

Ted Balbach: In Memoriam

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Ted Balbach was my friend and fellow worker in the small cohort that worked to improve monetary policy in the 1970s. As most of you know, Ted came to the United States after World War II. He managed to survive the war and the vicious murders known as the final solution.

I first met Ted in the winter of 1952 when I enrolled in graduate school at UCLA. Karl Brunner, then a new assistant professor, offered a course in logic and scientific method. It was a subject he loved, and his enthusiasm brought the material to life. The next fall I joined the teaching assistants and took an economic theory class with Armen Alchian. To put it mildly, it was a puzzling class. We used a textbook by George Stigler. Alchian lectured from Milton Friedman's notes that had been collected by two of his students. None of us knew about Friedman's notes. Trying to relate the lectures to the reading material was a problem.

After each class we went back to the teaching assistants' office where Ted would try to explain what the lecture had been about. After 55 years, I can recall those sessions and remember how much they helped. Ted could make far more sense of the lecture than I could.

Ted was a leader, *primus inter pares*. He loved to tease Walter Oi, but he helped all of us. The next year, I believe, he was drafted into the army. By the time he returned, I was off to France to work on my dissertation.

Most of the teaching assistants had very little income, but we socialized a lot. There were frequent parties and lots of fun to relieve the anxiety that is an ever present part of doctoral education.

Ted married Rae and taught for fifteen years at California State University at Northridge. One of his students, Jerry Jordan, describes him as an extraordinary teacher. In 1975 he replaced Jerry as Senior Vice President and Research Director at the St. Louis bank.

Ted wrote a few papers including a paper with Karl Brunner that was the forerunner of the famous Andersen-Jordan paper showing the relative effect of money growth and fiscal measures on GNP growth. During Ted's years as head of research, the department established its reputation as a main center for research on the role of money.

Although Ted and I remained friends, we were physically far apart. I do not know much about the details of his career, so I plan to talk about his struggle to change monetary policy in the 1970s.

It may be difficult for today's economists to recall some of the disputes of that period. James Tobin had persuaded policymakers and many economists that the prices would begin to rise before the economy reached full employment. He said that the way to control inflation was to impose guidelines for wage and price increases. This mixed price level changes with rates of price change—inflation. It took about 20 years before policymakers replaced Tobin's maxim with the claim that low inflation contributed to growth, even that it was necessary for sustained growth.

Other harmful beliefs that have since disappeared were; (1) there was a permanent tradeoff between unemployment and inflation; (2) nominal interest rates did not fully reflect the expected rate of inflation; (3) euro-dollars permitted banks to escape restrictive monetary policy; (4) velocity growth was highly variable, so money growth was a poor predictor of inflation; and (5) excess or deficient money growth was usually caused by unanticipated shifts in the demand for money. There were other issues, for example about exchange rates, but this sample suggests that basic issues were disputed with a majority of economists on the wrong side.

Ted's principal tasks were to maintain and guide the excellence and excitement of the research department, to protect it from internal and external threats, and to educate the presidents. Less than six months after Ted became senior vice president, Darryl Francis retired as president. His successor Larry Roos was a local politician with some banking experience. Arthur Burns wanted someone to silence criticism from St. Louis. Ted took on the task of educating him in monetarism. He succeeded. After seven years, Roos retired. His successor, Ted Roberts, did not stay very long. In June 1985, Tom Melzer became president. Melzer came from Wall Street, so he probably believed he knew a lot.

Ted succeeded in getting each of the presidents to respect the work of the research department, the staff's analysis and his analysis and interpretation. This sounds easier than it was. Surprisingly he succeeded even when his personal relationship with the president was less than cordial.

I draw much of my conclusion about his success as a teacher from reading the transcripts and discussions of open market committee meetings. There I found Presidents Roos, Roberts,

and Melzer reading opening statements that could have been written or edited by Ted, as I suspect many of them were. But I also find less precise but, nevertheless, broadly consistent statements in the discussions that followed. The presidents absorbed his lessons. Each had a different personality and different interests. A good teacher learns to work with and influence many different students. Ted was able to get through enough so that each of his presidents could speak with conviction about the rate of money growth, the importance of inflation control, and the need to maintain steady and persistent efforts to sustain growth and reduce inflation.

The St. Louis view of monetary policy was not directed solely at achieving and maintaining low inflation. Ted's statements are more balanced. They urged moderate and stable monetary growth in place of the prevailing stop and go policies. They usually recognized that large short-term deviations did not do much damage, if they didn't continue. Their policy accepted and urged others to achieve the two main objectives—stable growth and low inflation. In a 1977 FOMC meeting Larry Roos described the goals of monetary policy as including maintaining economic growth and keeping unemployment at a reasonably low level. St. Louis' presidents often urged concern for both objectives all the time instead of swinging from heightened concern about inflation to heightened concern about unemployment. They never succeeded in getting this more balanced approach adopted. I do not think we have succeeded yet. Below, I will offer an explanation.

As time went on events proved Ted and other monetarists right more often than wrong. Although policy did not change, the view gained occasional adherents. At times, the Federal Reserve committed to a policy of lowering inflation. Members swore to themselves and each other that they would persist. When the unemployment rates ticked up, they forgot their pledges and let money growth rise. Does this sound familiar? Last July's concern about inflation seems to have vanished in haste when the unemployment rate moved from 4.7 percent to 5 percent this January.

Slowly monetarist ideas gained attention in the 1970s. Several members of the FOMC recognized some of the principal problems with operating procedures. They mentioned uncertainty, inaccurate forecasts, the problem of distinguishing permanent or persistent changes from temporary changes. Governor Sherman Maisel chaired a Committee on the Directive that advocated more and better control of reserve growth. His committee and his successors on the committee on the Directive proposed restrictions on reserve growth. These efforts were never

successful. President Roos, Henry Wallich, John Balles, and others pointed to the tight control of interest rates as a reason for poor monetary control and urged a wider interest rate band. It didn't happen. Balbach's teachings were heard, but not applied. Even the atheoretical McChesney Martin commented at one point on "the difficulties which men have to distinguish the permanent from the temporary."

One of the lessons of the 1970s is that a country that cannot tolerate a small recession eventually accepts a large recession to reduce inflation. When policy switches from a balanced path to focus exclusively on avoiding recession, markets recognize that the monetary authority is unlikely to persist in anti-inflation policy. Price and wage changes incorporate the information. An anti-inflation policy becomes harder to achieve. Expectations work against the monetary authority. The combination of rising unemployment and rising inflation is called stagflation. The name suggests the apparent mystery that market participants see. There is no mystery – just the expectation that Federal Reserve policy will bring higher inflation.

Ted Balbach saw the problem in the 1970s. As inflation worsened in late 1978, Larry Roos asked his open market colleagues whether the FOMC set its economic objectives or its monetary objective first. Then he asked whether the Federal Reserve members agreed on their ultimate economic objectives and then implemented a monetary policy to achieve the objectives. These questions probably came from Ted.

The answer should have been NO. The Board's staff made its economic forecast without using any assumption about money growth. Other FOMC members ignored the question. It would be useful to ask the same question now. The apparent answer is that the Federal Reserve wants to avoid a possible recession even though it does not predict there will be one. And like the IMF, the CBO and many others, it forecasts that 2008 will have positive growth.

My answer to the Balbach-Roos question is that the Federal Reserve has again sacrificed its independence by yielding to pressure from Congress, the administration and the Wall Street traders. They act as if a solution to problems brought on by negative real interest rates is a return to negative real interest rates.

I understand the pressures they are under. They are the pressures that Ted faced repeatedly. It is an election year. Wall Street traders hope that prices of their portfolio assets will rise with lower interest rates. Chairman Bernanke's phone must ring persistently with calls for help. The Federal Reserve was made independent in 1913 to protect it from these pressures.

The Federal Reserve forecasts that inflation will fall in 2009. Why worry? I hope they are right, but the forecasting record is not comforting. In the 1970s forecasts underpredicted inflation for 16 quarters in a row. The only overprediction came when inflation declined in the 1980s. Recall that the two most successful chairmen, Paul Volcker and Alan Greenspan, did not find staff forecasts useful and claimed not to use them. Recall also that the Board's staff continues to rely on a Phillips curve to forecast inflation. A long list of economists concluded that Phillips curve forecasts are unreliable mainly because we lack accurate measures of the natural rate.

Inflation is much lower now than in the first years Ted served as Senior Vice President. The deflator rose 7.6 percent annual rate when he was appointed. It reached 12.1 percent five years later.

Will history repeat? My guess is that it will. Opposition to current policy seems muted. I hope I am wrong, but history is not comforting. There is frequent clamor for lower interest rates. Clamor for increases is rare.

The simple explanation of why inflation persisted and rose on average through the 1970s is that the Federal Reserve did not sustain actions that would end it. "That was basically political," Steven Axilrod told me. Herbert Stein said the same. The Federal Reserve started several times to lower inflation. It was aware that its actions on average increased inflation. At times it brought the inflation rate down, notably in 1976 during the Ford presidency. It did not maintain independence. The election of President Carter on a promise of more job creation and more expansion ended disinflation. Although Burns criticized the new administration's fiscal plan, the Federal Reserve did not want to be accused of undermining the expansion. Ted and his president resisted but were out voted.

There were many reasons for not insisting on independence and low or zero inflation. At the time the public did not regard inflation as a major problem, and many in the Congress reflected that attitude. Except for the start of the Gerald Ford administration, reducing unemployment dominated reducing inflation in policymakers' minds. The Ford administration's program to "whip inflation now" gave way under popular and Congressional pressure once recession started. Congress and successive administrations interpreted the Employment Act of 1946 as a commitment to full employment, defined as a 4 percent unemployment rate. Low inflation was not mentioned explicitly in the Employment Act.

In his 1979 Per Jacobsen lecture to the IMF in Belgrade, Arthur Burns recognized that he lacked political support for slowing money growth to end inflation. He was not willing to insist on independence to carry out the central bank's responsibility to maintain the value of money. His failure was not the first time the Federal Reserve had chosen not to rely on its statutory independence to change policies. In the late 1940s, it chafed under the policy of pegging interest rates, but it did not act until after Senator Paul Douglas showed support for independent monetary policy and brought many colleagues along. The Federal Reserve engaged in policy coordination, thereby financing a rising budget deficit by issuing money.

Although many members agreed with Ted that reducing inflation required consistent long-term action, there is scant evidence of longer-term planning. Discussion at FOMC meetings was often between those who favored and opposed raising the federal funds rate an additional 0.12 or 0.25 percentage points. The staff did not consider expectations when making its forecast, as Lyle Gramley noted at one point; expectations entered the member's discussion mainly as evidence of public attitudes and concerns.

The record of the 1970s showed that inflation and unemployment rose together, on average, propelled by expectations of inflation. These errors did not shift concern from quarterly near-term changes to longer-term implications of the FOMC's actions. Some recognized, as Ted had, that FOMC actions had little effect on near-term changes and major effect on the maintained rate of inflation, but this occasional recognition did not lead to changes in procedures.

One important consequence was the failure to distinguish between permanent or persistent problems and transitory or short-term events. The oil price increases in 1973 and 1979 were the most notable examples. In part a result of its short-term focus, the System in the 1970s did not distinguish the one-time price level change induced by the oil price increases from the persistent inflation induced by its policy. The former was real, the latter monetary. If the Federal Reserve had held a coherent view of its objective, it might have recognized that preventing a one-time price level change by reducing aggregate spending worked to stabilize the price level at the cost of recession. Controlling money growth worked to lower inflation and expectations of inflation. Ted argued for controlling money growth to control sustained inflation.

Rising unemployment and inflation did not protect the Federal Reserve from Congressional legislation. Congress found its performance less than satisfactory. It legislated

objectives and required more reporting and oversight. The 1970s like the 1930s suggest that poor performance is a greater threat to Federal Reserve independence than effective action to maintain stability.

Despite its problems in the 1970s, the members of FOMC never discussed how their actions affected inflation and output or whether they could agree upon a framework for improving performance. They argued many times that lower average money growth was necessary to control and lower the inflation rate; they were unwilling to let interest rate variability increase. No one suggested bold, decisive actions to end inflation.

Ted Balbach was a hero. He was willing to insist on a less inflationary, more balanced approach to monetary policy. He was not alone, but he was outnumbered. He persisted despite the opposition. And he was fortunate to see the turnaround when Paul Volcker used the arguments that he had written so often for the presidents he served. Volcker even called himself a practical monetarist.

For me, and I believe for Ted, in 1807, Henry Thornton gave as good a definition of practical monetarism as one can find.

The policy of the central bank should “limit the total amount of paper issued, and to resort for this purpose, whenever the temptation to borrow is strong, to some effectual principle of restriction; in no case, however, materially to diminish the sum in circulation, but to let it vibrate only within certain limits; to allow a slow and cautious extension of it, as the general trade of the kingdom enlarges itself ... To suffer the solicitations of the merchants, or the wishes of government, to determine the measure of bank issues, is unquestionably to adopt a very false principle of conduct.”

The European Central Bank is more independent than the Federal Reserve. To date its policy reflects its greater independence. It has pursued both policy goals and has not abandoned its commitment to low inflation.

Ted Balbach fought hard for the Thornton principles. He taught his presidents to honor those principles. In more than 90 years, the Federal Reserve rarely achieved reasonably steady growth and low inflation. The years 1923 to 1929, a few years in the 1950s and early 1960s and the long period from about 1985 to about 2004 are its best years. Let us hope the policy of 1985 to 2005 and its benefits will return.

While writing the history of the Federal Reserve, I learned that Federal Reserve policy was best in the postwar years when the administration respected independence. The Eisenhower, Reagan, and Clinton years stand out. Most of the rest of the time, the Federal Reserve sacrificed its independence. It is doing so again. To his great credit, Ted fought against it then and, I believe, he would do so again.