A Monetary Policymaker's Perspective

The Cato Institute Book Forum
Celebrating the 40th Anniversary of the Publication of *A Monetary History of the United States, 1867-1960*
(by Milton Friedman and Anna J. Schwartz, Princeton University Press, 1963)
Washington, D.C.
November 21, 2003

It is an honor to participate in this event, recognizing the enormous importance of the publication of the Friedman and Schwartz's *Monetary History* 40 years ago. I've been asked to focus on the policymaker's perspective. However, I must emphasize that the views I express are those of a policymaker, and do not necessarily reflect official positions of the Federal Reserve System.

The introduction to the *Monetary History* starts with this sentence: "This book is about the stock of money in the United States" (p. 3). Friedman and Schwartz show convincingly that failure to pay attention to money growth was the source of many policy mistakes. I confess to feeling very uneasy that money plays practically no role in policy discussions in the Federal Reserve today. I am one of the few members of the FOMC who ever mentions money during the meetings. Despite this observation, there is no doubt that Friedman and Schwartz have taught everyone to watch for warning signs from money growth; if and when those signs appear, I will not be the only one talking about them.

Fortunately, the book is about a lot more than the stock of money. The *Monetary History* is an important scholarly contribution about U.S. economic history, monetary policy, *and* the stock of money. There can be no distinct policymaker view of the book's importance because it bears on the monetary analysis of both academics and policymakers.

Perhaps the most important message I take away from the *Monetary History* is the tremendous importance of ideas in shaping monetary policy. Bad economic analysis will almost certainly produce bad monetary policy. The real-bills doctrine had a lot to do with the Federal Reserve's catastrophic mistakes in the early 1930s. Later, beyond the period covered by the *Monetary History*, the theory of a Phillips curve tradeoff between inflation and unemployment played a similar role in fostering the Fed's inflationary mistakes of the 1960s and 1970s. So also did neglect of the key distinction between real and nominal interest rates.

The nation is asking for trouble if central bankers are not current on the latest developments in monetary and macroeconomics. By "current on" I certainly do not mean "automatically accepting." Many current developments coming out of the academic world turn out to be wrong. I am not criticizing academics; the essential nature of research is a search for deeper understanding and the effort inevitably yields approaches that sometimes, and even frequently, turn out to be blind alleys.

The Phillips curve tradeoff was an important example of a wrong idea that gained wide acceptance and had a major impact on monetary policy. Although ignorance of economics is a likely recipe for failure, following the advice of mainstream economics is hardly a guarantee of success. The Fed did follow mainstream advice in the late 1960s and most of the 1970s, and it was precisely that advice that created the Great Inflation.

There is no substitute for sound economics as the underpinning for sound monetary policy, but for me as a policymaker that fact creates a profound problem. I am not a layman economist, but along with laymen must find a way to sort

out correct from incorrect ideas when the experts differ.

Academics can help by speaking more directly to the problems policymakers face; from my years as both an academic and as a policymaker, I find that academic economists are often out of touch with the situation faced by policymakers. I am particularly annoyed, frankly, when I hear academics' pleas for more research when that solution is simply not relevant to a pressing need to decide one way or the other right now. I know that advances in economics can have important policy implications. Those advances will register more quickly on actual policy decisions if academics explain their relevance as they might if they were sitting at the FOMC table and had responsibility for policy decisions. The *Monetary History* has that kind of relevance, for the analysis can be brought to bear directly on current developments as they unfold.

There has been a substantial change in attitudes within the Federal Reserve over the years. I was a staff member at the Board of Governors in the early 1970s and remember the visceral negative reactions to monetarism so evident in many senior Fed staff members and governors. I do not see those attitudes today. Fed people are much more open-minded than they used to be, and that attitude is extremely helpful to the cause of making good economics bear on monetary policy. The Federal Reserve as an institution has changed; today, it invites open discussion and is tolerant of dissenting views.

Friedman and Schwartz are clear about the importance of good leadership. In discussing why Fed policy was so inept during the early 1930s, they say, "[t]he detailed story of every banking crisis in our history shows how much depends on the presence of one or more outstanding individuals willing to assume responsibility and leadership" (p. 418). They emphasize the important role played by Benjamin Strong in the 1920s and the void left by his death in 1928. The leadership of Paul Volcker and Alan Greenspan made an enormous difference to outcomes over the last quarter century and their example will have lasting importance for the practice of central banking.

If competent leadership is essential to good monetary policy, then a natural focus is on institutional arrangements that maximize the potential for putting competent leaders in office and ensuring that they have the political freedom to manage policy wisely. The *Monetary History* does treat some issues of institutional design, especially the unsatisfactory features of the original Federal Reserve Act that created an ambiguous governance structure between the Federal Reserve Banks and the Board in Washington. Legislation in the 1930s largely cleared up this problem. However, I do not recall much discussion in the *Monetary History* about how Fed governors and Bank presidents were selected.

The issues of institutional design are important, and are on my mind a lot. I recall the Friedman and Schwartz discussion of how the Fed, in the early 1930s, engaged in expansive open market operations under congressional pressure, but ceased such efforts when Congress went out of session. Unfortunately, it would not be difficult to find a hundred examples of bad congressional advice for every example of good congressional advice.

Since the *Monetary History*, the profession has developed a consensus that central bank independence is a better institutional design than tight control by the legislative or executive branch of government. It is interesting to note that the Federal Reserve, with Reserve Bank presidents appointed by the boards of the Reserve banks, has a greater private sector input than any other major policy institution in the United States. Some view this structure as antidemocratic, but in my view the current arrangement provides clear political control through the Board of Governors while the private sector role through the Reserve Banks makes the institution more directly accountable to the broad public interest than would be the case if all control came from Washington. In any event, issues of institutional design were part of the analysis in the *Monetary History* and what Friedman and Schwartz say about these issues is highly relevant to debates today.

One of my special interests is the role of expectations in shaping economic developments. Friedman and Schwartz discuss expectations in a number of contexts. One of these concerns the effects of anticipations of a depression following World War II. Today, our knowledge of expectations is vastly superior to the data available for the period covered by the *Monetary History*. We have extensive survey data on expectations about a wide variety of economic variables. More importantly, we have excellent market data on inflation expectations, from trading in indexed bonds, data on oil price expectations from trading in long-term oil price futures, and data on monetary policy expectations from the federal funds futures markets. Data from derivatives markets permit calculations of risk assessments in many markets. Data on expectations certainly make the life of a policymaker a lot easier.

I wonder, though, to what extent the behavior of the economy itself has changed as a consequence of the proliferation of financial instruments. Certainly, behavior in many individual markets has changed, but as far as I know we do not have reliable estimates of effects on the macroeconomy. This is an important issue, as a changing economic structure degrades the value for current policy of experience in earlier eras.

I'll finish by returning to my main point, which is the importance of good economics for good monetary policy. A theme running through the *Monetary History* is role of inflation in the business cycle. The Federal Reserve has finally been successful, at least for the moment, in stabilizing the price level. Depending on your view as to the bias in price indexes, the rate of inflation today is zero or only slightly above zero. The Friedman and Schwartz work demonstrates that price stability was achieved momentarily a number of times in U.S. history, but that blissful state was never lasting. I am acutely aware of that history today and hope that the Federal Reserve's recent success in creating price stability can become a permanent feature of the economy. Our history makes clear that price stability is not automatic.