July 17, 1997

DISCUSSION NOTES - ALLAN MELTZER'S PAPER
WEA CONFERENCE - Seattle, Washington
July 10-12, 1997

Chapter 4 of Allan's study of the Fed covers the period 1923-1929. It has several themes and issues that bear on how we think about other periods.

<u>I'll discuss five issues:</u>

1. International Issue:

   inconsistency between price levels in United States and Europe and the desire on both sides of the Atlantic to return to 1914 gold price parities.

2. Inflation diagnosis issue:

   disparity between goods prices and asset prices.

3. Money diagnosis issue:

   disparate behavior of broad and narrow measures of money.

4. Theoretical issue:

   Riefler-Burgess vs. real bills doctrine.

5. Understanding issue:

   OMO and inflation

<u>I won't discuss other issues:</u>

1. Improved credibility thesis

2. Favorable productivity surprise thesis

1. International Issue

In the decade from 1914 to 1924, the United Kingdom had experienced considerably more inflation on balance then the United States or France. Nevertheless, all three countries wanted to return to their respective 1914 gold prices. That is equivalent to returning to the 1914 exchange rates between the dollar, the pound Sterling and the French franc.

But, since the Sterling prices of internationally traded goods had risen considerably more on balance than the dollar or French Franc prices of those same goods, to return to 1914 parities would mean either the dollar and French Franc prices had to rise or Sterling prices had to fall.

Given the objectives of the respective countries, gold flowed out of the United Kingdom and into the United States. Ordinarily, that would have simultaneously reduced the price level in the United Kingdom and raised the price level in the United States. Allan argues that the Federal Reserve sterilized the gold inflow into the United States, in effect forcing all the adjustment on the British, which meant substantial deflation.

My guess is that Allan does **not** believe the United States should have accepted the full inflationary implications of the gold inflow, but, rather, it was simply wrong on both sides of the Atlantic to attempt to return to 1914 gold prices.

- this, he argues, was the predominant cause of the crash of 1929 and the subsequent Great Contraction.

2. Inflation Diagnosis Issue

Allan argues that at least by 1926 the Federal Reserve was pursuing a deflationary policy, as evidenced by the falling PPI and CPI:

- he documents that at least some members of the Federal Reserve Board of Governors viewed the stance of policy as inflationary, as evidenced by rising equity and other asset prices.

- implicit in part of the chapter is that <u>if</u> monetary policy had been less restrictive, then earnings expectations could have been realized and the crash of 1929 avoided.

- some in the Federal Reserve (as well as Friedman & Schwartz) argue that the crash became unavoidable after excessively expansionary central bank credit growth had permitted an equity market bubble that could not be sustained.

- Friedman & Schwartz are not clear on either their diagnosis or their prescription when they state that policy before 1929 was "too easy to break the speculative boom, yet too tight to promote healthy economic growth".

3. Money Diagnosis Issue

- Monetary base grew slowly (1926-1928).
- Narrow money fell or grew even more slowly.
- Broad money grew more rapidly.

In other words,

- narrow money multiplier fell, while
- broad money multiplier rose, and what was happening to the demand for central bank money is not clear.

Cagan and Friedman/Schwartz treated the public's and commercial bank's behavior -- shifting from high reserve transaction liabilities to low or no reserve time deposits -- as though it was an exogenous event that raised the broad money multiplier, while reducing the narrow money multiplier, and thereby

- expanding broad money growth faster than people really wanted to hold (excess supply) while at the same time contracting narrow money (excess demand?), and I'm not sure what they thought was happening to demand for base money.

Allan suggests that the interest rate policies pursued by Federal Reserve Banks -- (raising opportunity costs of holding high reserve transactions liabilities induced the banks to adopt practices to "encourage depositors to shift from [demand to time], (footnote 185, page 171) -- reducing average reserve requirement ratio and permitting bank assets to rise relative to Money growth."

This sounds like commercial banks had to find ways to <u>economize</u> on holdings of base money because the growth of supply was restricted -- <u>excess</u> <u>demand</u> for base money.

But, if bank policies and technologies were operating like sweep accounts today [Cagan, Friedman/Schwartz], then the <u>demand</u> for central bank money was falling, -- even slower growth of monetary base was <u>excess</u> <u>supply</u>.

This gets at the heart of central banking.

4. The Theoretical Issue

Which, as documented by Allan, is different than either of the interpretations of M growth, because neither the view held by the Board of Governors nor the Reserve Banks relied on money as an indicator.

Instead,

Board of Governors was sold on the "real bills doctrine" and felt central bank credit could and should be used only to finance real economic activity such as plant and equipment and working capital. If so limited, there could be neither an excess supply of nor excess demand for currency, so the purchasing power would be stable.

Allan documents that the Board of Governors criticized Federal Reserve Banks for [perhaps naively and inadvertently] financing equity market speculations -- and therefore risking inflation.

(Riefler-Burgess)

The Reserve Bank response [especially New York and Benjamin Strong] was that "cutting edge" of monetary policy was commercial bank "reluctance to borrow" from FRBs; then, commercial banks contracted earning assets to pay off borrowings -- restraining economy.

5. Understanding Issue

- what causes inflation, or
- how is price level stability maintained

Allan documents some Federal Reserve officials stating:

that: OMO have nothing to do with rate of inflation.

that: money growth has nothing to do with interest rates.

that: legislation should NOT (1926) mandate price stability because that would mean the Federal Reserve Banks would be required to stabilize the prices of specific commodities such as cotton!

In fact, their testimony against proposed legislation requiring stabilization of the purchasing power of the dollar is similar to arguments economists would use today to argue that wage and price controls are harmful to the economy.

Other Issues

- Reserve Bank's desire to buy (or reluctance to sell) securities for earnings reasons

- View of some that what the Federal Reserve Banks did was unrelated to the quantify of money.

- Keynes praise of Federal Reserve policies from 1923-1928.

- Arrogance: Governor Miller re: Ben Strong [p. 79]

- Carter Glass (great structure in spite of ignorance about monetary policy).