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Allan Meltzer and the History of the Federal Reserve

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Allan Meltzer was one of the leading monetary economists of the twentieth century. Allan was a key player in the debates over Monetarist and Keynesian doctrines as well as the debates over how to conduct monetary policy. He was always a strong advocate for rules-based monetary and lender of last resort policy. A salient part of his contribution was his monumental two volume *History of the Federal Reserve 1913 to 1986 (2003 and 2010)*. In this essay, I present the main arguments of the *History* and provide an evaluation his contribution.

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Allan Meltzer and The History of the Federal Reserve

Allan Meltzer was one of the leading monetary economists of the twentieth century. He was a pioneer monetarist along with Karl Brunner, Milton Friedman and Anna Schwartz in revolutionizing thinking in the post -World War II era on the role of money and the conduct of monetary policy in the economy. A key element of the monetarist approach has been to use monetary history as a way to provide evidence on the relationship between monetary forces/ monetary policy on the price level and the level of real output under different institutional arrangements.

Milton Friedman and Anna Schwartz in *A Monetary History of the United States* (1963) developed the widely acclaimed "narrative approach ' to identify natural experiments using historical episodes to identify unique causation in the relationship between money and income. Karl Brunner and Allan Meltzer (1964) used a variant of this approach in examining the motivation for Federal Reserve policy actions since its establishment by delving into the official record of the discussions of Fed staff and officials associated with key policy actions.

Allan Meltzer along with Karl Brunner was a key player in the US monetary policy debate from the 1950s until Karl's death in 1989 and ever since. Allan, along with Karl and Anna, founded the Shadow Open Market Committee in 1973 , and with Karl founded the highly successful Carnegie Rochester conference Series, the Konstanz conference series, the Interlaken conference series, in addition to writing hundreds of influential articles and many books . Throughout his career, Allan was a strong and vocal critic of the Fed and a tireless advocate for sound money.

Allan's contribution to monetary history preceded the publication of his critically acclaimed two volume *A History of the Federal Reserve* published in 2003 and 2010.Two key earlier articles that influenced my work and that of other economic historians were his 1968 *Canadian Journal of Economics* article which attributed the Federal Reserve's failure to prevent the Great Contraction 1929 to 1933 to its having followed a flawed policy doctrine which they referred to as the Burgess Riefler Strong Doctrine-- a variant of the real bills doctrine. A second influential article published in the *Journal of Monetary Economics* in 1976 attributed the breakdown of the interwar international monetary system to the failure of the balance of payments adjustment mechanism.

A History of the Federal Reserve follows logically from these earlier studies. Allan Meltzer, as a pioneer monetarist, accepted the basic quantity theory of money framework but his focus in these books is less on the monetary history per se as in Friedman and Schwartz's *A Monetary History of the United States* (1963), but more as a biography of the Federal Reserve as an institution, i.e on the decision making by its leaders. His analytical approach encompassed much more than the tenets of established monetary theory but also political economy, especially the complex interactions between the government (Administration, Treasury and Congress) and the Fed.

The publication of A *History* was greeted with great acclaim. Michael Bordo in the *Journal of Monetary Economics* (2003) called Volume I "a monumental achievement", David Laidler in the *Journal of Economic Literature* (2003) praised it as "an exceptionally clear story, John Taylor in the *Journal of Monetary Economics* (2010) said "the history is comprehensive, thorough and serious' and Thomas Cargill in *International Finance* (2011) referred to the two volumes " as a " tour de force of the history of the Federal Reserve".

To understand the books and its emphasis on flawed doctrine (and political impingement on central bank independence) it is important to read chapter two of Volume I because it gives a thorough history of classical monetary doctrine as espoused by Henry Thornton, Walter Bagehot and Irving Fisher. These economists presented the fundamentals of monetary economics and especially the relationship between central bank policies and the macro-economy (prices , output and exchange rates) under fixed and floating rates, the case for rules over discretion, rules for a lender of last resort, and the distinction between nominal and real interest rates. These fundamentals were at the heart of the Fed's failures and successes. Meltzer argues that had the Fed followed classical monetary theory (and its modern offshoots) it could have avoided its three big failures: the Great Contraction 1929-33; the Great Inflation 1965 to 1982; and the recent Great Financial Crisis 2007-2008. Morever the Fed's two great triumphs (Paul Volcker's successful disinflation 1979 to 1982 and the Great Moderation 1985 to 2001) reflected the pursuit of sound monetary principles. In what follows I briefly provide a highly selective guided tour of A History and then give an overall evaluation.

Narrative 1913 to 2010

The Federal Reserve System (FRS) was founded in 1913 as an independent central bank based on the principles of the real bills doctrine and the gold standard. Monetary policy was supposed to be conducted like the Bank of England in the pre- World War I era with the Fed passively rediscounting eligible commercial paper at the discount rate. The FRS was a compromise between the interests of the Northeast financial centers who wanted a European style central bank and the rest of the country that wanted local reserve banks dedicated to accommodating regional credit needs. World War I changed the environment drastically. Most countries suspended the gold standard, and the Fed lost its independence to serve as the financier of the Treasury by lending at preferential rates to finance the purchase of Treasury securities. It became an engine of inflation. After the war the Fed followed the Bank of England's approach of raising its discount rate to roll back the large run up in inflation. The resultant political backlash to the severe recession of 1920-21 led the Fed to look for a new form of monetary control based on open market operations.

The new approach to monetary policy was laid out in the Tenth Annual Report of the Fed in 1923. Meltzer explains how the new approach called the Burgess Rieffler (BR) doctrine was a derivative of the real bills doctrine and how it became the source of serious policy errors in the succeeding years. The premise for BR was that member banks were reluctant to turn to the discount window, and so the Fed would use its open market operations to force them to the window when the economy was in recession and repay loans when the economy was strong. Two indicators of the stance of the economy were: the levels of member bank borrowing in the two key Reserve cities, New York and Chicago; and the level of short term nominal interest rates. Meltzer is critical of this approach because it assumes that banks only borrow when in need and not to make profits and because it doesn't account for the difference between nominal and real interest rates.

Volume I analyzes Fed policy actions through the lens of the BR doctrine. Meltzer shows that the doctrine did work in two minor recessions in the 1920s but failed miserably between 1930-

33 because the two indicators provided misleading signals that the economy was in good shape when it wasn't. Member bank borrowing was low because the economy was depressed and nominal rates were low reflecting expectations of deflation. Meltzer also blames the Fed for creating the depression in the first place in 1929 by using tight monetary policy to prick the Wall Street boom. This was done on real bills doctrine grounds that asset price inflation would eventually lead to general inflation and then deflation.

A key signature of Volume I is that, unlike Friedman and Schwartz 1963, Meltzer does not blame the Fed's failure to prevent the banking panics on deep flaws in the Fed's governance structure (the struggle between the Reserve banks and the Board) and the fact that Benjamin Strong , who led the system until 1928, had died and there was no comparable successor. He argues that Strong also followed the BR doctrine and would have made the same mistakes as the other officials did. Thus for Meltzer bad doctrine was the key cause of the Fed's first calamitous policy failure.

In the mid 1930s major reforms in the Bank acts of 1933 and 1935 gave the Federal Reserve Board much more power and independence de jure but de facto the Fed became subservient to the Treasury and followed a bond support policy to keep interest rates low to help the Treasury finance its deficits. He also shows how the monetary reflation that occurred after the end of the Great Contraction in 1933 was solely attributable to expansionary Treasury gold purchase policies and the devaluation of the dollar in 1934. The one time that the Fed did take serious policy action was in 1936-37 when on BR grounds the Fed doubled member banks' reserve requirements to eliminate a build up in excess reserves. This led to the serious recession of 1937-38. The recovery was aided by the Treasury rescinding its sterilization of gold inflows (originally imposed in 1936 to prevent the accumulation of excess reserves).

During World War II the Fed followed the Treasury's lead and pegged bond prices, acting as it did in World War I as an engine of inflation. After the War the interest rate peg regime continued under the Treasury's control. Meltzer brilliantly documents the struggle that began in the late 40s between the Fed and the Treasury and the Administration to end the interest rate pegs and restore the Fed's independence. The Fed recovered control of monetary policy in the Federal Reserve Treasury Accord of February 1951 which ends Volume I of *A History* . Volume 2 begins with William McChesney Martin becoming Chairman of the Fed in 1951 and the system returning to active monetary policy making. Meltzer documents how after the Fed regained its independence it reverted back to its old procedures of focusing on money market indicators and a variant of the BR doctrine, the targeting of net free reserves (NFR, excess reserves less borrowing). As he and Karl Brunner had pointed out decades earlier the NFR doctrine led to serious errors in Fed policymaking in the 1950s and 60s.

Meltzer is highly critical of Martin's tutelage --- for his limited understanding of monetary economics (his use of nautical terms eg "leaning against the wind"), for his conception of the Fed's independence ("independent within the government") which meant that monetary policy was secondary to fiscal policy, and to his later acceptance of the Phillips curve and Keynesian doctrine. Meltzer disagrees with Christina and David Romer (2002) who viewed the 1950s as a period of great success for the Fed. He argues that the only reason the macro economy performed so well was that the Eisenhower administration and later the early Kennedy administration were relatively fiscally conservative and believed in balanced budgets, the importance of adhering to the Bretton Woods gold constraint, and price stability. Had they ran big fiscal deficits he believes that Martin would have accommodated them.

Meltzer then documents how the Great Inflation 1965 to 1982 began under Martin in 1965. He focusses on the ascendency of Keynesian views in the Kennedy administration in the 1962 Council of Economic Advisors and then within the Federal Reserve Staff and FOMC, the belief in the superior performance of fiscal over monetary policy, the use of fine tuning stabilization policy ,the adoption of the Phillips curve tradeoff between inflation and unemployment. The Fed followed an influential article by Samuelson and Solow (1960) on the Phillips curve which argued that the benefits of reducing unemployment outweighed the costs of raising inflation. This meant that the weights the Fed attached to inflation and real growth in its policy reaction function between the 1950s and 1960s shifted away from price stability toward growth.

When Lyndon Baines Johnson became President in 1963 the administration shifted to an expansionary fiscal policy to finance burgeoning domestic programs and the Vietnam war,. The Martin Fed accommodated the Treasury via the use of “even keel” policy and by the increasing reluctance to raise rates in the face of incipient inflationary pressure for fear of thwarting the Administration’s plans. This set the stage for the Great Inflation.

Another important theme in both Volumes but especially in Volume 2 is the international economy. The Bretton Woods system was the international monetary regime from 1945 to 1973 and the book discusses the influence of the balance of payments and the level of US gold reserves on Fed decision making. The decline in the US monetary gold stock became particularly worrisome after the Western European countries declared current account convertibility in the late 1958. After a spike in the price of gold in October 1960 the Kennedy

Administration and the Fed began adopting policies to preserve gold. The Fed's key policies in this period were the creation of swap lines with other central banks and Operation Twist. In the early 1960s the FOMC in its policy deliberations, on occasion, took into account the balance of payments and gold reserves in its domestic policy decision making. Gold and the dollar also provided a reason for a number of Fed officials to maintain price stability. But after 1965 the Fed's policy became increasingly dominated by domestic concerns. This created another factor behind the Great Inflation.

Arthur Burns succeded Martin as Fed chairman in 1970. Meltzer is especially critical of his regime, in part because as a well -respected economist he should have known better. He describes how Burns was increasingly unwilling to tighten monetary policy to stem the rise in inflation and inflationary expectations because of his fear of the political consequences of the recession that would follow. He also was subservient to the political ambitions of both Presidents Nixon and Carter. The Burns era is a key example of one of the great flaws in the Fed's record in being fiscally dominated. Burns also subscribed to the importance of non-monetary forces (especially the two oil price shocks and labor union power) and he was instrumental in the US adopting wage price controls in the 1970s which led to disastrous consequences. Burns also was responsible for the accommodation of the two oil price shocks which further increased inflation. In addition, Meltzer criticizes Burns for not recognizing the important distinction between nominal and real interest rates. The Fed believed that rising nominal rates were evidence of tight money when in fact they just incorporated expectations of rising inflation.

President Carter replaced Burns by G William Miller in March 1978 but he was even worse than Burns and only lasted a bit more than a year. By 1978 the US was in the midst of a major economic crisis ; inflation was in double digits, unemployment was rising ;the dollar was collapsing; and there was increased financial instability reflecting the interaction between rising inflation and financial controls like regulation Q. Meltzer views that period as the consequence of disastrous policy mistakes by the Federal Reserve comparable to the Great Contraction of 1929-33.

President Carter appointed Paul Volcker to be Fed chairman in the summer of 1979 with a mandate to break the back of inflation and inflationary expectations. Meltzer praises Carter for that decision. The Volcker disinflation began with a major monetary policy regime change in October 1979 when the Fed shifted from using interest rates as its policy instrument to monetary aggregates (non borrowed reserves). Meltzer gives Paul Volcker the highest praise for following sound monetary principles and successfully ending the Great inflation. The process was painful. It involved two recessions and a rise in unemployment well above 10 per cent. Regaining credibility for low inflation was hampered by the Carter credit controls in 1980. In addition to Volcker's astute guidance, Meltzer also praises the Reagan administration for backing Volcker's actions, in sharp contrast to the political interference of the 60s and 70s.

Volume 2 ends after low inflation is restored in the mid 1980s and Alan Greenspan succeeds Volcker as Chairman of the Fed.

In an Epilogue written in 2010, Allan Meltzer covers the period 1986 to 2010. He gives high marks to Chairman Allan Greenspan for the Great Moderation—a period with low and stable inflation and high and stable economic growth -- for following rule like monetary policy to maintain credibility for low inflation.

Allan Meltzer criticizes the Fed for shifting back to its old ways beginning in 2001 by keeping its policy interest rate well below the Taylor rule rate in an bogus attempt to prevent the emergence of Japan style deflation in the US , thereby fueling a housing price boom which led to the Great Financial Crisis (GFC) of 2007-2008. Meltzer views the GFC as equivalent to the two previous Federal Reserve major policy errors in the twentieth century. He criticizes the Fed under Chairman Ben Bernanke for its handling of the financial crisis: in violating Bagehot's rule, in inconsistently bailing out Bear Stearns in March 2008 and letting Lehman Brothers fail in September, in following credit policy which threatened its independence; and in shifting to discretionary policy with the adoption of Quantitative Easing and Forward Guidance in late 2008.

Evaluation: The Bottom Line

Allan Meltzer gives two key reasons to explain why the Fed did so poorly in its monumental failures and so well in its triumphs. These are :a) sound monetary doctrine/theory; b)political pressure (the loss of independence from the government). Reason a) dominated the Great Depression; reasons a) and b) were behind the Great Inflation. He argues that both factors also were present in the Great Financial Crisis.

Allan Meltzer's key prescription for successful central bank policy is to follow rule based monetary policy, a rule based lender of last resort policy, to focus on the medium to long term and avoid short termism and to avoid fine tuning. These are the principles posited by Thornton, Bagehot and Fisher that Meltzer emphasizes in chapter 2, Volume I .

The two volumes of *A History of the Federal Reserve* cover many other important topics that time prevented me from discussing. These include: international issues; regulation; Fed governance issues; the payments mechanism; the term structure and many other topics in this encyclopedic study.

Allan Meltzer had the courage and force of will to let policy makers know when they were on or off track. His reputation earned by over 70 years of sound scholarship culminating in *A History of the Federal Reserve* made influential people pay heed to his advice.

We will greatly miss Allan.

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