

THE MAKING OF A "MAVERICK" MONETARY POLICYMAKER

Remarks by Thomas C. Melzer
The Newcomen Society of the United States
St. Louis, Missouri
November 8, 1989

I want to express, on behalf of the Federal Reserve Bank of St. Louis, our appreciation to American Newcomen for honoring the Bank tonight in connection with our 75th anniversary. I should confess that I was somewhat puzzled when I first learned that we were being considered for recognition. Honorees are typically firms that have made substantive and lasting contributions to the free enterprise system, so my initial thought was "Why us?" After all, Federal Reserve Banks are quasi-governmental institutions with significant bank supervisory responsibilities; I am sure many bankers question whether the Fed, in fact, contributes to their free enterprise!

But there is one area in which the St. Louis Reserve Bank has made an important contribution toward maintaining and strengthening the free enterprise system. This is the distinctive role that we have played in monetary research and in the formulation of U.S. monetary policy over the past three decades--one which we continue to play today.

Unfortunately, in monetary policy, just as in other aspects of life, being perceived as "unique" or "different" is not always an advantage. For much of the past several decades, for example, the St. Louis Fed has been labeled, often not in a flattering way, as a "maverick"—meaning, presumably, "one who takes an independent stand from its associates." Our associates in the domestic monetary policy business are the other 11

Reserve Banks and the Board of Governors in Washington. In the international sphere, our associates are the other central banks around the world.

Now, what in the world would persuade a group of people here in St. Louis to become monetary policy mavericks in the first place? Why would they maintain that reputation for so long? And has this nation, and its free enterprise system, truly benefited from the maverick efforts of the Federal Reserve Bank of St. Louis? These are the questions that I hope to answer this evening.

To understand how the St. Louis Fed came to be a maverick in the first place requires a slight detour through the often baffling worlds of central banking, monetary policy and the economy.

Every society, ancient or modern, democratic or autocratic, small or large, uses something called money. It is an extremely clever social invention that enables people to exchange goods and services efficiently and, hopefully, easily. Virtually no primitive society has ever been without money; certainly no highly-specialized, modern society could exist without it.

The best kind of money is one that has certain well-defined properties; for example, it should be easily recognizable, divisible and portable--to name just a few. Its most useful property, however, is that it should maintain its value over time. And, the best way to make sure that money actually maintains its value is to place some limits, either natural or unnatural, on its supply.

In times past, various commodities, for example, gold and silver, were used as money. Because these commodities were costly to produce, there were always natural constraints on their supply. To be sure,

however, new gold and silver discoveries were occasionally made, and these discoveries invariably produced temporary bouts of inflation. But, over long periods of time, price levels tended to be fairly stable, which means that commodity money maintained its value fairly well.

Of course, as time has passed, we have become much more financially sophisticated. We now use paper fiat money; but because the supply of paper is virtually unlimited, we need some "unnatural" constraint to maintain its value. This constraint, of course, is the central bank; and monetary policy is the name given to the actions it takes to influence and control the supply of money.

The St. Louis Fed's advocacy of maverick monetary policy can be traced back to two developments in the post World War II era. First, there were advances in monetary theory, and second, there were unexpected consequences of monetary policy actions taken during this period.

Immediately following the end of the war, there were widespread fears (and some forecasts) that another depression, similar to that of the 1930s, was likely. The common economic wisdom at that time, termed Keynesian economics, suggested that fiscal policy--which focused on federal government revenues and expenditures--determined economic activity and employment. While monetary policy was not thought to matter very much, it was presumed to influence interest rates; consequently, monetary policy was assigned the role of stabilizing interest rates at low levels to supplement fiscal policy. There was virtually no concern about inflation at that time because, except for wartime periods, inflation had never really been a major U.S. problem.

Unfortunately, for both economic orthodoxy and the nation, inflation became more and more of a problem as time passed. At first, the rise in

inflation was slow, almost imperceptible. However, the rise in inflation and the associated faster money growth convinced several economists, notably Milton Friedman and Karl Brunner, that the conventional wisdom was wrong. Their research led instead to some very unorthodox conclusions about the impacts of money growth on the economy.

The chief result of these studies was that monetary policy had extremely powerful effects. In the short run, it directly influenced spending and general economic activity; in the long run, it chiefly influenced inflation alone. The general thrust of their results was that inflation--defined as a continuing rise in the general level of prices--was always and everywhere a monetary phenomenon. Furthermore, they concluded that policy actions taken in ignorance of the actual effects of money on the economy were likely to yield unpleasant results for the nation.

This criticism of monetary policy actions was almost entirely academic; coming chiefly from outside the Federal Reserve System, it was largely ignored. Certainly, it had virtually no direct influence on the conduct of monetary policy.

However, at about the same time that academic economists were questioning monetary theory and criticizing policy actions from outside the Fed, there was a conversion of sorts going on within the System itself, if only in St. Louis. This "palace revolt" did not occur overnight, nor was its full range and extent ever really planned as such. It actually started out simply as a disagreement about the role of the regional Reserve Bank presidents in the monetary policy process.

The fifth president of the St. Louis Fed, D.C. Johns, apparently felt that his advice and opinions, as well as those of the other regional

Bank presidents, were largely being ignored by the Board of Governors. His response to this problem turned out to have much greater consequences for the St. Louis Bank and for monetary policy than he, I am sure, ever imagined.

Mr. Johns decided to find someone who could seriously question and effectively challenge the prevalent notions about monetary policy. The person he found was Homer Jones; in 1958, Homer was appointed as the St. Louis Fed's Director of Research.

At that time, Homer was already well known for his views on the importance of monetary growth. He was thoroughly familiar with the University of Chicago monetary tradition. Indeed, he was both a former teacher and student of Milton Friedman. Moreover, in Homer's previous position at the Federal Deposit Insurance Corporation, he had been closely associated with Clark Warburton, who had been advocating greater monetary control since the late 1920s. D.C. Johns and Homer Jones thus began the "tradition" that has been maintained and strengthened by subsequent presidents and research directors at the Bank.

Homer possessed several characteristics that contributed directly to the St. Louis Federal Reserve's reputation for original, innovative monetary research and to its reputation as a monetary maverick. He possessed a sharp inquisitive mind. He was deeply skeptical of any claim unless it had convincing empirical support. And, perhaps most important of all, he demanded that the studies published by the Bank be written clearly enough that all interested individuals could understand their importance.

D.C. Johns' immediate successors--first, Darryl Francis and then, Larry Roos--greatly expanded the Bank's influence in monetary theory and

policy affairs. As a result of their enthusiastic interest and support, the research department attracted a staff of monetary economists that challenged the conventional economic wisdom from within the System. In addition, numerous academic scholars visited the bank for extended periods and contributed to the study of monetary policy's influences on the economy.

It was in the Bank's Review that Karl Brunner first coined the term "monetarism" to describe the new view that money growth and monetary policy had extremely important effects on the economy. It was in the Bank's Review that numerous articles, starting with the seminal Andersen-Jordan study of the relative effects of monetary versus fiscal policy, provided extensive empirical support for the monetarist view. As a result of this research, St. Louis Bank presidents--from Darryl Francis to the present--have consistently, even persistently, urged that the Federal Reserve System should adopt and adhere to publicly-announced monetary base or money growth guidelines. In addition, these individuals were obliged, on occasion, to dissent publicly from the policy actions adopted by the System.

Has the St. Louis Fed's maverick approach really had much effect on policy? The answer to this question depends largely on your point of view. In a narrow sense, regional Reserve Bank presidents as a group still have less impact on policy decisions than do the System's Board of Governors; thus, were he alive today, D.C. Johns might well feel that not too much has really changed over the years.

However, in a broader sense, the Federal Reserve Bank of St. Louis has had a significant influence on monetary policy both in the U.S. and abroad. The weekly measures of U.S. money stock were initially developed,

calculated and published by our Bank in the 1960s. Likewise, the well-known St. Louis adjusted monetary base was developed and published here well before the System decided to calculate and publish its own monetary base series.

Moreover, due, in part to the research published in the Bank's Review, increased public pressure for greater accountability resulted in the adoption of publicly-announced U.S. monetary targets beginning in the middle 1970s. Since then, monetary targeting has been adopted by numerous foreign central banks as well. Readers of the Bank's Review would not be surprised to find that Switzerland and West Germany, the two countries who have adhered most closely to their monetary targets, have also been the most successful in achieving low inflation and low interest rates.

Thus, if judged by the Bank's national and international reputation for monetary research and by the policy changes it helped to bring about, the St. Louis Federal Reserve Bank's influence extends far beyond what D.C. Johns might ever have imagined.

Of course, even if the St. Louis Fed's maverick policy views have been broadly successful in monetary policy circles, it does not necessarily follow that the free enterprise system has benefited in any significant sense. Thus, it is important to ask, "Has the St. Louis Fed's maverick role really made an important difference for free enterprise?"

In my view, this is the easiest question to answer. While a free enterprise society may survive in the face of inflation, it will never thrive under such conditions. The heightened uncertainty and capricious wealth redistributions that accompany inflation inevitably produce slower economic growth and a less free society. For three decades, our research and our publications have made people more conscious of the causes and

costs of inflation. In addition, over that period of time, our work has contributed to the adoption of monetary aggregate targeting and standards for monetary policy accountability. It seems clear, to me at least, that these results are important contributions toward a stronger free enterprise system. And, for precisely these reasons, the St. Louis Reserve Bank may belong, after all, alongside the others that have been honored by the Newcomen Society.

Now, when I first thought about what I wanted to say to you tonight, this seemed as good a place as any to end my talk. Having had to listen to me for the past 20 minutes or so, many of you may wholeheartedly agree with this thought! However, as you well know, at the present time there are some political pressures that threaten the continued independence, not just of the St. Louis Fed's monetary policy stance, but of the Federal Reserve System itself. These pressures naturally lead one to ask "Do we really need, or want, a central bank that may, at times, operate independently from other branches of government?"

The Federal Reserve System was created to overcome chaotic conditions in banking and to provide liquidity to the financial system when economic downturns occurred. However, at that time, 75 years ago, there was also a deep mistrust, or at least, suspicion of what a central bank might do. What kind of a central bank could provide the hoped-for benefits and still protect individuals from the dangers of too much centralized power? The Federal Reserve System, with its 12 independent regional banks, was the odd but innovative solution that arose from the political give-and-take of that time--a decentralized central bank.

In the mid 1930s, much, but not all, of the power and authority within the System was transferred to the Board of Governors in Washington.

Monetary policy decisions are now made by the Federal Open Market Committee--the seven governors and, on a rotating basis, five of the 12 Federal Reserve Bank presidents. Because the governors are appointed to 14-year terms and constitute a majority of the Federal Open Market Committee, it is not surprising that D.C. Johns was somewhat suspicious of their concern for the opinions of the Reserve Bank presidents. It is also clear, however, that even under the present system, monetary policy decisions are insulated, although neither isolated nor immune, from political pressures.

Why do we want an "independent" central bank? First of all, without some independence, and the associated decentralization from which it derives, our Bank would never have been able to pursue its own independent research and policy agenda; and, as I have stated in some detail, I believe that the St. Louis Fed's brand of maverick monetary research and policy has contributed significantly to what we know about the impact of monetary forces on the economy.

But there is a much more important reason to support the notion of an independent central bank. It has to do with the nature of the political pressures that are generally imposed on central banks. It is a political "fact of life" that politicians feel that, in order to be elected, they must promise their constituents more and more benefits. At the same time, these benefits must appear to be essentially costless. In other words, they must promise to spend more and tax less.

One way to do this is to print more money. The printing of money, of course, is a crude description of this activity. Usually it is called "keeping interest rates low," or "keeping our goods competitive in foreign markets," or "providing enough liquidity." Regardless of what label we

may use, however, this pressure always faces democratic governments and, of course, central banks as well.

Given this political pressure on central banks, only an institution that is relatively independent of the political process can resist the short-term demands of various political groups and concentrate, instead, on the long-term goal of stable prices. The historical record contains all-too-numerous examples of central banks that have little or no independence from political authorities and their associated failures to maintain price stability. The record also clearly shows that countries with independent monetary authorities have always had lower inflation, and fewer money-induced crises, than other countries.

The notion of "independence" does not mean that a central bank should not be accountable for its actions. If anything, such independence actually strengthens the central bank's accountability in terms of what it should really be held accountable for--namely, price stability. This is possible only when a central bank does not have to respond to every wiggle in the economy or every complaint by political constituents. Up to now, the United States has had a relatively independent central bank and relatively stable prices. Other countries that have had similar price experiences, such as Switzerland and West Germany, also have independent central banks.

Thus, to conclude this history of a maverick monetary institution, the Federal Reserve Bank of St. Louis has contributed significantly to the free enterprise system by advocating monetary policy actions designed to stabilize prices. The St. Louis Fed's unique approach to policy owes its existence to D.C. Johns and Homer Jones and its persistence to the

efforts and support of subsequent presidents and research directors. I am pleased to say that this approach is still alive and well at the Bank.

But it is also true that such "maverick" activity could never have been possible were it not for a monetary system that allowed diversity of opinion from within--in other words, a monetary system that itself enjoys a measure of independence from political pressures. At present, that independence is being threatened. Let us hope that we have learned enough, both from the history of the St. Louis Reserve Bank and from the historical record in general, to preserve the right of the Federal Reserve System itself to remain a maverick.