"The Fed Has No Clothes"

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Every now and then a reporter asks my opinion about "current monetary policy." My standard reply has become that I would be glad to answer if he would first tell me what "current monetary policy" is. I know, or can find out, what monetary actions have been: open-market purchases and sales and discount rates at Federal Reserve Banks. I know also the federal funds rate and rates of growth of various monetary aggregates that have accompanied these actions. What I do not know is the policy that produced these actions.

Many alternative policies have been proposed. For example, undertaking monetary actions directed at attaining a specified steady numerical rate of growth of: (1) seasonally adjusted or (2) unadjusted monetary base, or (3) one or another broader monetary aggregate or (4) nominal gross national product. Or: stabilizing at a specified numerical level (5) one or another price index or (6) exchange rate or (7) index of exchange rates or (8) one or another nominal or real interest rate or (9) rate of unemployment.

However, the closest I can come to an official specification of current monetary policy is that it is to take those actions that the monetary authorities, in light of all evidence available, judge will best promote price stability and full employment – i.e., to do the right thing at the right time. But that surely is not a "policy." It is simply an expression of good intentions and an injunction to "trust us."

The accuracy of this description can be readily documented. Consider the following excerpts from the nearly 1,000-word statement of "Monetary Policy Plans for 1988" in the Federal Reserve's Monetary Policy Report to Congress, submitted Feb. 24, 1988, in accordance with legislated requirements:

"For 1988, the [Open Market Investment] Committee set ranges of 4% to 8% for growth of M2 and M3 …. [W]hile the Committee at this time expects that growth of M2 and M3 will be around the middle of their ranges, the outcome could differ if significant changes in interest rates are required to counter unanticipated weakness in aggregate demand or an intensification of inflation. In carrying out policy, the Committee will continue to assess the behavior of the aggregates in light of information about the pace of business expansions and the source and strength of price pressures, with attention to the performance of the dollar on foreign-exchange markets and other indicators of the impact of monetary policy."

Is it inaccurate to summarize this gobbledygook as "doing the right thing at the right time"? Indeed, the one specific element – the numerical ranges for M2 and M3 – is there only because Congress mandated it in 1975 over the vigorous objections of the Fed.

Such a "policy" can be used to judge present actions or anticipate future actions only through informed conjecture based on empirical extrapolation of past reactions of the Fed to a variety of stimuli, and analysis of the beliefs and attitudes of the participants in the decision-making

process – that is, by statistical extrapolation and psychoanalysis. And, of course, there is a sizable and remunerative industry in the financial community engaged in reading the Federal Reserve tea leaves.

Contrast such a process with, at the one extreme, a policy of steady growth in the monetary base or of buying and selling gold at fixed prices; or, at the other, of stabilizing an index of basic commodity prices. The first two would yield precise predictions of monetary actions; the third would not, but at least it would provide a ready means of judging the success or failure of the monetary authorities in carrying out their stated policy and of anticipating their future actions.

I hasten to add that the present situation is not unique. On the contrary, it has persisted for nearly the entire 74-year life of the Federal Reserve System. The only exception was from the outbreak of World War II to 1951, when the Fed followed an announced policy of pegging interest rates on federal government securities. For the rest, the Fed has consistently resorted to statements of good intentions both with respect to the future and with respect to its past actions. It has claimed credit for good results and blamed forces beyond its control – generally fiscal policy – for any bad outcomes. And this avoidance of accountability has paid spectacular dividends. No major institution in the U.S. has so poor a record of performance over so long a period as the Federal Reserve, yet so high a public reputation.

To come down to cases, consider the past quarter-century, from 1962 to 1987. Growth in both monetary aggregates and prices fluctuated widely, averaging 8.5% a year in M2 and 5.5% in the GNP deflator; severe recessions occurred from 1972 to 1975 and again from 1980 to 1982; accelerating inflation reached more than 15% during the 1970s and was accompanied by stagflation, followed by drastic disinflation and wild gyrations in interest rates and economic activity.

During the prior decade (1952 to 1962), M2 grew at an average annual rate of 5.5%, and prices of 2.3%, suggesting, in line with much other experience, that monetary growth at about 3% a year was consistent with stable prices. Suppose that in 1962 the Fed had adopted a policy of increasing M2 at an annual rate of 3% to 5% year after year. It could not have stayed within that range week by week or even month by month. However, it clearly could have done so on a semi-annual or annual basis, if it had taken steady monetary growth as its overriding objective.

If monetary growth from 1962 to 1987 had averaged 4% a year instead of 8.5%, M2 currently would be roughly one-third its present level and so would the price level, implying that inflation would have averaged about 1% a year instead of 5.5%. Even more important, the country (and the world) would never have suffered the accelerating inflation of the '70s and the accompanying stagflation, or the subsequent disinflation and erratic movements in interest rates and exchange rates.

Ups and downs in the economy, in prices, interest rates and employment would still have occurred, but they would have been far milder. President Nixon would never have had occasion to impose price controls or President Carter to impose credit controls. Departure from Bretton Woods would at the very least have been postponed. When it did occur, it would not have been followed by the revolution that occurred in financial markets and institutions.

You can readily add to this story. And, though hypothetical, it is by no means fanciful – as is suggested by the experience of Japan, which adopted a very similar policy in 1971 under much less favorable circumstances. (Japan, under pressure from us, now appears to be departing from that policy in an inflationary direction, with, as usual, favorable initial effects. It remains to be seen whether it will revert to its earlier policy soon enough to avoid the later bad effects.)

The hypothetical alternative policy would have had one other result: The news media would have paid far less attention to the Federal Reserve System. No poll would have designated the Chairman of the System as the second most powerful person in the country and far fewer people would know his name or the names of the other members of the board. The able people now earning high salaries reading the Fed tea leaves would be earning equally high salaries engaged in more productive activities. Similarly, it would be hard to attract individuals of the caliber of Arthur Burns or Paul Volcker or Alan Greenspan to serve as chairman. Why not, they might well say, turn such a boring job over to a computer? And, indeed, why not? It's my own favorite recipe for improving monetary performance.

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