1982

Comments on External Pressures and the Operations of the Fed

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Published In

Political Economy and International Domestic Monetary Relations, (eds.) R. Lombra and W.E. Witte.

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Ed Kane offers us some thoughtful propositions about the political economy of the Federal Reserve and a useful summary of his earlier work. As the title suggests, Kane emphasizes external pressures coming from Congress and the Executive and outlines the way in which these pressures operate on the Fed. He finds that the Fed's political role is to act as a scapegoat, or buffer, between the public and the government. The Fed accepts the opprobrium for decisions over which it has limited influence in exchange for the appearance of independence.

Kane states three main, and several subsidiary, propositions. I will restate the propositions and comment on them. Then, I offer some suggestions for extensions.

One of Kane's main propositions is that the Federal Reserve is a political institution -- part of the government. Related to this proposition, is Kane's view that Federal Reserve independence is greatly exaggerated. The truth, he believes, is that the Fed adjusts to accommodate political and economic developments.

Kane is generally correct, I believe. Policy without politics is hard to imagine. My main caveat is that institutional arrangements can matter more than Kane recognizes. Often an institutional facade is created, then takes on a life of its own and restrains subsequent actions. The Bundesbank and the Swiss Nationalbank seem to have greater freedom than the Federal Reserve currently enjoys. Further, the Federal Reserve produced the deflations of the thirties and the early twenties with minimal interference from the
rest of the government despite the presence of the Secretary of the Treasury
and the Comptroller on the (then) Federal Reserve Board. I doubt that a
repetition of these mistakes would leave the Fed in its present form.

Recent Federal Reserve chairmen -- Burns and Miller -- seemed eager
to be part of the broader policy process. In an earlier day, Marriner Eccles
was an active participant in the policy planning of the Roosevelt administra-
tion. Is independence irreversible, so that it cannot be reclaimed once it
has been given up? Do the personalities who serve as chairmen have more
lasting influence on the institution than social scientists concede? Or,
is there some more fundamental process at work? I am inclined to the latter
view, but the influence of Burns on the inflation of the 1970's, of Eccles
on the recession of 1937, of Riefler and Strong in the twenties and similar
examples from other countries leave room for doubt.

Kane's second main proposition is that the Federal Reserve acts as a
scapegoat bearing the brunt of criticism for fluctuations in prices, output,
employment and interest rates, particularly at election time. This is the
price the Fed pays for its limited independence. In recent years, Congress has
further restricted the Fed's authority, for example, by requiring more
frequent reports but, Kane argues, Congress has stopped short of assuming
control of Federal Reserve policy because it wants to retain a scapegoat.

How different is the Fed from other agencies? Congress does not control
all government activities directly, and cannot get along without agents. When
the public, or a significant segment of the public, desires a change in
agency duties or actions, Congress responds. Recent changes ranging from
environmental protection or health and safety to the deregulation of trucking
and airline routes and fares suggests that Congress responds, albeit slowly,
not just to the regulated and the regulators but to the public. The history of the Federal Trade Commission under Chairman Pertschuk shows one way in which the constraints operate.

Kane's view, that the Federal Reserve is an agent of the Congress or of Congress and the President, differs from a substantial part of the literature in political science and economics. There much credence is given to the notion that bureaucrats determine policy and that agencies are relatively unconstrained. A good, formal statement of one version of this hypothesis is Niskanen (1971). Kane's view seems, to me, better founded.

A third proposition, loosely related to the preceding two, states that policymaking involves a choice about distribution of benefits. Kane notes the Federal Reserve's concentration on a narrow range of interest rates, their well-known money market myopia. This, he claims, benefits a vocal group of borrowers. Kane also notes the distributional effects of Regulation Q, the bailout of Franklin National Bank, First Pennsylvania Bank and the Hunt brothers.

I believe that distribution is the feature that should receive most emphasis in discussions of the political process. One of the main ways in which political economy differs from economics is that voters choose to redistribute income. Decisions in the market place differ from decisions in the polling place because individuals in the polling place maximize subject to an additional constraint -- the voting rule which specifies who votes, how often a person votes and what constitutes a majority. I will summarize the voting rule, following the well established tradition by referring to the decisive voter.
It is easy to show that with universal suffrage and majority rule, the median voter is the decisive voter. What matters, qualitatively, is not whether the decisive voter is precisely at the median but whether he is to the right or left of the mean income recipient. If the decisive voter earns less income than the mean income recipient, he has an incentive to tax and redistribute.

This argument, developed more fully in Meltzer and Richard (1980), suggests that Kane has not pushed his hypothesis far enough. The Fed is an agent of Congress, but Congress and the Executive are agents of the public. The President, Congress and the Fed do not respond instantly to changes in the decisive voter's demands, but they respond fast enough to retain the positions they occupy.

This line of argument suggests that the Fed produces inflation not accidentally but as a response to the decisive voter's desire for higher taxes on current income and on assets. Unanticipated inflation is a tax on wealth, but inflation is also a means of lifting people into higher tax brackets. Should we treat as accidental the fact that social security benefits, welfare payments and Congressmen's expenses are indexed, but the tax system is not indexed? I do not think so. More importantly, the failure to index tax rates and willingness to index redistribution suggests an intent to increase the share of income redistributed.

Much of the Fed's action is purposeful. If we trace the gains and losses back to the voters, we may learn what the purposes are. To avoid misunderstanding, let me add that I do not think of Federal Reserve Governors as careful calculators who count the votes in Congress and the electorate.
Institutional arrangements, and high costs of monitoring, give agents some discretion. Also, many of the Governors of the Federal Reserve do not have much substantive knowledge of the monetary process. A number of papers, most recently Lombra and Moran (1980), present a consistent view of Fed governors as not very well informed about the consequences of their actions. None of this should suggest that they are oblivious or ignorant of the political pressures for income redistribution.

Kane ends on a hopeful note. He believes that the recent legislative changes strengthen the Fed's control of its constituents and, thus, increases the Fed's ability to reduce secular inflation. I am not convinced. If we get lower inflation in the eighties, I believe it will be a result of voter choice -- as in Britain -- and not a result of more power at the Fed.
REFERENCES

