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Statement at Hearings on Financial Institutions and the Nation's Economy

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Statement of Allan H. Meltzer
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The issues before the committee may appear to be narrow technical issues of procedure and organization and in a sense they are. There is, as always, a broader set of issues that, once resolved, can guide the choice of procedures. Principal among these is the degree of independence that the Federal Reserve should be permitted. I address the broader issues first to present a set of principles that are helpful in resolving the narrower issues. Then, I offer some specific proposals.

My recommendations differ in several respects from those reached in the careful report Professor Mayer has prepared for this committee. I believe that the differences reflect differences in judgment about the proper degree of centralization or decentralization within the Federal Reserve System as well as differences about the nature and type of independence to be given to an organization like the Federal Reserve. These issues cannot be resolved without asking: From whom is the Federal Reserve independent? On what issues and to what extent is the Federal Reserve permitted to choose an independent course?

Independence

The independence of the Federal Reserve is a much discussed topic, but much of the discussion is misdirected. The formal relations between the Federal Reserve, the executive branch and the Congress receive disproportionate attention. Proposals for reform are directed at these formal arrangements and neglect informal arrangements based on past and current practice.
I believe that the reasons for making the Federal Reserve an independent agency are more valid today than in 1913 when our commitment to the gold standard restricted monetary policy. Furthermore, I believe that the solutions to the principal problems in the relations between the Congress and the Federal Reserve or between the Federal Reserve and the executive do not require an end to the formal independence that now exists. Nor should the relationship be designed by referring to some simple standard of democratic or non-democratic control.

All agencies have some autonomy. Neither the Congress nor the President can scrutinize all the actions of the bureaucracy or control the decisions and outcomes. Once that is recognized, the term "democratic" loses the power to discriminate between types of organization. The formal structure of an organization has very little relation to the way in which decisions are made.

A principal reason for making the Federal Reserve an independent agency was to keep the power to print money away from the executive. Centuries of experience have taught that the temptation to debase the currency has proven difficult for sovereigns to resist. The modern means of debasing the currency, printing money, was known in 1913. There had been considerable inflation during the Civil War from excessive circulation of paper money in the North and South. Hindsight strengthened foresight.

Recent experience fully justifies the belief that the power to print money is often abused. An independent Federal Reserve did not protect the public from inflation. On the contrary, the Federal Reserve helped to finance the government by printing money. Their decisions started, sustained and continued the most severe peacetime inflation in our history.
It is the record of history that tells us that the independence of the Federal Reserve failed to protect the public from the major monetary mistakes of this century -- deflation and depression in the 1930's and inflation in the 1960's and 1970's. In both instances, independence permitted the Federal Reserve to rely on improper procedures, to continue archaic practices and to pursue inappropriate goals.

These experiences, supplemented by others, inform us that the procedures for monitoring the Federal Reserve's performance are inadequate. We must develop procedures that reduce the opportunities for persistent error.

It would be a mistake to conclude that the executive branch should be given increased authority over the Federal Reserve or increased responsibility for monetary policy. Nothing in monetary history supports that conclusion. Our recent experience does not show that the President and his aides were prevented from achieving their aims by the recalcitrance of the Federal Reserve.

The Council of Economic Advisers has a public platform and an obligation to recommend economic policies that maintain employment and price stability. Generally, they have not criticized monetary policy or recommended alternatives. Their annual reports contain very little information about the monetary policy they regard as appropriate. They have been reluctant to inform the Congress and the public about the monetary policies they or the President believes to be appropriate. They rarely indicate the monetary policy that is consistent with their responsibility to maintain high employment without inflation.

The Congress has only recently offered policy guidelines to the Federal Reserve. Through most of its history, the Federal Reserve operated under archaic guidelines that had no important influence on policy decisions.
Concurrent Resolution 133 changed the relationship between Congress and the Federal Reserve in two respects. The Congress stated goals or objectives that can and should be achieved. And, the Congress improved the procedures for monitoring the Federal Reserve actions.

The new procedures do not conflict with the position of the Federal Reserve as an independent agency. But, they provide an opportunity for the Congress to oversee performance and to compare promise with performance. Below, I recommend some changes to improve Congressional oversight.

The Federal Reserve has not adopted methods or procedures that are well designed to carry out its responsibilities. In response to critical comments by the Congress of the policies that produced severe deflation in 1920 and 1921, the Federal Reserve developed new procedures for implementing monetary policy in the early 1920's. These procedures guided the interpretation of policy for the next forty years and continue to influence policy today. The procedures encourage the Federal Reserve to focus attention on the day-to-day changes in money market interest rates. The Federal Reserve does not adopt procedures that are well designed to control monetary aggregates and thereby contribute to greater economic stability. Some steps should be taken to reduce the centralized bureaucratic structure of the Federal Reserve to speed the generation and implementation of new ideas.

Relations between the regional Federal Reserve banks and the Board in Washington have changed considerably since 1913. Power is much more centralized in Washington, and the Reserve banks have much less independence. The existence of independent regional banks with research
staffs helped to provide the impetus for two of the most important changes in procedures. The New York bank was a major source of ideas in the 1920's. The St. Louis bank was an important stimulus to change in the 1960's. These instances suggest that there is a potential gain to be achieved by encouraging greater independence by the Reserve banks in developing procedures and in the discussion of monetary policy.

Some Proposed Changes

Three proposals for change are offered to improve the information available to Congress and the public about the conduct of monetary policy and to improve Congressional oversight. I regard these proposals as an alternative to proposals that change the formal organization or legal structure of the Federal Reserve. Many proposals have been made to alter the term of Federal Reserve governors, the number of members of the Federal Open Market Committee or the relationship between the Federal Reserve and other agencies responsible for economic policy. Often the effect of the proposals is to give the President greater responsibility for and control of monetary policy.

It is the responsibility of the Congress to resolve conflicts about the goals of economic policy. Issues of this kind should not be hidden from public scrutiny or from the Congress. Increased centralization of responsibility is not, in my view, desirable. There are better alternatives. Existing arrangements provide regular opportunities for exchanges of views between the Federal Reserve, the Treasury, the Council of Economic Advisers and other economic policy agencies. These discussions should continue. The relationships should not be altered in such a way as to reduce the ability of the Federal Reserve to dissent from the administration's program.
To improve the effectiveness of Congressional oversight of monetary policy, I propose three principal changes.

(1) The Council of Economic Advisers should be required to state in their annual reports the growth rate of money that is consistent with the President's program. The Congress and the public will obtain the benefit of the administration's view of appropriate monetary policy.

(2) Congress should make permanent the requirement under Resolution 133 that the Federal Reserve report semi-annually on the proposed growth rate of money that achieves the maximum growth of employment that is consistent with stable prices.

(3) Conflicts between the administration and the Federal Reserve should be the subject of open hearings at which the consequences of the alternative programs are brought to the attention of Congress and the public.

The effectiveness of Congressional oversight can be increased by providing Congress with information about policy conflicts between the administration and the Federal Reserve. But Congress must also develop increased ability to assess performance. Present procedures permit the Federal Reserve to specify several different monetary aggregates and to adjust the time span over which the growth rates are measured. These procedures are inconsistent with effective oversight.
Much can be done also to improve the internal operations of the Federal Reserve. I agree with the thrust of several of the changes proposed by Professor Mayer to reduce centralization of authority in the Federal Reserve System. One useful means of increasing the responsibility of the Reserve banks is to increase control by the Reserve banks of their budgets. A formula for dividing receipts from portfolio earnings between the banks, the Board of Governors and the Treasury would increase the authority of the Reserve banks. Consideration should be given to these and other means of developing broader, more meaningful internal discussion of the policies and procedures for achieving more stable growth of output and employment and increased price stability.