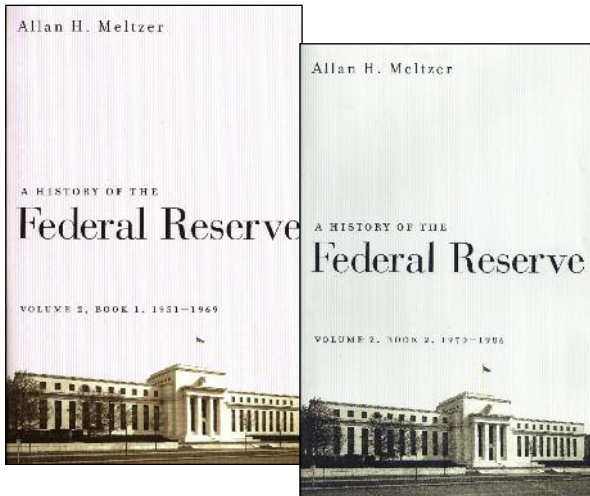


BOOKREVIEW

The Birth of the Modern Fed



A HISTORY OF THE FEDERAL RESERVE: VOLUME 2, BOOK 1, 1951-1969
CHICAGO: UNIVERSITY OF CHICAGO PRESS, 2010, 682 PAGES

A HISTORY OF THE FEDERAL RESERVE: VOLUME 2, BOOK 2, 1970-1986
CHICAGO: UNIVERSITY OF CHICAGO PRESS, 2010, 628 PAGES

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The first volume of Alan Meltzer's comprehensive two-volume history of the Federal Reserve, published in 2003, focuses on the years between 1913 and 1951 when the Fed was mainly a vehicle for the federal government to finance wartime federal debt. The Fed would buy Treasury bonds at the command of the government with little attention paid to the effects that this manipulation of the money supply would have on the economy. Part of that was due to a lack of knowledge or a coherent theoretical model to guide monetary policy. A large part, however, was due to the immense political pressure applied to the new institution. Such political pressure is something that the Fed has had to endure since the beginning, and how it deals with those pressures is a major theme in Meltzer's first book.

The second volume being reviewed has been published as two books. Book one begins in 1951, the year in which the Fed as we know it today began to take shape. The big turning point was the March 1951 accord with the Treasury Department that, as described by Meltzer, "changed the Fed's formal status from subservient to co-equal partner with the Treasury." Yet, as both books of Meltzer's second volume make plain, *de jure* independence isn't always an indicator of *de facto* independence.

The chairmanship of William McChesney Martin is the

subject of most of book one. It's a period in which the Fed was seen as largely independent — dramatically so when compared to previous wartime years — and stands as the first test of the newly independent Fed's ability to maintain price stability. Between 1951 and 1965, inflation dropped from more than 8 percent to being constrained within a range of zero percent to 4 percent.

This accompanied a shift in Fed policy to the "bills-only" doctrine, which meant that the Fed would conduct open-market operations only through the purchase of short-term Treasury bills. This left the long-term Treasury rates to be set by market forces and was a departure from the years when the Fed was used as a tool to cheaply finance wartime spending.

Yet Meltzer also highlights a contrary and important element of Martin's tenure. Martin described his view of Fed independence as qualified. It assumed the Fed's independence within the government, not from the government. There were times when Martin was willing to coordinate policy with the executive branch.

In fact, Martin saw an important function for the Fed's open-market operations as a way to pursue an "even keel" policy wherein the Fed would stand ready to make sure that auctions of Treasury bills would not fall flat. This meant that the Fed would implicitly commit to buying enough T-bills to satisfy a specified interest rate target desired by the Treasury. Between 1951 and 1965, this didn't influence monetary policy very much. The federal government under President Dwight Eisenhower was balancing its books, obviating the need for the Treasury to issue debt that the Fed could buy. Meltzer argues, however, that Martin's willingness to collaborate with the executive branch — usually implicitly — opened the door to policy mistakes that precipitated the Great Inflation of the 1970s.

President Lyndon Johnson was never shy about applying pressure to Martin. To his credit, Martin was generally impervious to the attempts to directly influence Fed actions before 1966. Yet the monetary loosening began when his even keel approach dominated and the federal government began to run deficits to finance the Vietnam War and social spending through the Great Society transfer programs.

It wasn't obvious initially that this could lead to inflation. The lack of a coherent or accurate model to predict how monetary policy might influence the economy, Meltzer argues, is a reason why Martin, normally vigilant about inflation, allowed the Federal Open Market Committee (FOMC) to embark on an easy money policy. Fed policymakers "did not distinguish between real and nominal [interest] rates until much later." Higher nominal rates led Fed economists

to overestimate the degree of restraint that FOMC actions were creating.

What was missing from the analysis, Meltzer points out, was an understanding that higher anticipated inflation would drive up nominal interest rates. Once monetary policymakers fell behind the curve by misinterpreting the signals that interest rates were sending, their control over inflation slowly began to ebb.

An additional strain came in the form of the Employment Act of 1946. The law set up a new dual mandate for the Fed: the pursuit of price stability and maximum employment. Over time, the political emphasis on keeping unemployment down would become a strong pressure on the Fed. And, as an empirical matter, Fed policymakers in the 1960s began to sense that they could lower the unemployment rate if they followed a looser monetary path. At the time it wasn't clear to many Fed economists that such a policy could become unsustainable. But, as Meltzer notes, the employment mandate would gradually become the main concern of the Fed in the next decade.

The period during which the Fed made the pursuit of full employment its main guiding principle occurred once Martin was replaced by Arthur Burns as Fed chairman in 1970. The Nixon administration was keen on reducing unemployment. (Indeed, Nixon believed a too-tight monetary policy under Martin destroyed his chances to win the presidential election against John F. Kennedy in 1960 although he was fresh off a second term as Eisenhower's vice president and was effectively running as an incumbent.)

Nixon and his advisers wanted a loose monetary policy to achieve higher short-term employment. Burns was quite willing to provide such support and did tremendous damage to the Fed's credibility as an independent institution. Meltzer flavors his chapters in this period with transcripts of White House meetings, recorded by Nixon's infamous Oval Office microphones, in which it is clear that Burns was actively seeking input from the president and his advisers.

Burns did believe the Fed could do little to stem the inflationary tide. His view was that a rising cost of labor, bolstered by rigid contracts written under pressure by powerful labor unions, was the main force driving prices higher. This "cost-push" explanation of inflation led Burns to support wage and price controls as a means to arrest price increases while the Fed tried to drive down unemployment with an expansionary monetary policy. As Meltzer points out, Burns was more than just a willing accomplice — he was a forceful advocate behind the scenes. Burns, Meltzer writes, had "little opposition" on the FOMC. Most of the members voted with the chairman out of deference or mainly because they believed that monetary policy did indeed need to be eased to further spur employment.

We know in retrospect these expansionary policies were misguided and contributed to high and persistent inflation. This was not without its critics at the time. Adherents to the monetarist school, led by economist Milton Friedman, were developing the models that implied the unemployment-

inflation trade-off was unsustainable. Another set of scholars who began to have substantial influence in academic macroeconomics during this time were those from the "rational expectations" school. Both they and the monetarists came to the same general conclusion: As soon as the market built into its assumptions a new, higher price level, the employment boost would abate but the inflation would remain.

This point was understood and respected by Paul Volcker, the Fed chairman who is most responsible for not only restoring a hard-money approach to policy but also restoring the badly damaged reputation of the Fed as an independent institution. Appointed by President Jimmy Carter in 1979, Volcker immediately changed the way the Fed approached its task. The main shift was a stated focus on restraining the money supply, an approach that was endorsed heartily by the monetarists.

Both Carter and his successor, Ronald Reagan, tended to let Volcker pursue the policy. Meltzer suggests that part of the reason there wasn't a broader political backlash against the policy or the Fed was because there was a popular consensus by that point that inflation was a bigger evil than unemployment. Since then, inflation control has been seen as the primary role of the Fed. In fact, to underscore his belief that the intellectual battle over the importance of price stability had largely been won, Meltzer ends this second volume of his history in 1986, just as Alan Greenspan assumed the chairmanship of the Fed.

The second volume of Meltzer's history suffers from some of the difficulties of any history aimed at being truly comprehensive. It can be redundant at times and has a tendency to read a bit like an authoritative list of events and policy actions with details that would appeal only to a select set of readers. However, everyone can benefit by the introductory material in each chapter and the synthesis of the most important elements at the end of each chapter. Overall, it would require an uncharitable reading to deem the books anything other than a success, a monument to a lifelong study of monetary history.

Also, just because it ends in 1986 doesn't mean that Meltzer has nothing important to contribute to the current policy debate. "Perhaps the most enduring lessons for central bankers from the Great Inflation and subsequent disinflation was that the responsibility for stopping inflation fell on them," he writes. Indeed, his history serves as an important reminder that it took the Fed a long and painful time to learn that lesson. As such, Meltzer ends the book with a chapter outlining what he sees as some unsettling trends, foremost among them the potential that recent Fed actions have to undermine the institution's independence. It is even more important now, suggests Meltzer, to redouble efforts to reclaim Fed independence in the wake of current policies. The hard-won lessons of the past depicted in this book are an important reminder of why the Fed must remain steadfast in its independence of the political branches if it is to effectively pursue a policy of price stability. **RF**