Winter 1984

The Cure for Monetary Madness

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Published In
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How to Reduce Uncertainty and Risk—and Thereby Encourage Economic Growth

Allan H. Meltzer

From 1947 to 1964 the United States maintained a relatively stable monetary framework under which many countries recovered, developed, and prospered. Inflation remained low in the United States and in other nations that tied the values of their currencies—their exchange rates—to the dollar. The framework and the procedures were not ideal, but they produced greater stability than the monetary systems that preceded or followed.

The system of fixed exchange rates based on the dollar, known as the Bretton Woods system, formally ended in 1971 when President Nixon allowed the exchange value of the dollar to be set by market forces. Holders of dollars and dollar securities became less certain about the long-term value of the dollar. Long before the Bretton Woods system ended, however, uncertainty about monetary policy and the future value of the dollar had increased. Inflationary policies after 1964 had eroded much of the credibility of the U.S. commitment to a fixed exchange rate and a noninflationary monetary policy. The unwillingness of the United States to change its policies and the unwillingness of other countries to increase their rates of inflation or change their exchange rates against the dollar had doomed the Bretton Woods system.

Misplaced Nostalgia

Many people look back on Bretton Woods nostalgically. They would like to restore some type of fixed exchange system to recapture some of the stability that enabled countries to achieve the benefits they associate with that system. There are several proposals. Some want to establish a world central bank that would issue a common money to be used as reserves and for settlements between national central banks. Others propose a return to some type of gold standard.

Such proposals misinterpret the experience of Bretton Woods. Fixed exchange rates were not a cause of increased stability and the relatively high growth of the world economy during those years. They were the result of the relatively stable policies followed in major trading countries, particularly the monetary and fiscal policies of the United States. From 1953 to 1964, when the Bretton Woods system flourished, budget deficits remained small on average, and the most common measure of the U.S. money stock—currency and checking deposits—rose at an average annual rate of less than 2 1/2 percent. In the succeeding seven years that ended with the breakdown of the system, average U.S. money growth rose to 5 percent, and the variability of money growth increased.

By the early 1980s, monetary variability had increased dramatically. Actual rates of money growth bear little relation to targets announced by the Federal Reserve. No one can guess whether monetary policy will produce another round of inflation, a severe deflation, or a period of disinflation. No one can be certain whether money growth will be fast or slow.

The effect of unstable monetary policy has been compounded by increasing uncertainty about the world trading system and the fiscal policies of the major Western economies. For 30 years after World War II, businesses making investment decisions could be reasonably certain that trade barriers around the world were gradually coming down. Protectionist pressures began building in the midseventies, however, and during the recent recession these pressures intensified. Recent tax cuts in the United States have led to enormous uncertainty about who will eventually pay for the mounting deficits: If future taxpayers must pay, on whom will most of the tax burden fall?

The higher risk and uncertainty are a principal reason that real interest rates have remained above their postwar norms. Greater uncertainty about the future discourages investment in real assets and encourages people to hold relatively safe assets, such as currency, insured bank deposits, and short-term debt. The attempt to shift from long-term debt, land, common stocks, and other real assets to these safer assets raises the real rate of interest on long-term debt and on real assets. In principle, the increased demand for money and short-term securities may raise or lower the real rate of interest on short-term securities. If long-term debt is a closer substitute for

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short-term debt than for money, real rates on short-term
debt rise with long-term rates.

The mismanagement of monetary control by the Fed-
eral Reserve increased the variability of both money
growth and interest rates after 1979. When the Federal
Reserve changed its procedures and began targeting re-
serves instead of interest rates, quarterly averages of
short- and long-term interest rates became two or three
times more variable. The Fed thus heightened uncertain-
ty. And when uncertainty increases, people reduce their
holdings of risky assets like bonds and equity shares and
increase their holdings of money. The reduced demand
for risky assets lowered the price and raised the return
received by holders. Asset prices fell and rates of return
rose until holders received sufficient compensation for
bearing greater uncertainty. The increased compensation
takes the form of a higher risk premium on all earning
assets. Despite the recent increase in equity and bond
prices, risk premiums in interest rates remain at levels not
experienced since the early 1930s.

Those increases in risk premiums and the demand for
money help to explain several recent developments, in-
cluding the rapid decline in inflation, the length of the
recession, and the strength of the dollar in world mar-
kets. The increased demand for money contributed to the
decline in inflation by reducing spending and prices, but
it also contributed to the recession. The reduced demand
for real capital helps explain the persistent stagnation of
real output from 1979 through 1982 and the low rate of
investment. The rise in real rates of interest attracted
foreign capital and contributed to the higher exchange
value of the dollar. In each case the risk premium supple-
mented other forces that have depressed the economy in
recent years.

The Clouded Crystal Ball

Little has been done to solve the long-term problems of
the economy. Uncertainty remains high. No one can
possibly know what the Federal Reserve will do because
the Federal Reserve has unlimited discretion and little
accountability. The only monetary discipline that re-
mains is achieved by market forces that cause an increase
in interest rates or a flight from the dollar. The markets
have forced the Federal Reserve to correct past errors but
has not produced disciplined policies. Fiscal and trade
policies are just as uncertain. Who knows what tax rates
will be in two or three years?

What is needed now is a new set of monetary, fiscal,
and trade policy rules to reduce uncertainty and encour-
age the stable growth and relatively low interest rates of

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When the savings rate is too low to finance a large deficit without a substantial increase in interest rates and when paying the interest on outstanding debts becomes a burden, governments typically rely on inflation to reduce the debt and tax the wealthy.