and together with President Truman, who had a populist background, prevented any change in short-term interest rates until 1951 and made the Fed wary about raising interest rates for many years afterward.

Of course, the populists have never had the field to themselves. The financial community and the managers of large business have always been concerned with "money." Stable prices and stable exchange rates have been viewed as "good things" in themselves. Self-interest is involved, but not necessarily of the short-run immediate profit type. Banks have not always enjoyed tight money periods, and the interest of large businesses in either high interest rates or stable, sometimes overvalued, exchange rates, is not so clear. The self-interest of the management and financial community in sound money is in the connection between stable government, stable prices, and exchange rates. In the 19th century strong governments had stable prices, stayed on the gold standard and paid their debts like respectable middle class households. The "ruling classes" have acquired a more sophisticated view of things but have never really got rid of the idea that a well-run country should have stable prices and avoid exchange depreciation. If, as often happens, rising interest rates or limited money supply are the recommended cure for inflation, they are willing to support them. It may be worth noting that when populists become concerned with inflation, they propose price control as an alternative to monetary restraint. The

sound money contingent would bear a good deal of monetary pain to avoid that.

Though I have labeled them as ideological, the two groups I have just described are essentially pragmatic. The ideological character of the academic views on monetary policy is more clearly marked. The monetarists and Keynesians have carried on an intense controversy for many years. The academic camps and others have made some uneasy alliances but only for tactical purposes.

The Keynesians have, in fact, been allied at times with both camps. Since Keynesian methodology accommodates a fairly broad range of views of scientific issues as well as on values and policy a number of conservative Keynesians have allied themselves with and even become leaders of the "sound money" forces. On the other hand, "liberal" Keynesians who are more concerned with full employment and growth than with price stability have often been allied with politicians of somewhat populist persuasion.

Monetarists have a scientific doctrine, a set of values, and some beliefs about how monetary politics work. I shall say something later about their scientific doctrine. At the moment it is their values and politics that matter. Generally speaking, monetarists seem to have a low opinion of government and all its works. At the same time, they have great concern for price stability. Finally, they reluctantly conclude that money will not run itself—everything else will, but not money. Accordingly, it is necessary to provide a stable money supply in a way that minimizes the opportunity for pernicious government meddling.

In a practical context the main thrust of monetarism has been to argue against active measures to prevent or recover from recessions and to argue that money growth should not accommodate price increases due to supply shocks. That position has, of course, often put the monetarists at odds with most politicians. In recent years, however, they have acquired a certain popularity as a result of public disenchantment with all other proposals for inflation control.

A final problem in defining the nature of the political forces affecting monetary policy is the politics of the policymakers. Every officeholder or prospective officeholder has to adjust his statements and actions to the political environment in which he operates. There are, of course, notable examples of chameleon politicians who have no substantive interest in the problems in which they deal, but are only concerned with the effect of the votes they cast and the positions they take on their prospects for getting elected or reelected. More commonly, we suppose that they have genuine beliefs and values but are forced to compromise for "political reasons." If they agree with us, they simply act virtuously, but if we are disappointed in their actions, we say that they made a political compromise.

II.

It has often been suggested that the political forces just described

express themselves in terms of specific actions, e.g., a shift to more rapid money growth in the months before a Presidential election or a change in Federal Reserve policy coincidental with a change of Presidents. Such things probably occur at times, though the evidence for them is not overwhelming. In my view, however, political forces have conditioned Federal Reserve policy in a deeper and more fundamental sense than is suggested by the examples given above. I shall argue that the operating modes, e.g., use of free reserves and federal funds targets have had a political function which is as important as, or more important than, their economic function. I shall argue that the targets in use most of the time until 1979 have served to preserve the Federal Reserve System's political capital until needed for a major anti-inflation action. I shall then argue that the timing and duration of the exceptions to the target procedures have been influenced by political forces in fairly specific and visible ways.

For most of the last 30 years Federal Reserve policy has followed a pattern that can be described as "accommodation punctuated by occasional panic." In periods of moderate expansion the reserve base and discount rate have been managed so as to "accommodate" expansion of nominal demand with a very moderate and gradual rise in short-term interest rates. In those periods policy answers Chairman Martin's "leaning against the wind" description.

At times, however, an actual increase in the inflation rate or some indication that strong demand would lead to more inflationary pressure has led the Federal Reserve to shift quickly to a very restrictive policy. At other times the Fed has shifted in the opposite direction in response to the onset of a recession.

At one time, those three policy postures and some variants were well-described in official Federal Reserve terminology. Directives and other Federal Reserve statements spoke of "accommodation" or of open market operations directed toward "maintenance of current money market conditions." The leaning against the wind posture was described as one in which open market operations were to be aimed at producing "somewhat firmer" conditions. While the latter statement usually indicated a desire for some gradual rise in interest rates, it was also intended to indicate a desire to reduce bank liquidity and perhaps to increase member bank borrowing from the Fed.

In the periods of full accommodation, or nearly full accommodation, money supply growth was largely determined by growth of demand for money, since the Fed supplied the reserves required to meet the demand for money at its interest rate target (explicit or implicit). Given the very low short-term interest elasticity of demand for money, the effects of relatively modest changes in interest rates on money demand were small compared to those generated by rising income. Accordingly, the money supply was in large measure endogenous.

A large number of studies—many of them by monetarists—testify to the method used during most of the 1970s. For the better part of the dec-

ade, the FOMC established a narrow target level for the funds rate and the actual rate was within the band almost every month. The FOMC also set targets for monetary aggregates. When, as usually happened, actual money growth deviated from target, the FOMC adjusted the funds rate upward. However, the adjustments were so small as to have little influence. Adjustments were also made in response to movements of unemployment and inflation rate.

Given the rather small size of the funds rate adjustments, the System behaved very much as it had when Chairman Martin spoke of leaning against the breeze. With the exception of a few months in 1974 (described below) money supply was largely endogenous—driven by the growth of demand until late 1979. The discount rate generally followed in the wake of the funds rate. Because of the use of explicit funds rates targets, the method in use in the 1970s was more clearly understandable than the comparable one used from the accord until the end of 1965. I have described it first because the earlier method is easier to understand in light of its successor.

During the 1950s and 1960s, the FOMC used the language of "active ease," "firmer conditions" and so on but it also made use of "free reserves" targets. Policy could be described in terms of directives to conduct open market operations in such a way as to cause a rise or fall in free reserves. In a remarkable exercise of patience and ingenuity Brunner and Meltzer calibrated the picturesque verbiage of the FOMC directives and plotted them on a chart, also showing the movements of free reserves. The chart shows clearly that vague language was translated into relatively precise action.

The Board of Governors also moved the discount rate—generally following the Treasury bill rate. The method was much maligned, especially by monetarists. Considered as a system for controlling money supply, it was certainly not effective. But considered as a system for controlling short-term interest rates and exerting some pressure on changes in bank liquidity and on bank lending policy it made a good deal of sense.

On the upswing the supply of unborrowed reserves could be made to grow a little less than the amount required to meet the demand for bank reserves at the initial Treasury bill rate. The Treasury bill rate would rise, and banks would reduce excess reserves, and increase borrowing as the bill rate rose above discount rate. But because of the rationing procedures used at the discount window only a limited amount could be borrowed.

By choosing different combinations of unborrowed reserves and discount rate, the FOMC and Board of Governors together could manage the level of free reserves (and more importantly of borrowing) and the level of short-term market rates separately. The borrowing position was taken to be a measure of the pressure on banks to sell liquid assets to meet loan demand in excess of deposit growth. It was assumed that because banks had no alternative sources of funds, they would tighten credit standards when their liquidity reserves were seen to be declining.

The significance of these liquidity pressure considerations may be doubted, though they would have been considered perfectly reasonable in

banking circles in the late 50s. Indeed, the negotiable certificates of deposit and renewed interest of commercial banks in time deposits were the commercial banks' response to pressures of loan demand in excess of deposit growth in the 50s. The development of new sources of funds rendered free reserves as such obsolete as a measure of monetary tightness. It remained true, however, that the Fed could raise the interest rate by a two-step process. In step 1, growth of unborrowed reserves was limited, forcing up the Treasury bill rate. Banks borrowed more as the bill rate-discount rate spread increased, but that was incidental. In step 2, the discount rate was raised "to follow the market." It was thus made to appear that the Fed was manipulating the mysterious quantity called "free reserves" which was understood to have something to do with bank liquidity and willingness to lend. However, the Fed did not say anything about interest rates until it was deemed necessary to raise the discount rate to keep it in line with the market.

The use of free reserves targets and "market oriented" discount rate changes had a "scientific" background in the Federal Reserve view of how banks operated. As noted above, it had some support from the verbal testimony of bank officers.

At the same time, it met the political needs of the system. The shift from the low-pegged interest rates of the war and early postwar years to significantly higher ones and the acceptance of gradual changes in interest rates as a means of controlling inflation was perceived as a delicate task. The need for arguments like the "lock in" effect indicates the Fed's concern to allay fears that use of interest rates to control demand would require very high and possibly rapidly changing rates.

The approach used in the 1970s, though similar in many respects, had a different political rationale. The populist monster had become less fierce, but monetarists had become much more effective. Congressmen were able to express their dislike of Federal Reserve independence by demanding that the Fed report its targets for growth of monetary aggregates to congressional committees. They finally succeeded in forcing the Fed to do so. At the same time monetarism grew more popular among economists and increased in influence within the System.

The target and rate adjustment system used during the Burns regime appeared to give the monetarists a victory. But Burns, like Martin, was no more of a monetarist than he was a Keynesian. As monetarists have often noted, with considerable annoyance, control of the money supply in the seventies was no tighter than it had been in the fifties and early sixties. The only consequence of the Federal Reserve bow to monetarism of the seventies was to cause some aberrations in policy in response to random variations in money demand.

Another aspect of Federal Reserve policy was the emphasis on gradualism. The gradualism in question was interest rate gradualism. It was certainly motivated by concern for the stability of financial markets as well as by a concern about populist reaction to sharp changes in interest rates.

There was, however, another factor—admission of limited forecasting power. Anyone who thinks about making monetary policy in terms of national income analysis will find that he faces a very difficult task. The policymakers must face three facts. First, central bank action affects economic activity and prices with a long lag. Any estimate of the consequences of policy action must be based on forecasts of economic events over the next year or two. Second, economic forecasts are subject to considerable error. Forecasts of the differential effect of economic policy actions are subject to even greater error. Third, it is costly in both political and economic terms to change the direction of policy very frequently. Those considerations all lead one to conclude that gradual policy adjustments based on forecasts will give the best result most of the time. Only occasionally will oil shocks or wars lead to a very sharp change in policy. That view is, I think, supported by optimal control theory models.

Since the end of World War II, monetary policy during economic expansions has been characterized by the kind of partial accommodation described above. On several occasions, however, i.e., in 1966, 1969, 1974, and 1979 policy has shifted to severe restraint. In those instances there was good reason for serious concern with inflationary pressures. In each case a sharp rise in interest rates disrupted the mortgage market and brought on a recession. In the first three instances the policy was reversed fairly soon after the onset of the recession.

Political issues arise with respect to the timing of the shift toward restraint and the timing of the shift toward easier money. Political forces clearly affected monetary policy during the Johnson administration. The President had made his objections to rising interest rates clear even before he engaged in a public dispute with Chairman Martin. After that affair in late 1965 new arrangements for consultation were made. Reserve growth was limited in the spring and summer of 1965. That led to a burst of disintermediation, a decline in home construction, and the mini recession or "welcome slowdown" of 1967. The slowdown and a momentary reduction in the rate of price increase provided an excuse for a shift to a more accommodative policy. President Johnson's commitment to support a tax increase provided further justification for the action.

In fact, however, the tax increase did not occur until mid-1968. Meanwhile, accommodating monetary policy and expansive fiscal policy caused new inflationary pressures. In the light of hindsight, it seems clear that monetary restraint should not have been given up so readily. There were forecasting errors, especially in 1968, and errors of judgment as to the objective effect of the problems of the thrift institutions. Everyone was too optimistic about early passage of the tax surcharge and about the effect of the wage price guideposts. At the same time there were powerful political forces at work. The construction and thrift industries made themselves felt on Capitol Hill and in the White House. Johnson's acceptance of the tax surcharge was as much influenced by dislike of tight money as by dislike of inflation. At the same time the Federal Reserve wished to avoid a direct

confrontation with the President. By participating in planning for the surcharge, they moved closer to the administration and were inhibited in shifting to a strongly restrictive policy.

When at last the Fed did shift toward restraint, the surcharge and the belated change in monetary policy brought on a mild recession in 1970–71. As in earlier cases the Federal Reserve moved to expand money supply and reduce short-term interest rates as soon as the downturn began. The new President had no desire to fight inflation by recession and high unemployment. Indeed, there were few who did. Chairman Burns strongly advocated price controls rather than fiscal and monetary restraint as the remedy for inflation.

The decision to go for price controls and economic expansion surely reflected the political concerns of those involved. The experience of 1957–61 (when unemployment averaged 2 percent higher than in the preceding four years) could be taken to show that inflation can be slowed by a recession but that the recession must be prolonged. It could also be taken to show the high political cost of prolonged slack. Chairman Burns had not shown any enthusiasm for the use of unemployment as a price stabilizer when he advised the Vice President to press the Fed for expansion in 1960. His attitude was apparently unchanged when he urged price controls and expansion a decade later.

The Burns regime has supplied one of the more definite allegations of political influence on monetary policy. The money supply grew rapidly in 1972. It has been argued that money growth was accelerated to improve President Nixon's reelection prospects. In fact, however, funds rate adjustments in 1972 do not appear at all abnormal. It was the expansion of the economy, not the election, which caused the money growth.

The Fed pursued a policy of pseudomonetarism and interest rate gradualism until the end of 1979. In spite of severe criticism, the gradualism dominated the monetarism.

In late 1979 a policy of severe restraint was adopted. The FOMC announced that it would adhere much more closely to its announced targets for monetary aggregates. Given the level of those targets the new policy implied that real output growth must halt unless the inflation rate declined. However, the implication was not spelled out in Federal Reserve statements. In spite of some wavering in 1980, the record shows that on the whole M1 did follow the target path until mid-1982.

The peculiarity of this performance arises from the fact that few of the Federal Reserve Bank Presidents and none of the Governors had previously shown much attachment to monetarism. One can only attribute the apparent mass conversion to the need for some device to cover the severe and prolonged restraint required to bring down the inflation rate.

The use of monetarism by the Fed as a cover for a severely restrictive policy was a triumph of political astuteness as well as an act of courage. It did, however, have some unfortunate implications for the future. By mid-1982, the time to lower interest rates had clearly come. The inflation rate

had declined, unemployment was at record levels, thrift institutions were on the verge of failure and LDC debt problems threatened to cause a worldwide financial crisis. Very wisely the Fed bailed out and caused short-term interest rates to drop sharply in August of 1982.

Given the circumstances, only diehard monetarists were inclined to be critical at the time. However, the Fed, instead of announcing that it had lost its faith in monetarism, proclaimed a temporary suspension of the use of M1 targets on the ground that institutional changes would make M1 velocity very unstable during the next few months. That was certainly true and was well received at the time. Once recovery got well under way, however, monetarist demands for a return to M1 targets became much stronger. So far the Fed has resisted and kept short-term interest rates in a fairly narrow range. Given the present uncertainty, that is not an unreasonable posture from a discretionary point of view. A continuing mild recovery, a resolution of fiscal issues, and a period of low inflation would permit a gradual decline in interest rates regardless of the behavior of M1 or other aggregates.

If, however, we should have a relatively strong recovery with some acceleration of price increases and a continuation of the recent rapid increase in M1, there will be a real dilemma for monetary policy. In those circumstances pressures would be very strong for a return to M1 targeting. Since no one has the vaguest idea how long it will be before M1 demand settles down, such a policy would be very dangerous. Although it could be changed again in the right circumstances, there is always some lag in reaching that kind of decision.

III.

In view of the unstable behavior of the traditional monetary aggregates some economists have proposed the use of such broad financial aggregates as total liquid assets or total debt. Before considering the potential use of new aggregates it may be useful to say a word about the logic of target proposals derived from the traditional monetarist point of view. The monetarist argument may be divided into two parts. First, it can be argued that the best way to achieve both price stability and stable growth of real output is to stabilize the growth of nominal GNP. Second, it is argued that the way to control nominal GNP is to control a monetary aggregate. Those who propose the use of new aggregates accept the first proposal but differ on the second.

The view that we should try to stabilize the growth of nominal GNP can be defended in two ways. One can argue that prices are sufficiently flexible to keep actual output close to potential, provided that nominal GNP grows steadily. Prices pivot on the base of a fixed or predetermined nominal GNP. Many pragmatic neoclassical economists worked to improve monetary institutions to stabilize money supply growth. Others apparently thought that it might be necessary to adjust the money supply to offset undesirable changes in velocity.

A more tactical argument for the use of nominal GNP targets or for upper limits on nominal GNP growth is to provide a rationale for anti-inflationary action. At times it may be important to establish a barrier against increases in the rate of inflation regardless of cause. In that case, a commitment to a path or upper limit for nominal GNP growth will trigger restrictive action whenever the price level or real output increases faster than expected. It is important to note that this view can be accepted as an *end* of policy by people who do not accept monetarist analysis of the *means* for controlling nominal GNP. Indeed, some well-known Keynesians have taken that view. One might call the position in question "nominalism." Monetarists would then be a sect within the broader nominalist church.

A Keynesian nominalist might advocate a variety of measures to control nominal GNP. Indeed, all the usual instruments could be used with a nominal, instead of a real, GNP objective. However, one might also suppose that for the purpose of controlling nominal GNP, it would be desirable to avoid all sorts of indexing. For those who play textbook games with IS-LM curves and aggregate demand curves, it will be apparent at once that a fixed dollar budget is likely to be a major element in the aggregate demand curve.

Old-fashioned monetarist nominalists have supposed that nominal GNP could be controlled by fixing nominal money supply. They have argued that the money supply has played the central role in determining the movements of nominal GNP. In fact, hardly anyone wants to deny that money plays an important role in economic events. No one denies that monetary problems played an important role in supporting speculative booms and causing financial panics in prewar business cycles. Few would deny the role played by credit crunches in the postwar recessions. Nor would anyone deny that without an accommodating monetary policy the inflationary impulses from the Vietnam War or from supply shocks would have worked out differently. Indeed, our experience since 1979 is a demonstration of the power of money.

Nonetheless, monetarists themselves have argued, as I noted earlier, that for three-quarters of the time, money has been actively determined by Federal Reserve policy and in that time has accounted for much of the variance of nominal GNP from its trend. The record shows that when money growth does not accommodate the demand generated by other factors, it can act as an effective brake—though often jolting the passengers rather badly. There is, however, no reliable evidence that M1 can (under the best of circumstances) be a reliable instrument for generating a steadily growing nominal GNP.

The Keynesian critique of the causal significance of observed relations between money and nominal GNP has been strongly reinforced by the instability of the relation between M1 and GNP. That has led some economists to argue that we should accept the "nominalist" goal of steady growth of nominal GNP but seek to achieve it by any means available.

From an economic point of view, nominal GNP targets are unsatisfac-

tory because they are based on an arbitrary tradeoff between inflation and output in the short run. They have value mainly because of their simplicity and because at times a firm commitment against rising rates of inflation is required.

If we were to make a serious effort to coordinate monetary and fiscal policy, a good case could be made for seeking to reach agreement on nominal GNP goals simply because they provide a language related to the units in which both bank reserves and budgets are expressed. However, it would be unwise for the central bank to announce nominal GNP goals unilaterally. Such a move at times put the bank in direct conflict with the administration's announced policy goals. Moreover, it brings the conflict between output growth and price increases nearer the surface. In fact, just because nominal GNP goals might make a good vehicle for coordinating monetary and fiscal policy, they make a bad vehicle for a central bank which knows that the President, rather than the Board Chairman, will make coordinating decisions.

New Aggregates

In response to recent instability of monetary aggregates it has been suggested that new and much broader aggregates should be adopted as targets for Federal Reserve policy. The two prime candidates are "Total Liquid Assets" and "Nonfinancial Debt." Both have had relatively stable ratios to nominal GNP and might therefore be thought to be effective instruments for controlling GNP. One can also make arguments which provide a rationale for the role of these aggregates in controlling the economy. In the case of liquid assets the argument is straightforward. According to the "portfolio approach" to asset management, the supply of liquid assets plays a critical role in determining asset prices. Asset prices in turn play a central role in decisions with respect to saving and investment and therefore in aggregate demand determination. All one has to do is to substitute liquid assets for money in the writings of either Tobin or Milton Friedman or Brunner and Meltzer and one has the story.

It would not be difficult to produce a rationale for an upper limit on the ratio of private debt to GNP but the ratio which is stable in the data includes government debt. No one has come up with a good rationale for that kind of regularity. Still it exists and may be another example of the proposition that economics consists of elegant theories which do not fit the facts and empirical rules for which there is no explanation.

In discussion of monetary aggregates it is necessary to distinguish the use of aggregates for control from their use as proxies for or predictors of nominal GNP.

No one has ever controlled total debt or total liquid assets, and no one knows how they could be controlled in any direct way. So far as one can tell total debt and total liquid assets are related to GNP and its components. Any factor which affects spending is likely to affect the demand for liquid

assets. The market is likely to respond through intermediation and other changes in methods of finance. If the authorities succeed in controlling the established patterns of intermediation, there may be a change in term structure. Alternatively credit rationing may limit the growth of GNP and maintain the ratio by holding down the denominator.

Monetary aggregates may be used to predict rather than to control nominal GNP. It can be shown that total debt forecasts nominal GNP as well as or better than M1. In view of the recent instability of demand for M1 it has been proposed that debt be used instead of M1 as a predictor of GNP. Alternatively it has been suggested that both should be used. Debt would provide a "second opinion." Two may be better than one but the second opinion approach looks very much like a rather simple form of forecasting by financial leading indicators. Finally, debt or liquid assets may be used as proxies for nominal GNP.

Those who argue that the central bank should announce target paths for variables such as debt and liquid assets are obviously students of the political economy of central banking. They propose to set target paths for variables that appear to move with GNP. Those variables are simply proxies for GNP. In effect, then, it is proposed that the central bank should control GNP.

They also propose to do it in a way which looks like monetarism. Moreover, the indirect formulation reduces the likelihood of direct conflict between the announced targets of the administration and those of the Fed.

There are, however, some serious dangers in a commitment to new monetary aggregates. First, as already noted, no one knows why the ratio of total debt to GNP has remained stable in the postwar period. It is not one of nature's constants and has shown a good deal of variation from place to place and time to time. The liquid asset ratio moved a good deal last year, the debt ratio may be next. Second, the Fed has no idea how to control either debt or nominal GNP with any precision. Promising to do something one does not know how to do does not seem a very wise course to me.

What should be done? We must start from the proposition that our quantitative knowledge of how the economy works and of how to control it is sadly limited. We cannot perform the "fine tuning" which econometric models once appeared to promise. Nor do we know how to design a satisfactory automatic pilot. The fact is that no matter how the public relations are handled, the makers of monetary policy will have to feel their way, moving cautiously until the need for drastic action becomes obvious. In my view, the little that we know still tells us that interest rate gradualism, guided by all available signals indicating the probably course of prices and outputs, is the best procedure. Three important changes from past procedure can be made. First, interest rates can be moved over a wider range than in earlier times. The market has become used to rate variation and will not panic over small movements. Second, real rates, though hard to calibrate, are the important thing and should be emphasized in discussion of

rate policy. Third, the public is better informed and the press is trying to make news out of monetary policy. The Fed should give up its sibyline stance and try to explain what it is doing. Why should the interpretation of monetary policy be left to brokers? At the moment it is important to discuss policy in terms of the changes in real interest rates and the allocational issues posed by the budget. Honesty may not always be the best policy but in the current circumstances it may be worth a try.

Discussion

Frank E. Morris*

Unlike most central banks, which are responsible to the Executive, the Federal Reserve is a creature of the Legislature. As such, the Federal Reserve cannot follow, *for any extended period of time*, a policy that is not acceptable to the Congress. For shorter periods, the Federal Reserve can establish policies unpopular with the Congress, and for longer periods the Federal Reserve can follow policies that the Congress could not bring itself to vote for, but that it finds tolerable, if only barely tolerable. The Congress is typically a slow-moving body. Normally, it takes a considerable time for a consensus to develop on any policy issue. Within this time frame the Federal Reserve has freedom to impose policies that it might not be able to adhere to for long. The scope for independent action by the Federal Reserve is, thus, very important even though it is constrained.

William McChesney Martin, Chairman of the Federal Reserve Board for an unprecedented (and not likely to be repeated) 19 years, used to describe the Federal Reserve as "independent within the government, but not independent *of* the government." By this rather obscure statement, I think he meant the constrained sort of independence described above.

A case in point is the dramatic action taken by the Federal Reserve in October 1979 in response both to an acceleration of inflation domestically and an impending collapse of the dollar on the foreign exchange market. The Federal Reserve had the power to act in that situation without prior consultation with the Executive or the Congress. It was quite another matter, however, to adhere to a very restrictive policy for the three years following the October 1979 actions. This was possible only because an anti-inflation constituency had developed for the first time in the United States. The average citizen had chosen to give inflation control number one policy priority for the first time in anyone's memory, and was willing to accept some considerable sacrifices in terms of output and employment to get inflation under control. The Congress, sensing this, permitted the Federal Reserve to follow during the 1979–82 period a much more restrictive policy than it would have accepted in any prior period.

One might ask why the Federal Reserve did not move this vigorously against inflation prior to 1979. The answer, I believe, is that it could not have. In the absence of a strong anti-inflationary constituency, which did not exist in the United States before 1979, such a vigorous anti-inflationary policy could not have been sustained. Without such a constituency, the special interest groups mentioned by Professor Duesenberry, particularly

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what he calls the "real estate connection," would have had a much greater influence on the Congress. So would the populist forces that tend to look upon high interest rates as solely a function of the greed of bankers. In the post-1979 period the influence of these groups was submerged by the new anti-inflationary constituency and, despite a 10 percent unemployment rate, their influence remains submerged.

I am pleased that Professor Duesenberry has thrown cold water on the mythology that the Federal Reserve has stimulated the economy prior to elections in order to help incumbents get reelected. The most discussed case is the Presidential election year of 1972. In retrospect it is undeniable that monetary policy was too expansionary in 1972, but the causation was not a desire on the part of the Federal Reserve to reelect President Nixon. As one who *both* attended every FOMC meeting in 1972 and voted against the reelection of Nixon, I can assure you that nothing of the kind happened. The policy mistake was due to a misestimate of the natural rate of unemployment. The unemployment rate in mid-1972 was 5.6 percent, with the consensus at the time that the natural rate of unemployment was 4 percent to 4½ percent. It was only much later that the consensus was changed and it was realized that we had had in mid-1972 little room in the economy for an expansionary policy.

Professor Duesenberry concludes his paper by discussing the issue of the appropriate targets for monetary policy, and it is only here that we have some differences. Money supply targeting has provided a considerable amount of political sheltering for monetary policy. There is a broad public understanding of the concept that the growth of the money supply must be gradually decelerated if inflation is to be brought under control. Congressional oversight of policy in focusing on monetary growth rates has, more or less automatically, been induced to view the appropriateness of policy from a longer run point of view than if attention had been focused on interest rates, which was the principal focus of earlier years. This was a very constructive change in the orientation of Congressional oversight, and is not something that the Federal Reserve should willingly seek to change.

In referring to the decision of the FOMC to move to monetary targeting, Professor Duesenberry says: "The peculiarity of this performance arises from the fact that few of the Federal Reserve Bank presidents and none of the Governors had previously shown much attachment to monetarism. One can only attribute the apparent mass conversion to the need for some device to cover the severe and prolonged restraint required to bring down the inflation rate."

He is giving us too much credit for political astuteness. We did not know in October 1979 that we would be following a very restrictive policy for most of the next three years, nor did we appreciate then the political sheltering that the move to monetary targeting would provide.

The October 1979 decision reflected a response to the failure of the policy of interest rate gradualism. The policy had been successful in earlier years because of the vulnerability of the thrift institutions to relatively

small interest rate changes. When market rates moved above the ceiling rate on thrift deposits, funds would flow out and the availability of mortgage money would shrink. The decline in the housing industry would soon cool off the economy.

However, once the thrift industry received authority to pay market rates of interest on certain accounts, as it did in 1978, the prompt response of the housing industry to small interest rate changes was lost. Mortgage money would be available at a price.

The basic problem of interest rate gradualism was that the Committee never knew how much of a change in interest rates was required to meet our economic objectives. It did know that major moves in interest rates would make sizable waves in financial markets. As a consequence, although interest rates were usually moving in the right direction, the amplitude of the changes was typically too small to have the desired result.

The shift to monetary targeting was seen by most of the FOMC members as a device to deal with this problem. The FOMC manager was instructed to follow a reserve path designed to produce the desired growth in the money supply. He was given an interest rate constraint, but typically it was 400 to 500 basis points centered on the existing rate. The Committee voted for a money growth path and was prepared to accept, within broad limits, whatever interest rate levels fell out of that path. As a consequence, interest rates moved much more rapidly than could have occurred under the earlier regime.

Ironically, this switch to monetary targeting occurred precisely at the time that we would have increasing difficulties in measuring the money supply.

The rationale for controlling money is that the rate of growth of transactions balances is predictably related to the nominal GNP. The problem is that financial innovation has made it impossible to measure transactions balances in the United States, i.e., to differentiate transactions balances from short-term investment balances. It is not surprising, therefore that what we call M1 today, which includes large and growing amounts of interest-earning assets, should behave differently relative to the nominal GNP from the old M1, none of which was interest-bearing.

If our measure of the money supply is no longer predictably related to the nominal GNP, it is no longer suitable as an intermediate target of monetary policy. Among the suggested alternatives are to target on the nominal GNP, to target broader monetary and financial aggregates which are both predictably related to the nominal GNP and unaffected by financial innovation or, as Professor Duesenberry recommends, to return to interest rate gradualism.

Duesenberry correctly assessed the problems in adopting a nominal GNP target when he wrote: "It would be unwise for the central bank to announce nominal GNP goals unilaterally. Such a move would at times put the bank in direct conflict with the administration's announced policy goals. Moreover, it brings the conflict between output growth and price increases

nearer the surface."

I think his judgment is faulty, however, when he proposes returning to interest rate gradualism. I see no reason to believe that it would be more successful now than it was in the late seventies. Until we return to the kind of economy in which small changes in interest rates can produce large changes in real economic activity, interest rate gradualism is likely to again produce procyclical policy.

In my judgment, the proper response is to move to the broader aggregates as intermediate targets, specifically, M3, total liquid assets and total domestic nonfinancial debt.