Destabilizing Factors in Contemporary Monetary Policy

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> You set up a National Bank to watch the other banks; but who is to watch the watcher? ... Is it not far better to dismiss the watchmann, and so to arrange things that it shall be for the interest of the rogues to watch and betray each other's roguery.[1]

I. Overview of Aggregate Data for Three Time Periods

This paper concentrates on contemporary monetary policy in an effort to identify the forces that have brought the economy to its present distressed condition. If central bankers are to be believed, the ills of the economy do not result from inappropriate monetary policies. The present Chairman of the Federal Reserve System's Board of Governors, Arthur *Burns*, recently stated:

> The upsurge of the price level this year hardly represents either the basic trend of prices or the response of prices to previous monetary or fiscal policies. ... The severe rate of inflation ... in 1973 cannot responsibly be attributed to monetary management or to public [government] policies more generally.[2]

While *Burns* qualified his self-absolution to "this year" (1973), his remarks here and in other statements imply that the present inflation has had no provocation from Federal Reserve policies, and that the Fed has done everything it could to "fight" inflation.

This kind of disclaimer from the Chairman of the central bank suggests many questions: Does inflation occur randomly and inevitably like death and taxes? Is it perhaps visited on present-day economies like the plagues on the ancients? Do political factors play a part? And precisely

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[1] Richard *Hildreth*, History of Banks, 1st ed., Gray and Co. (Boston: 1837). [reprinted by Augustus *Kelly* (New York: 1968)], pp. 138 - 139.

[2] Board of Governors of the Federal Reserve System, Federal Reserve Bulletin (hereafter referred to as FRB), Washington, D. C., November 1973, p. 797.

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what has the central bank done, either to initiate inflation or to retard it after it started?

In order to get a perspective on what has happened, some simple aggregate data are presented in Table 1. These statistics describe the inflation that has occurred over the past 10 years, and compare this recent data to data for a period of stability 50 years ago. The remainder of this study then concentrates on the concepts and actions that have shaped Federal Reserve policy over this later period.

The data show some significant developments. M_1, for example, increased at an increasing rate during the years of the *Johnson* Administration. In 1968, the rate of increase was 68 percent greater than in 1964, while the average rate of increase for the period was 5.2 percent. This rate was almost double that of the *Coolidge* era, and triple the rate of the preceding five years, 1958 - 1963 (not shown), when M_1 grew at a rate of 1.4 percent per year. The rate was sharply reduced in 1969 from its high value of 1968, but then it increased again, and in 1972 surpassed the values for 1967 and 1968. All told, the increase in the average rate of increase in M_1 was 15 percent greater during the years of the *Nixon* Administration than during the *Johnson* Administration, and about 100 percent greater during both than during the *Coolidge* Administration.

The values for M_2 need little explanation. Rates of increase for this item were almost equal during both recent Administrations. The most significant observation is how closely the rates of increase in M_2 approximate the rates of increase in monetary GNP.

These data reflect a basic economic stability in the era of the 1920's. Bathtub gin, flappers, and *Gatsbys* notwithstanding, the unglamorous spending variables — the stock of money, velocity, and prices — were notably stable. Federal government expenditures as a percent of GNP were less than one-sixth the current value, and becoming smaller all the time! The second period, which takes in the years of the *Johnson* Administration, shows an increasing involvement of government, an increasing rate of increase in the stock of money, and an increasing rate of price level increase — all the marks of general instability. That this instability was imposed by government and was not endemic in the private economy is confirmed by the less variable behavior of money. The third period seems simply to be a harmonic of the second period. Some of the indicators, such as government spending, do not increase as

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much during the third period, but others, such as prices and growth in the quantity of money, show no progress toward stable values. Certainly, the data for the third period reflect no fundamental change in political philosophy or economic policy. If anything, the era of instability begun in the middle 'sixties shows aggravation in the early 'seventies.

II. The Federal Reserve's Self-Image

The data for money and its growth summarized in Table 1 suggest that monetary factors may be a sizable determinant of the gross problems the economy faces, in spite of Chairman *Burns'* allegation to the contrary. To explore this issue further, attention first needs to be directed to the middle 1960's when significant price level increases initially appeared.

In a statement to a Senate subcommittee in 1965, William McChesney *Martin,* who was at that time Chairman of the Board of Governors, admitted that the Federal Reserve System had a tolerable degree of control over the monetary base. "It is fair to say", he stated, "that from month to month and year to year the supply of [bank] reserves is determined by the policies of the Federal Open Market Committee [FOMC]."[3]

The official Federal Reserve explanation given to the growth in the money supply in 1963 - 1964 implied, however, that the Fed was no more than a passive and remote agent in the process. "The acceleration in money growth over the past 2 years", stated the article, 'Bank Credit and Monetary Developments', "suggests that expanding transactions needs may now be having a greater influence on the public's demands for cash balances than formerly."[4] The article pointed out that the Fed's action in 1962 of raising the interest rate ceiling on time deposits "may" have encouraged a move toward greater spending, which in turn would have increased "transactions needs related to income and output". Then, the higher level of transactions "may help to explain the larger rate of growth of the money stock in those years."[5]

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[3] FRB, September 1965, p. 1237. See also similar statement in FRB, April, 1967, p. 561.

[4] FRB, February 1965, p. 219.

[5] Ibid. The Fed has authority over ceiling rates payable on time and savings deposits under Regulation Q.

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Table 1: **GNP, The Stock of Money, Prices, Government Expenditures, Employment, and Annual Changes for Three Five-Year Time Periods, 1923 - 1928, 1963 - 1968, and 1969 - 1973**

Calendar Year	GNP ($ billions)	% change year-to-year	CPI[a]	% change during year	GNP ÷ CPI ($ billions)	% change year-to-year	Fed. Govt. Exp. ($ billions)	% change year-to-year	Fed. Govt. Exp. ÷ GNP (%)	Total Civilian Employment (millions)[b]
1923	86.1		73		85.8		3.29		3.82	28.4
1924	87.6	1.7	73	0.0	88.4	3.0	3.05	− 7.9	3.48	28.0
1925	91.3	4.2	75	2.7	90.5	2.4	3.06	0.3	3.35	28.8
1926	97.7	7.0	76	1.3	96.4	6.5	3.10	1.3	3.17	29.8
1927	96.3	− 1.5	74	− 2.7	97.3	0.9	2.97	− 4.4	3.08	30.0
1928	98.2	2.0	73	− 1.3	98.5	1.2	3.10	4.4	3.16	30.0
1963	591		92		642		117		19.8	67.8
1964	632	6.9	93	1.1	680	5.9	120	2.6	19.0	69.3
1965	685	8.4	95	2.0	721	6.0	128	6.7	18.8	71.1
1966	750	11.0	97	3.3	773	7.2	151	18.0	20.1	72.9
1967	794	5.9	100	3.1	794	2.7	164	8.6	20.6	74.4
1968	865	8.9	104	4.7	832	4.8	186	13.4	21.5	75.9
1969	930	7.5	110	6.1	845	1.6	190	2.2	20.4	77.9
1970	977	5.1	116	5.5	842	− 0.4	202	6.3	20.7	78.6
1971	1,056	8.1	121	3.4	873	3.7	219	8.4	20.7	79.1
1972	1,155	9.4	125	3.4	924	5.8	239	9.1	20.7	81.7
1973	1,289	11.6	133	8.8	969	4.9	258	7.9	20.0	84.4
Averages 1st period		2.7		0.0		2.8		− 1.3		
Averages 2nd period		8.2		2.8		5.3		9.9		
Averages 3rd period		8.3		5.4		3.1		6.8		
1974 1st half				12.6						

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Calendar Year	% change year-to-year	M_1 c) ($ billions)	% change during year	M_2 c) ($ billions)	% change during to year	V_1 c) (GNP / M_1)	% change year-to-year	V_2 c) (GNP / M_2)	% change year-to-year
1923		22.7	0.4	36.4	3.8	3.79		2.37	
1924	— 1.4	23.1	6.4	38.4	7.8	3.79	0.0	2.28	— 3.9
1925	2.9	24.9	6.9	41.9	7.7	3.67	— 3.3	2.18	— 4.6
1926	3.5	25.6	— 2.6	43.3	— 0.4	3.82	4.1	2.26	3.7
1927	0.7	25.5	1.2	44.4	4.6	3.78	— 1.1	2.17	— 4.1
1928	0.0	25.9	2.7	46.1	3.6	3.79	0.3	2.13	— 1.9
1963		151	3.7	257	8.0	3.91		2.30	
1964	2.2	157	4.7	276	8.0	4.03	3.1	2.29	— 0.4
1965	2.6	164	4.7	302	9.5	4.18	3.7	2.27	— 0.9
1966	2.5	171	2.2	325	4.9	4.39	5.0	2.31	1.8
1967	2.1	178	6.6	351	11.1	4.46	1.6	2.26	— 2.2
1968	2.0	190 194	7.9	383 366	9.7	4.55 4.46	2.0	2.26 2.36	0.0
1969	2.6	206	3.4	390	2.5	4.51	1.1	2.38	0.8
1970	0.9	216	6.0	407	8.3	4.52	0.2	2.40	0.8
1971	0.6	231	6.3	455	11.2	4.57	1.1	2.32	— 3.4
1972	3.3	246	8.7	501	11.0	4.70	2.8	2.31	— 0.4
1973	3.3	264	5.7	549	8.5	4.88	3.8	2.35	1.7
Averages 1st period	1.1		2.9		4.7		0.0		— 2.2
Averages 2nd period	2.3		5.2		8.6		3.1		— 0.3
Averages 3rd period	2.1		6.0		8.3		1.8		— 0.1
1974 1st half			7.0		9.0				

Sources: Data for first period taken from U. S. Department of Commerce, Historical Statistics of the United States, Washington, D. C., 1969, Milton *Friedman* and Anna *Schwartz*, A Monetary History of the United States, 1867 - 1960, and from BLS Bulletin, # 1312 - 8. Data for second and third periods were taken from the Federal Reserve Bulletin. All changes are annual rates.

a) For first period, 1947 - 49 = 100, and for second and third periods, 1967 = 100. — b) Data for employment during 1920s include only about 80 percent of the labor force. They exclude agricultural workers and some other self-employed. — c) The M_1 and M_2 measures were revised in 1970. Both old and new values are included for 1968 in order to get comparable rates of change in M_1, M_2, V_1 and V_2.

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This rationalization is an example of the accommodation philosophy. It implies that the real sector initiates a change in the demand for money that is translated to the Fed through various money market indicators and finally becomes a fresh supply by means of the Fed's "accommodation". All of this action "may" take place, of course, but such a view ignores the fact that the Fed's willingness to supply reserves is a necessary condition for monetary expansion.

The continuance of mild inflation through 1966 and 1967 prompted official discussion of the fact by Chairman *Martin*. He acknowledged again before the Senate Select Committee on Small Business that: "We [the FOMC] can ... alter the volume of both total and required reserves, [and] exert considerable influence over the readiness with which the banks will extend credit."[6]

But a few days later before the Senate Committee on Finance in support of the investment tax credit, he studiously neglected the causative role of money on the inflation. The economy in 1965 - 1966, he claimed, was "overstimulated", not by money, but "by rapidly expanding business investment and defense spending. ... Monetary policy", he excused, "was doing all it could to restrain aggregate demand ..."[7]

A few years earlier, *Martin* had presented a candid view of Federal Reserve policy-philosophy as it appeared to him, when he was asked for his opinion on a bill that would have made the Secretary of the Treasury Chairman of a 12-man Federal Reserve Board. He replied that the principal officer in charge of paying the government's bills should not also be entrusted with the power to create the money to pay them.[8] He saw in this situation a conflict of interest for the Secretary of the Treasury. (He would have been on firmer ground if he had argued that it would have violated the principle of the separation of powers.) He contrasted the partisan position of the Secretary to the disinterested concern of the FOMC. This latter agency, he claimed, "is beholden to no group or faction in public life, and [is] dedicated exclusively ... to the service of the whole American public."[9] He likened the Federal Reserve Act to the U. S. Constitution — a comparison that had been made frequently in the past. The Act, he continued, created a structure

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[6] FRB, April 1967, p. 561.
[7] Ibid., p. 565.
[8] FRB, February 1964, p. 151.
[9] Ibid., p. 152.

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that "places trusteeship over the creation of money in a body that is insulated from shortsighted pressures for abuse of that power . . ."[10] The Fed, he admitted, could regulate the growth of bank reserves "in accordance with some set formula", but it preferred to use human judgement to assess current economic needs. "With this approach", he stated, "the growth of bank reserves reflects in part market factors, which depend in turn on the strength of credit demands within the economy."[11] Then, with all the demand factors having been taken into account, the effects of policy changes, he said,

> . . . are not subject to exact scientific determination and so remain a matter of judgement, and one on which judgements may differ.
>
> I am stressing these limits of our knowledge in order to explain why central banking remains an art rather than a science.[12]

To say that central banking is an "art" and subject to interpretative judgements is to deny to it the principles of constitutional management. Such a view is also an insufferable excuse for uncontrolled discretion. If judgements may differ, the means by which the different judgements may be evaluated should be a part of the traditional political machinery; or Congress should provide constitutional principles — specific targets and indicators — for central bank operations. Even someone who "does not know anything about art", can know what he "likes". So anyone's prescriptions for policy as an "art" are as good as anyone else's.

III. Constraints on Federal Reserve Policies in the Mid-Sixties

The over-expansive policies of the Fed became generally apparent early in 1965. The FOMC then moved to a "firmer" policy, and member bank borrowings by July 1965 became "net".[13]

While this situation reflected some disequilibrium, it was a stable and manageable disequilibrium for several reasons. Most of these reasons involved international financial constraints — the fixed price of gold, the gold reserve requirements of the Federal Reserve Banks, and balance of payments considerations. Too easy a monetary policy would lead to

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[10] Ibid., p. 148.

[11] FRB, September 1965, p. 1238.

[12] Ibid.

[13] FRB, July 1965, p. 930. "Net" borrowings means that gross borrowings exceed gross excess reserves.

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an adverse balance of payments and gold outflows, and would threaten the minimal gold reserve requirements of Federal Reserve Banks and the fixed price of gold. As early as July 1964, for example, the Bulletin stated that Fed policy was to maintain a firm tone in the money market in order "to limit incentive for liquid funds to move abroad in search of higher yields. . . . The continued adverse balance [of payments] still constituted a major consideration in the formulation of monetary policy." [14]

The force of the federal government's international policy on the central bank's largess is seen even more vividly in a comprehensive statement made by *Martin* in August 1965 before a subcommittee of the Senate Committee on Government Operations. "The United States", he said,

> . . . can have only one foreign policy. Any action the Federal Reserve may take in matters connected with foreign relations, . . . anything we do or say in this area is carefully coordinated with those Government agencies to which the President [sic, *not* Congress] has delegated authority, and on occasions directly with the White House.[15]

Besides emphasizing the constraint of foreign policy, this statement also reveals the Executive's political influence on the "independent" central bank — an institution that supposedly is accountable to Congress.

The gold requirements were abolished by Congress in separate actions in 1966 and 1968. By the time they were abolished, they were only technical make believe; the Federal Reserve Board could have set them aside quasi-permanently anytime it wished.[16] However, the combination of constraints — gold reserve requirements, the fixed price of gold at $ 35 per ounce, and balance of payments equilibrium — had political prestige value that was formidable. Before the formal rules over the price of gold and gold reserve requirements were abandoned, official Fed policy mentioned them prominently, and growth in the money stock seemed under control. After their abandonment, balance of payments considerations became the last item in the FOMC's list of

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[14] FRB, July 1964, "Recent Monetary and Credit Developments", p. 813. See also, FRB, February 1965, pp. 214 and 395.

[15] FRB, September 1965, p. 1238.

[16] FRB, February 1968, Statement by Martin before House of Representatives Committee on Banking and Currency, p. 126. See, also, The Board of Governors, The Federal Reserve Act as Amended through 1961, p. 35.

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priorities and money supply growth was as erratically expansive as the variable discretion of the FOMC and the unrecorded political pressures from the Executive and Legislative branches would have it.

IV. Destabilizing Effects of Interest Rate Policy

Throughout 1967, Federal Reserve policy became more and more relaxed. The application of the monetary brake pedal in 1966 had overdone restraint, and policy in 1967 and 1968 in turn seemed to be overcompensating in the other direction. The business expansion that was initiated by the reversal of monetary policy late in 1966 demonstrated the fallacy and peril of using interest rates or "money market conditions" — the Federal Funds rate and the Treasury three-month bill rate — as guides for monetary policy.

Interest rates are mercurial targets because they respond in diverse ways to real and monetary forces. In conditions of stable equilibrium, an increased demand for liquidity by households, firms, and banks results in higher market rates of interest, a condition that a money-supplying central bank can relieve by appropriate action. This kind of result may be labeled (1) the liquidity effect. Then, as business activity picks up, more money is needed for transactions purposes, so interest rates reattain their former levels: (2) the transactions or income effect. If a business boom subsequently develops, a rise in interest rates may result from the enhanced investment demands made manifest by the boom itself: (3) the investment effect. Further increases in the money supply may then aggravate the boom and provoke significant price level increases that raise interest rates still further: (4) the inflation effect. In sum, increases in the money supply that temporarily may lower short term rates frequently have transactions, investment, and (or) inflation effects, and subsequently raise interest rates further than a liquidity effect alone would have done if left unattended. The appearance of some of these tendencies in the U. S. economy could be seen in late 1967. "The rise in interest rates since mid-year", Chairman Martin reported in late 1967, "[has] occurred *even though* [sic] the reserves available to the banking system have been expanding rapidly." [17]

The fickle nature of interest rates as indicators of financial conditions was seen again in 1971. The new Chairman of the Federal Reserve

[17] FRB, December 1967, p. 2033. (Italics supplied.)

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Board, Arthur *Burns,* in his July report to the Joint Economic Committee noted: "Interest rates are responding to fears of inflation by moving up again *despite rapid monetary expansion.*" [18] If the Fed had cut back on the rate of monetary growth in the second quarter of 1971, as many of the indicators advised, he added, short-term interest rates perhaps would have risen even more. But "in view of the delicate state of the economic recovery", he said, "it seemed desirable [to whom?] to prevent the possible adverse effects of sharply higher interest rates on expenditure plans and public psychology." [19] *Burns* here was in the absurd position of arguing, first, that monetary growth was continued, despite advisory indications to the contrary, in order to hold down interest rates. At the same time, he observed that interest rates rose anyway in the face of monetary expansion. So the economy in the end experienced both more inflation and higher interest rates.

Another element of interest rate instability became manifest in 1972 and continued through 1973. As the inflation premium in interest rates was exacerbated, a significant gap appeared between money market rates and the Federal Reserve discount rate. The latter rate is "administered" and may lag significantly behind rapidly rising market rates. The gap widened as FOMC policy tightened slightly in late 1972. Banks developed liquidity "needs", and exerted pressure on the Fed for increased accommodation at the discount window. Member bank borrowings rose from almost nothing in early 1972 to over $ 1 billion by the year's end.[20] By September 1973, borrowings were over $ 2 billion, and in mid-1974 they were $ 3.5 billion.[21]

The use of the discount window, central bank legend has it, is a privilege and not a right. Furthermore, the iron-clad rule for discount policy in early central banking theory is that the central bank's rate should be kept above current market rates.[22] Otherwise, the privilege becomes a subsidy that the commercial banks can be expected to indulge

[18] FRB, August 1971, p. 656. (Italics supplied.)

[19] Ibid., p. 659.

[20] FRB, June 1973, p. 406. Borrowings would have been even higher except for the frequent compromises made in loosening policy "to avoid further reserve pressure". (Ibid.) See also FRB, May 1973, p. 320.

[21] FRB, December 1973, p. 887, and Federal Reserve Bank of St. Louis, U. S. Financial Data, October 2, 1974. The Fed funds rate currently is three percentage points above the Federal Reserve discount rate.

[22] See, e. g., A. Barton *Hepburn,* A History of Coinage and Currency in the United States, 3rd ed., Macmillan (N. Y.: 1924), pp. 500 - 504.

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until the reserves of the central bank are depleted. As Jacob *Viner* has observed, if the central bank rate is low enough, it "might ... permit or even ... foster a wild inflation".[23] In the contemporary Fed, reserves are not depleted because reserves no longer exist. The principal effect is a decided amelioration of other Fed policies that aim at tightening the monetary system. In short, the discount window, in the presence of a positive interest rate differential between money market rates and the central bank discount rate, allows commercial banks to avoid the strictures of what would otherwise be a tight money policy and thereby subtly fosters continued inflation.

Another "random" factor that provoked higher interest rates was the appearance of sizeable federal budget deficits beginning in 1967 and continuing to the present. The greater supply of government securities coming into investment markets tended to lower security prices and raise yields because of the increasing demand by government for investment money. The FOMC's Record of Policy Actions thereafter reflected Treasury 'needs". Any targets for policy were almost always qualified by the clause, "to the extent permitted by Treasury financing". For example, in the Record for the meeting of April 30, 1968, the policy directive called for "firmer conditions, to the extent permitted by Treasury financing". One member of the Committee, Mr. Braddock *Hickman,* dissented because he thought that the rise in interest rates had been less than necessary to stem inflationary pressures. But, "he agreed that the prospective Treasury financing precluded substantial firming of money market conditions before the Committee's next meeting."[24]

The Passage of the 10 percent tax surcharge Act in 1968 was aimed at relieving the fiscal pressures on monetary policy, but it had too buoyant an effect on official Federal Reserve attitude toward policy. The FOMC assumed thereafter that it could ease monetary policy and assist the Treasury with no adverse side effects. The policy directive for July 1968 stated: "System open-market operations ... shall be conducted with a view to accommodating the tendency toward somewhat less firm conditions in the money market ... while taking account of forth-

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[23] Jacob *Viner*, Studies in the Theory of International Trade, Harper (New York: 1937), p. 153.

[24] FRB, August 1968, p. 678. *Hickman* was the only dissenter. In previous meetings, Mr. Darryl *Francis* had expressed an even firmer opinion in favor of restraint. By this time, however, he had rotated off the Committee.

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coming Treasury financing."[25] Staff reports to the FOMC in August then conjectured that "overall activity would slow considerably in the months ahead as a result of the new fiscal constraint measures."[26] Again in September 1968, the Committee decided that, "Greater restraint was not considered desirable in view of the outlook for slowing in overall economic activity, *although it was noted that firm evidence was lacking thus far on the amount of slowing in prospect.*"[27] Not until the FOMC meeting of January 14, 1969, was a policy of firmness adopted.[28] By this time, the money supply had increased over the year past by 7.9 per cent.

Chairman *Martin,* in testimony before the Joint Economic Committee in February, 1969, admitted that the Fed had been "overly hasty last summer in expecting an immediate impact from fiscal restraint." Even while admitting this poor judgement, he put primary blame for the developing inflation on consumer and business spending decisions. "The ebullient [spending] behavior of consumers", he claimed, "infected the business community. ... In this heady atmosphere, cost increases were rapidly passed on in the form of higher prices."[29] He noted that the money supply had accelerated to a 7.5 percent annual rate of increase in the third quarter *even though interest rates were rising,* but he attributed the increase to "the larger-than-seasonal rundown in U. S. treasury balances at commercial banks during the fall."[30]

V. The Aggregates vs. Money Market Conditions

Monetary policy firmed markedly throughout 1969. The money supply (M_1) increased during the year by about 3 per cent — a value that would have looked "high" in 1963, but was "low" relative to monetary growth in 1968. In early 1970, the firm policy was eased to one of achieving "modest growth in the monetary aggregates, with about equal weight being given to bank credit and the money stock."[31]

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[25] FRB, October 1968, p. 866.

[26] FRB, November 1968, p. 911.

[27] FRB, December 1968, p. 1009. (Italics supplied.)

[28] FRB, April 1969, p. 352. However, in the November 1968 meeting, four members had dissented from the majority and favored tighter policy. (FRB, March 1969, p. 265.)

[29] FRB, March 1969, p. 235.

[30] Ibid., p. 237.

[31] FRB, April 1970, p. 339.

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The "aggregates" by this time had begun to appear more prominently in FOMC directives.[32] However, Mr. Andrew *Brimmer*, a member of the Board, in a statement of official Federal Reserve policy before the Joint Economic Committee in mid-1970, disabused all and sundry that the Fed had any intention "to pursue fixed target rates of growth in the monetary aggregates on a more or less continuous basis. ... We do not propose to let adherence to any fixed growth rate of the money supply," he stated, "stand in the way of achieving [the objectives of full employment, rapid improvement in productivity, price stability, and balance of payments equilibrium]."[33]

This statement, first of all, confirms the supposition that the Fed can indeed control the aggregates. It also appears to be a firm commitment to a multi-function posture for Fed policy. It seems to reject a narrow construction of the Federal Reserve's role and scope. Yet, by the implication of a commitment to all the objectives that would be realized by "good" policies, it promises too much. It overstates by implication the results that can be expected from a money-supplying institution, and makes the institution vulnerable to political demands that it deliver on the goals it is not "standing in the way of."[34]

Throughout 1970, policy remained "moderate", which is to say that M_1 grew by 6.0 per cent and M_2 by 8.3 per cent. In the October meeting of the FOMC, however, several members "stressed the desirability of fostering declines in interest rates over coming months in order to encourage needed recovery in residential construction outlays."[35] Then, in the December 1970 meeting, the emphasis clearly shifted to "money market conditions" from the previous emphasis on the "aggregates", and some members expressed the view that this shift "was desirable on more general grounds, apart from present uncertainties."[36]

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[32] The "aggregates" include two measures of the economy's money stock, M_1 and M_2, the bank credit proxy — daily-average member bank deposits (a sort of reduced form M_2), and member bank reserves.

[33] FRB, August 1970, p. 624.

[34] This lesson was well taught by Milton *Friedman* in his presidential address to the American Economic Association in December 1967. See Milton *Friedman*, "The Role of Monetary Policy", American Economic Review, March 1968, pp. 1 - 17.

[35] FRB, January 1971, p. 26. (Italics supplied.) Here, the Fed implies an ability to cope with business conditions in a specialized industry (housing). Why not the dry cleaning industry and drug stores? And under what authorization does it grant subsidies?

[36] FRB, February 1971, p. 119.

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The tenor of FOMC meetings continued expansive throughout 1971. One excuse for allowing an admittedly inflationary growth rate in the money supply was "to compensate for the shortfall [in M_1] in the fourth quarter [of 1970]."[37] In fact, M_1 in the fourth quarter had grown at a rate of 1.0 percent, seasonally adjusted, or 4.6 percent, not seasonally adjusted. The issue of whether a seasonally adjusted money supply can be a target or an indicator is debatable. In this case, it is also irrelevant. What was important was what had happened to the money supply over the entire year. More and more, a previous period's "shortfall" was used by Fed officials as an excuse for allowing an excessive rate of growth in the aggregates over a later period, without reference to the fact that any given "shortfall" was only partial compensation for yet an earlier period's excess. In fact, the cyclical pattern of monetary growth over the past 12 years has an ominous implication. (See Table II.) In every period, the initial rate of growth is higher than the initial rate of the previous period, and the peak rate is higher than the previous peak. As must quickly happen, the initial rate of growth in a later period (e. g., the one starting in 1973) becomes higher than the peak rates of some earlier periods.

Table 2

Cyclical Patterns in Monetary Growth, 1962 - 1974

Period 1		Period 2		Period 3		Period 4	
Year	Growth rate in M_1	Year	Growth rate in M_1	Year	Growth rate in M_1	Year	Growth rate in M_1
1962	2.1	1966	2.2	1969	3.4	1973	5.7
1963	3.7	1967	6.6	1970	6.0	1974 (First half)	7.0
1964	4.7*)	1968	7.9*)	1971	6.3	1975p)	9.8
1965	4.7			1972	8.7*)	1976p)	12.5*)

*) Election year. — p) = Projected if present trend continues.

In a revealing article in the FRB (Federal Reserve Bulletin) for June 1973 by Alan R. *Holmes* of the Federal Reserve Bank of New York, the outsized growth in money during 1972 was seen resulting from the

[37] FRB, April 1971, p. 325.

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fact that M_1 was an "elusive target."[38] This misleading view is commonly projected by Fed officials. It changes the Brimmer norm of "we will not," cited above, to "we cannot". It implies that the technical operational facilities of the central bank are at times inadequate to cope with the complexities of precise growth rates in the money supply. However, M_1 turns out to be "elusive" because it is not the only target. When the Fed Funds rate, Holmes notes, rose "*to the upper limit of the Comittee's prescribed tolerance range*," the Trading Desk at the New York Fed acted to increase RDPs, whereupon M_1 duly increased.[39]

An easily demonstrable mathematical proposition can be used to show that two target variables cannot necessarily be obtained simultaneously. Especially is this proposition true if control over one of the variables (in this case, interest rates) is not even attainable, except ephemerally.

VI. Monetary Policy under the "New Economic Program"

Throughout mid-1971, the FOMC policy directives moved toward easier money and an emphasis on growth in real product. Abatement of inflation became a secondary objective.[40] In August of that year, the Administration projected the "New Economic Policy", which included among other things implementation of the Economic Stabilization Act (ESA). Activation of wage and price controls under this Act was both a reflection of central bank failure to control inflation and, paradoxically, a move that was to intensify inflation by its counter-productive effects on the economy.[41]

Official Federal Reserve reaction to the wage-price freeze under the Economic Stabilization Act was positively favorable. The FOMC had already moved to a tighter monetary policy in mid-year. During the first half of 1971, M_1 had been increased at an annual rate of 9.8 per cent; during the second half the rate was reduced to 2.4 per cent.

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[38] Alan R. *Holmes*, "Open Market Operations in 1972", FRB, June 1973, pp. 405 - 416.

[39] Ibid., RPD's — reserves available to support private deposits — were adopted in March 1972 as one of the official targets for Fed policy.

[40] FRB, August 1971, pp. 669 - 670, and October 1971, p. 825.

[41] Besides the Economic Stabilization Act, the NEP also included a loosening of fiscal constraints by adoption of the concept of a "full employment budget", and the abandonment of the policy of fixed exchange rates.

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By Federal Reserve analysis, the wage-price freeze reduced the transactions demand for money and thereby retarded the growth in the money supply.[42] By equally logical reasoning, they could have argued that the imposition of price and wage controls would have provoked evasions of the law, which in turn would have resulted in a greater demand for money and a correspondingly greater supply. Or they could have reasoned that the imposition of controls made tight money unnecessary; so they could use their money-supplying powers as prodigally as they wished.

This last option was seen in subsequent policy actions during 1972. Inflation control in the FOMC's policy directive had become a secondary objective in January 1971, but at least it had been secondary. First place had been given to "sustainable economic growth". After passage of the ESA in August 1971, the directive had a new order of priorities. It stated that the policy of the Committee was to "foster financial conditions (1) consistent with the aims of the new governmental program, (2) including sustainable real economic growth, ... (3) increased employment, (4) abatement of inflationary pressures, and (5) attainment of reasonable equilibrium in the country's balance of payments."[43]

Further grist for the inflationary mill was seen in adoption for policy purposes of the "full-employment budget" concept, which called for a budget deficit on the order of $ 40 billion during 1972. Chairman *Burns* noted the acceptance of this policy in his appearance before the Joint Economic Committee in February 1972. Unbalancing the budget by $ 40 billion as this doctrine specified, he only said, "gives me some pause."[44] He also recognized that growth rates in the monetary aggregates had been unusually high; but he defended these growth rates for their stimulation effect in overcoming the "sluggish economic growth" the economy had been experiencing.[45]

The destabilizing influence of the stimulation principle in Federal Reserve policy can be seen when it is viewed in conjunction with the accommodation principle. The stimulation principle appears at times,

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[42] FRB, December 1971, p. 994.

[43] Ibid.

[44] February 1972, p. 125. In 1947, the total budget for the federal government was $ 40 billion.

[45] Ibid., p. 126.

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such as, 1967 and 1970 - 71, when the economy is recovering from a recession. The money supply is geared to increase at a much greater than normal rate to overcome the residual drag effects of a recession. When spending and real output finally increase after lags of from two to six quarters, the stimulative policy then appears to have been overstimulative and inflationary. To retard the money supply and spending sufficiently at this juncture is politically unpalatable. (It may be an election year.) The Fed, thereupon, can invoke the accommodation principle, which will allow it to continue expansive increases in the money supply to accommodate "sustainable economic growth" and the increased "transactions needs" for money. Together, the stimulation and accommodation principles form a highly destabilizing policy doctrine. Clear-cut examples of this doctrine appeared in 1967 - 1968, and again in 1971 - 1972.[46]

Throughout 1972, monetary policy continued expansive. Over the year as a whole M_1 increased at the unprecedented rate of 8.7 per cent. Late in the summer, some sentiment developed in the FOMC to moderate the rate of growth. However, around Labor Day the Fed funds rate began climbing substantially as a higher inflation premium appeared in the interest rate structure, and the FOMC saw to it that "reserves were supplied more generously" — again, the accommodation principle, and the same kind of policy that had been recognized in the past as self-defeating in the printed statements of *Martin*, *Burns* and other Fed spokesmen.[47]

Policy in 1973 allowed continued growth in the aggregates of about six percent. But late in the year, a policy of "moderate stimulation" was invoked in order to "cushion the effects on production and employment growing out of the oil shortage."[48] Abatement of inflation was still given top priority in the directives, but it was in practice significantly compromised by the proviso that "money market conditions be maintained".

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[46] One may also add the penitence principle as a third phase of Federal Reserve actions. The Fed finally realizes the error of its ways and reduces the growth rate in the money supply to a fraction of the values it had been perpetrating. The economy then pays penance.

[47] FRB, December 1972, p. 1020.

[48] FRB, February 1974, pp. 112 and 121. A serious question may be raised as to the propriety of using monetary policy to control a particular industrial problem.

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The reappearance during the year of severe price level inflation coupled with steadily increasing interest rates provoked further statements of policy from Chairman *Burns*. In appearances before congressional committees in 1973 and 1974, he claimed that the mistake of too expansive a monetary policy in 1972 "was swamped by [other] special factors." *Burns* listed a number of these factors, which included: (1) The move to Phase III — that is, "voluntary" wage — price controls. (This action was regarded, he claimed, as the general abandonment of controls.) (2) The devaluation of the dollar that had the effect of raising the prices of imported goods.[49] (3) The oil shortage. (4) The business investment boom ("a major force making for economic instability"). (5) Wage push, (6) and Government fiscal deficits.[50]

Some of these things undoubtedly played a part in the inflation. Nonetheless, the pervasive inflationary increases in the monetary base during the three years past were the fundamental cause of the inflation. Without them, the "special factors" would hardly have rippled the surface. In fact, several of the "special factors" were symptoms of monetary excess and would not have appeared at all without the expansive policies of the Fed.

In his famous "letter" to Senator *Proxmire* on the "Money Supply in the Conduct of Monetary Policy", *Burns* argued that the economy is not inherently stable and self-correcting. He lauded "discretionary economic policy", which he claimed had proven "reasonably successful."[51] One of the destabilizing factors he saw in the economy was the velocity of money. Independent changes in this variable, he alleged, "have historically played a large role in economic fluctuations, and they continue to do so."[52]

To support this contention, he cited the changes in M_1 and velocity for 1970 and 1971, which were years of recession in which velocity predictably would show a low positive or negative change. Over the 10-year period 1963 - 1973, as Table 1 shows, the rate of change in velocity was less than half the rate of change in M_1 and only 60 per cent as great as the average change in prices. Furthermore, much

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[49] FRB, February 1973, p. 102.

[50] FRB, June 1973, pp. 383 - 402, and March 1974, pp. 210 - 211.

[51] Arthur R. *Burns*, "Money Supply in the Conduct of Monetary Policy", FRB, November 1973, p. 792.

[52] Ibid., p. 793.

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empirical evidence can be mustered to demonstrate that (1) velocity is inherently a stable variable, and (2) most of its fluctuation results from prior and untoward changes in the stock of money.[53]

VII. Synopsis of Destabilizing Elements in Federal Reserve Policy

A significant number of policies in contemporary Federal Reserve culture over the period examined here have been found destabilizing to the financial and real sectors of the private economy:

1. First is the Fed's use of interest rates in the money market as targets for monetary policy. In their admittedly vain efforts to hold down short-term interest rates, Fed officials at critical times have had to abandon their control over the monetary base and the money supply. That they doggedly persist in the chase after such a target, which has been recognized both by them and the economics profession as a will o' the wisp, suggests the presence and dominance of political factors in their decision-making.

2. A second interest rate destabilizer is the Federal Reserve discount rate. Because this rate is administered, it may lag changes in money market rates. When money market rates rise as monetary policy is tightened, a substantial gap may then appear between market rates and the discount rate allowing the banks an escape route from the strictures of a firmer monetary policy.[54]

3. A third element causing instability, one that appears again and again over the decades and is related closely to the fanatical pursuit of interest rates, is the concern of the Fed with Treasury financing. In no period when Treasury financing was extensive has the Fed ever been

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[53] Milton *Friedman* and *David* Meiselman, "The Relative Stability of Monetary Velocity and the Investment Multiplier in the United States, 1897 - 1958" Stabilization Policies (Englewood Cliffs, New Jersey: Prentice Hall, 1963), pp. 165 - 268.

[54] A third interest rate destabilizer is the ceiling rate of interest on time and savings deposits administered by the Fed under Regulation Q. This ceiling rate has effects similar to statutory wage and price ceilings. When market rates rise above Reg. Q ceilings, time and savings depositors withdraw their funds and reinvest in higher yielding securities that are not bound by ceilings. This behavior has obvious effects on bank reserves and hence on various measures of the money supply. It changes the liquidity position of the private economy and makes central bank control over the stock of money more difficult. (Compare growth rates for M_1 and M_2 in Table 1.)

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less than accommodating to the good housekeeping image the Treasury seeks to maintain by financing its deficits at "low" interest rates. A clause in the Federal Reserve Act stipulates that "whenever any power vested by this Act in the Board of Governors ... appears to conflict with the powers of the Secretary of the Treasury, such powers shall be exercised subject to the supervision and control of the Secretary."[55] While this passage implies a certain priority for Treasury affairs, it would not also seem to imply that the Fed should take any special notice of Treasury fiscal problems. The Treasury, it can be well argued, should take its chances in the market along with every other private business; and it is not permitted, much less empowered, to force the central bank to create money for it. Anticipation of just such a contingency was the original reason for the creation of a central bank that supposedly would be independent.

4. "Independence", in practice, has primarily been a euphemism for discretion. It has allowed the Fed's managers to escape all blame, responsibility, and consequences for the Fed's mistakes, for example, the disastrous inflations of 1968 and 1972. Such lack of accountability is another destabilizing element. It was encouraged by repeal of the gold reserve requirements in 1966 and 1968, and the abandonment of fixed exchange rates. Much can be said for releasing gold from the useless cosmetic of being labeled as a "reserve" at the same time that it is prohibited from being used. And exchange rates more or less freely determined in markets seem to have economized international exchange. But these allowances emphasize the even more pressing necessity for Congress to impose new rules on central bank activities now that the old constraints, weak as they were, have been repealed.

5. A final element of instability is the eclectic philosophy that the Fed proudly embraces. "An eclectic approach is taken by the Federal Reserve", Chairman *Burns* stated recently, "in recognition of the fact that the state of economic knowledge does not justify reliance on any single forecasting technique."[56] The multiple guides for policy are matched by multiple goals that are socially and politically desirable but unattainable by means of central bank actions. When the Fed chooses a priority target of "sustainable economic growth" in a recession-recovery

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[55] The Federal Reserve Act as Amended, p. 31, Sec. 10, par. 6. I am indebted to Clark *Warburton* for emphasizing this issue to me.

[56] FRB, Nov. 1973, p. 793.

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period, as it did in 1970 - 1972, for example, and uses the unemployment statistic as a guide to policy, the result is (was) disastrous. (Here, too, the stimulation-accommodation principal adds an additional irritant to a destabilizing "philosophy".) But worst of all, it puts monetary policy in the position of trying to do something it cannot do, and forces it to lose control over the variable it can regulate — the monetary base directly and the money supply indirectly. By this chain of action, it makes inflation control look unachieveable by monetary methods, and provokes the general public, unschooled in the technical mystique of central banking, to demand that the government "do something". The "something" that remains is direct and ubiquitous political control over prices and wages, and the allocation of resources. Such programs are bound to be costly and counter-productive, and to threaten economic, political, and social freedoms.

Zusammenfassung

Destabilisierende Faktoren der gegenwärtigen Geldpolitik

Der Aufsatz betrachtet die Zeitgeschichte der Geldpolitik in den Vereinigten Staaten. Als Quellenmaterial dienen in erster Linie offizielle Äußerungen des Vorsitzenden des Board of Governors des Federal Reserve System. Diese Äußerungen spiegeln bestimmte Regeln und Grundsätze wider und versuchen, die vom Federal Reserve System in der Dekade von 1964 bis 1974 ergriffenen geldpolitischen Maßnahmen zu rechtfertigen. Diese Geldpolitik und die ihr zugrundeliegenden Grundsätze werden in dem Aufsatz kritisch analysiert, um herauszuarbeiten, wie aus der relativ geld-stabilen Volkswirtschaft der sechziger Jahre die instabile Volkswirtschaft der siebziger geworden ist.

Es wird festgestellt, daß bei der Begrenzung der Wirksamkeit der Zentralbankmaßnahmen das Gewicht der politischen Einflüsse stark ist, und daß dann immer passende Argumente vorgebracht werden, die diese Politik vernünftig erscheinen lassen. Die Kontroverse über „Geldmarktindikatoren" (Zinssätze) und „Aggregate" (Geldvolumen) als Leitlinien für die Geldpolitik ist ein typischer Fall für dieses Verhalten. Daß man eine Politik des billigen Geldes mit dem Lohn- und Preisstopp vom 15. August 1971 für vereinbar hielt, ist ein weiteres Beispiel dafür, daß die Geldpolitik politisch beherrscht wird.

Auch andere Grundlagen der Federal-Reserve-Politik werden im Hinblick auf ihre destabilisierenden Einflüsse untersucht. Der schwere Vorwurf gegen diese Politik liegt in der Tatsache, daß dadurch die vom Federal Reserve System geschaffene Inflationskontrolle mit Hilfe geldpolitischer Instrumente schwierig, wenn nicht unmöglich erscheint, und daß man damit umfassende

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Maßnahmen der Regierung provozierte, die die Produktivitätssteigerung weiterhin hemmen und die wirtschaftliche Handlungsfreiheit in anderen Wirtschaftsteilen in Frage stellen.

Summary

Destabilizing Factors in Contemporary Monetary Policy

This paper reviews the contemporary history of monetary policy in the United States. Official statements by the Chairmen and the Board of Governors of the Federal Reserve System are used as primary source material. These statements reflect certain theoretical precepts and principles, and attempt to justify the policy actions taken by the Federal Reserve during the ten-year period, 1964 - 1974. Federal Reserve policies and the principles supporting them are subjected to critical analysis in this paper, with the purpose of determining how the relatively stable monetary economy of the early 1960s became the unstable economy of the early 1970s.

It was found that political factors weighed heavily in determining central bank actions, and that appropriate economic arguments were then adduced to rationalize the policies taken. The controversy over "money market indicators" (interest rates) versus "the aggregates" (monetary stocks) as guides to policy is a significant reflection of this pattern of central bank behavior. The compatibility of an easy money policy with the wage-price freeze of August 15, 1971 is another example of political domination of monetary policy.

Other subsidiary principles of Federal Reserve policy are also examined for their destabilizing influences. The most serious indictment of these policies lies in the fact that the Federal Reserve made inflation control by monetary means look difficult, if not impossible, and thus encouraged ubiquitous interventions by the federal government that continue to hamper economic productivity and jeopardize economic freedoms in other sectors of the economy.

Résumé

Facteurs Déstabilisants de L'Actuelle Politique Monétaire

L'article examine le déroulement de la politique monétaire aux Etats-Unis. A titre de sources principales, l'on s'est servi de déclarations officielles du Président du Conseil des Gouverneurs du Federal Reserve System. Ces déclarations formulent certaines règles et certains principes de fond et tentent de justifier les mesures de politique monétaire appliquées au cours de la décennie 1964 - 1974. Cette politique monétaire et les principes qui en furent le fondement sont ici analysés sur un mode critique par l'auteur à l'effet de démontrer comment l'économie de relative stabilité monétaire des années soixante s'est muée en économie instable des années soixante-dix.

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Il est établi qu'à la limitation de l'efficience des actions des banques centrales correspond un poids très lourd des influences politiques et que l'on présente toujours des arguments appropriés qui font apparaître cette politique comme raisonnable. La controverse sur les « indicateurs du marché monétaire » (taux d'intérêt) et sur les « aggrégats » (volumes monétaires) considérés comme les lignes directrices de la politique monétaire est un cas typique de ce comportement. Que l'on ait cru une politique d'argent bon marché compatible avec le blocage des salaires et des prix du 15 août 1971 est un autre exemple de cette mainmise politique.

D'autres éléments fondamentaux de la politique de la Federal Reserve sont examinés pour leur influence déstabilisante. Le principal reproche à adresser à cette politique réside dans le fait que le contrôle de l'inflation par le Federal Reserve System au moyen d'instruments de politique monétaire semble malaisé, voire impossible, et suscite par conséquent d'importantes mesures gouvernementales qui persistent à freiner l'accroissement de la productivité et remettent en question la liberté de négociation dans d'autres secteurs de l'économie.

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