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The Debate About Monetarist Policy Recommendations

By Thomas Mayer*, Berkeley, Calif.

In the United States the Keynesian-monetarist debate about monetary policy, unlike the debate about monetary theory, resembles a dialog of the deaf. Both sides merely repeat their by now quite familiar arguments, and seem genuinely puzzled that their opponents refuse to concede these seemingly obvious points. This is due, in large part, to the issue not having been properly joined because of a methodological problem. This paper therefore does not attempt to confirm – or reject – monetarist policy recommendations, but to contribute to the methodology of the debate by bringing into the foreground an aspect of the debate that has received insufficient attention.

The methodological problem arises from the combination of three factors. One is that it is not possible to evaluate policy proposals adequately without considering the efficiency of the policy-making process. This obvious point is readily acknowledged in extreme cases – few economists would advocate that the government impose price controls to set price to equal marginal costs for oligopolistic industries. But the need to consider the efficiency of policy-making is ignored in less obvious cases. The second factor is that at least in the U.S., most economists want to confine their work entirely to economics, and do not want to analyze the policy-making process. Although they are willing to make strong assumptions, as well as strong assertions about the efficiency of policy-making, relatively few are willing to do substantial work on this subject. The third factor is that economists generally do not collaborate with political scientists in studies of policy-making, while political scientists generally lack the knowledge of economics needed to evaluate the efficiency of economic policies.

The result is that many, if not most discussions of macroeconomic policy choices present a peculiar combination of painstaking and often quite formal and rigorous analysis of the behavior of the private sector, along with casual assertions about the likely behavior of policy-makers. It seems almost

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as though economists have inverted the familiar principle that a logical chain is only as strong as its weakest link. While this inversion of the “weakest link” principle is widespread in economics, it is particularly pronounced in the debate about monetarist policy recommendations.

I. The Role of the Political Assumption

What divides monetarists and Keynesians on the central issues of monetary policy are two basic propositions. One is an economic proposition about whether econometric models and forecasts are accurate enough for a policy based on them to be stabilizing. It involved issues such as the length and variability of the lag in monetary policy. Few economists would attempt to resolve this issue simply by asserting that lags are, say long and variable, without presenting empirical evidence. The second proposition relates to the behavior of the central bank. Keynesians, but not monetarists, assert that the policy-makers use the available knowledge efficiently, and are benevolent in the sense that they do not, to a substantial extent, subordinate stabilization policy to their own bureaucratic interests, or to the interests of powerful groups. I will call this the “Keynesian policy assumption.” In a fiscal policy context *James Buchanan* and *Richard Wagner* (1977) have criticized it as “the presuppositions of Harvey Road”.

The proposition that the monetarist – Keynesian debate about monetary policy is to a substantial extent a debate about political economics rather than about economics in the narrow and technical sense can readily be documented. In his debate with *Franco Modigliani* (*Modigliani* and *Friedman*, 1977, pp. 17 - 18) *Friedman* stated:

My major difference ... with Franco is in two respects: First, with his assumption that he knows how to accommodate ... and second with the assumption that ... Franco Modigliani will be twisting the dials ... Once you adopt a policy of accommodating to changes there will be all sorts of changes that he and I know should not be accommodated with respect to which there will be enormous pressure to accommodate ... *I have increasingly moved to the position that the real argument for a steady rate of monetary growth is at least as much political as it is economic.* (italics added.)

More recently *Friedman* (1983, pp. 4 - 5) wrote:

We have had a tendency to treat monetary policy as if it could and would be conducted by a pure and disinterested technical economist completely isolated from political pressure, and taking account only of technical knowledge and information about monetary arrangements. This is far from the fact. In practice, any rule will operate in a political environment subject to pressures that experience tells us will produce results very different from those dictated by purely economic considerations. This consideration has become a major argument, in my mind, for a simple mechanical rule.

Friedman (1983, pp. 5 - 6) then illustrated his preference for a simple rule by discussing the appropriate disinflation policy. A policy that would be ideal “in a world of perfect information and control” would have the monetary growth rise again after its initial decline because lower inflation causes a fall in velocity. However, *Friedman* rejects such a policy, in part because the monetary authorities lack sufficient information, and in part because “the authorities tend to be deceived by the decline in velocity when it comes, regarding it as more than a one-shot affair, and hence run the danger – which has been realized more than once – of reigniting inflation.”

In a similar vein *Karl Brunner* (1981, pp. 37 - 38) wrote:

We should not expect that a monetary authority will naturally pursue the optimal social benefit achievable with cleverly designed stabilization policies ... An activist conception of policy ... offers excellent opportunities for actions and arrangements in the interests of the monetary authorities, and their bureaucracies, or of political coalitions formed with other agencies or the existing central executive. Considerations of the political economy surrounding the institution empowered to control monetary affairs thus reinforce our case for a non-activist strategy in matters of monetary policy.

William Poole (1978, p. 112) has argued:

There are three basic arguments for legislated monetary rules. One is political ... Officials ought not to be given broad grants of power ... The possibility of capricious and arbitrary actions ... is too great; hidden pressures from special interest groups and abuse of power are too common to be ignored. Why should monetary officials be any different in these respects from other government officials?

Friedman (1982) has attributed a wide variety of Fed actions, ranging from the insufficient emphasis on the monetary aggregates to delays in publishing the Directive, to the Fed’s own bureaucratic interests, while *Robert Hetzel* (1987) *Raymond Lombra* (forthcoming) *Edward Kane* (1984) and *Allan Meltzer* (1982) have attributed various Fed policies to political pressures.

This paper demonstrates the importance of the political assumption for the three propositions that are central to the monetarist policy position. They are that: (1) the central bank should use only a single target variable, (2) this variable should be the money growth rate, and (3) the growth rate of money (or the base) should be either stable, or predictably related to some other variable.¹ (For brevity I will refer to this as a stable monetary growth

¹ A belief that the growth rate of money or of the base *must* be stable is not a part of modern monetarism. Thus *Friedman* (1983, pp. 3 - 4) wrote:

the idea that monetary growth should be steady and predictable is the core of the monetarist view. All monetarists ... favor steadiness. ... Steadiness and predictability do not necessarily mean constancy. Personally I have favored constancy. ...

rate.) The next section argues that if one makes the Keynesian political assumption, then the monetarists have only a weak case. The following section shows that once the Keynesian political assumption is rejected, then the monetarist case becomes much stronger. The rest of the paper then discusses whether the Keynesian political assumption is so plausible that Keynesians are justified in ignoring monetarist challenges to it.

II. Monetarism, Given the Keynesian Political Assumption

Keynesians are sometimes surprised that monetarists want the central bank to look only at a single variable. This seems irrational. (See *John Kareken, Thomas Muench and Neil Wallace, 1973, Benjamin Friedman, 1977.*) Why discard information that other variables provide? Suppose, for example, that outstanding credit increases. This suggests that income is likely to rise, and hence argues for a lower money growth rate. Or, suppose that surveys of investment intentions project declining investment. Why not take this into account and raise the money growth rate to offset it? Unless velocity is completely stable, taking into account the messages sent by variables other than the money growth rate should improve monetary policy. Surely, we know at least the direction of the effect on GNP of variables, such as credit growth or investment intentions. Hence, if we reduce the growth rate of money by a very small amount when credit rises rapidly, or increase it slightly when investment intentions fall off greatly, we are likely to stabilize GNP, albeit perhaps only to a very small extent.

The next issue is whether the central bank should use as its target money or, as many Keynesian recommend, GNP. What complicates this debate is that these two targets are not on a par. They are complements and not rivals. If the central bank uses a money growth target it does not pull the appropriate growth rate of money out of thin air. It derives it from its assumptions about the appropriate growth rate of GNP and the growth rate of velocity. Similarly, if it has a GNP target, it cannot tell the Account Manager to conduct open market operations until GNP reaches a certain level. It must translate its GNP target into targets for more controllable variables, such as

However, some monetarists favor varying the rate of growth in accordance with one or another rule.

Allan Meltzer (1987) has advocated adjusting the monetary growth rate in accordance with prior changes in velocity. (For a similar proposal see *Mayer 1987a*). *William Poole (1986)* has suggested adjusting the monetary growth rate in accordance with changes in interest rates, since changes in interest rates generate changes in velocity.

the M-1 growth rate, or borrowed reserves. In this sense, a GNP target and a money growth target are entirely compatible.

What then is the debate about? One possibility is that the central bank may want to translate its GNP target, not just into a growth rate of money, but into several intermediate targets. If so, we are back at the previous issue of single versus multiple targets. A second possibility is that it may want to use a single target, but not the money growth rate. However, given the bad experience the Fed had with interest-rate targeting in the 1960s and 1970s, and the limited information available on credit, this does not seem likely, at least for the Fed.

Instead, the real focus of the debate is the following. Since a money target and a GNP target are compatible the question is not which one to use, but instead which one should be the publicly announced one, and which the implicit one. It is costly for a central bank to miss its target or to change its target frequently. Hence, if it announces a money growth target it has an incentive to stay with this target, and to ignore incoming information on all other variables. Given the Keynesian political assumption it is, of course, inefficient to tie the central bank to a money target. What harm could it do to give the it more flexibility?

Finally, there is the proposition of hard-core monetarism that money should grow at a fixed rate. One justification for this is our limited ability to forecast GNP, combined with long and variable lags in the impact of money on GNP. As *Friedman* (1953) has shown, relatively small errors in forecasting GNP, or in predicting the impact of the policy on GNP, can cause the policy to be destabilizing. But by themselves errors in forecasting GNP do not provide a plausible case for a fixed monetary growth rate. As long as the correlation coefficient between the forecast and actual GNP is positive, and we know something about the impact of monetary policy, there exists some variation in the monetary growth rate that is small enough to be stabilizing, at least to a very minor extent.

GNP forecasts are not all that bad, and they do not deteriorate seriously for up to six quarters ahead. (*Steven McNees and John Ries*, 1983, p. 8.) Are the errors in predicting the strength and lags of monetary policy really so large that they prevent policy based on these GNP forecasts from being stabilizing to any extent at all?

Monetarists claim that this is the case, and they can point to the wide divergence in the simulations of monetary-policy actions in econometric models. Since at most one of these divergent estimates can be correct, and there seems to be no way of knowing which one it is, one should not base

policy on such simulations.² Moreover, using variable coefficient regressions, *J. E. Tanner* (1979) and *Thomas Cargill and Robert Meyer* (1978) found that the lags of monetary policy are highly variable. *Tanner* concluded that this creates great difficulties for discretionary policy, though *Cargill and Meyer* state that their results are “not devastating” (p. 6) to the case for discretionary policy.

All in all, this debate consists mainly of arguments by assertion. Keynesians claim that we know enough to operate a stabilizing monetary policy, and monetarists deny this. Neither side has presented compelling evidence. Appeals to econometric models (e.g. *Modigliani* 1977, *Craine, Havener and Berry*, 1978) have to assume that these models are correct representations of the economy, and they are also subject to the *Lucas* critique. Attempts to compare the results of actual discretionary policy with the ideal monetary growth rate (e.g. *Modigliani*, 1964, *McPheters and Redman*, 1975) suffer from the problem of arbitrarily assumed lags, or from covering only a short span of time.

Thus, if one makes the Keynesian political assumption, neither economic analysis nor econometric evidence provide a reasonably strong case for either side on the “rules versus discretion” issue. But, on the other two issues, the use of only a single target variable, and the choice of money instead of nominal GNP as the target, the Keynesian case seems much stronger than the monetarist case.

III. Relaxing the Keynesian Political Assumption

But once one drops the assumption that the central bank is efficient and that it is not affected by its own bureaucratic self-interest or by political pressures, then the monetarist case becomes much stronger than before. Suppose that, perhaps due to political pressures, the central bank wants to adopt a too expansionary policy. If it uses many target variables, one of them can probably be used to rationalize this policy. Hence, use of only a single target provides a much better way of monitoring the central bank than do multiple targets. Similarly, suppose that the central bank is inefficient; it gives equal weight to say, four targets, when actually one of them,

² *Gary Fromm and Lawrence Klein* (1976) show monetary policy multipliers from simulations with various models. There is great divergence among these simulations. Some of this divergences is due to a lack of standardization in the runs made with the different models. However, strictly comparable monetary policy simulations with the DRI and Chase models (U.S. Cong., 1982) also show sharp differences, the mean difference being 60 percent of the mean estimated impact of the policy.

money, is much more important than the other three. In this case it is better off using only money as its target, despite the fact that the other variables also bear information.

If the central bank is self-serving, succumbs to political pressures or is inefficient, then there are several ways in which a monetary growth-rate target is superior to a GNP target. First, if it has a money target that is costly to violate or to change, then the central bank has to pass up certain opportunities to act in its self-interest. Second, the existence of a money target allows it to stand up to political pressures by claiming that its hands are tied. Third the public can monitor the central bank's performance much better if it has a monetary target or a base or reserves target than if it has a GNP target. If it misses its money or base target it can be held directly responsible for this. Its range of plausible excuses is severely limited. By contrast, if it misses a GNP target, it can claim that factors outside its control are responsible. Fourth, a money target is an antidote to myopia since it focuses the central bank's attention on the longer-run effects of its actions. One need not be a monetarist to argue that this is important; that without an aggregates target the Fed tends to be myopic. President *Morris* of the Boston Fed, though a strong critic of monetarism, has referred to monetary targets as "an important discipline ... [that] reduces the risk of excessive reactions to temporary shortfalls in employment and output" (*Morris*, 1985, p. 3).

The stable money growth rate rule is, of course, the ultimate defense against the Fed being influenced by its self-interest, yielding to political pressures, or behaving procyclically due to inefficiency. Monetarists have never advocated it as the appropriate policy in a world in which the central bank is wholly dedicated to stabilization and is highly efficient, if only because they believe that such a world does not exist.

In summary then, all three monetarist propositions become much more plausible once one drops the Keynesian political assumption. This does not mean that the problems created by insufficient knowledge, e.g. forecast errors and unpredictable lags, do not matter. Of course they do. They set a limit to what a counter-cyclical monetary policy could accomplish if the central bank were somehow to function in the way that Keynesians believe that it actually does function.

IV. The Treatment of the Keynesian Political Assumption

Given the critical role of the Keynesian political assumption, one might expect that economists have taken one of the following two paths: either they have tried to provide substantial evidence on the validity of this

assumption, or else they have been reluctant to express an opinions about whether the central bank should use a only a single target variable, money, and whether it should follow a stable monetary growth-rate rule. Obviously, the latter path does not describe reality, but neither does the former.

In only a few cases have Keynesians discussed their political assumptions at all. Thus in *James Tobin's* (1983) criticism of a stable monetary growth-rate rule the political assumption is not referred to at all.³ It is just taken for granted. *Franco Modigliani* (1977) devoted his presidential address before the American Economic Association to a criticism of the stable monetary growth-rate rule that does not even mention the Keynesian political assumption. In his subsequent debate with *Milton Friedman* (*Modigliani and Friedman*, 1977, pp. 19 & 21) he did mention it, but only in passing:

“if indeed it takes five years to dispose of unemployment, then it is hard to believe that a policy-maker can be so stupid that one would believe that he cannot do something to improve the situation. ... I have personally no reason to believe that the United States government (if you were talking about Italy it might be a different thing) is not able to attract able people who are interested in the common welfare and can do a good job. And I believe that if you look at the quality of the people that have shall we say, manned the Council of Economic Advisers, I think that suggests the good quality of the advice that is available to the President. If the President wants to use bad advice, I can't really imagine that he will be deterred by ... [a monetary growth-rate rule]; he'll find some way of getting around that. In the final analysis one has to use one's political activity to make sure that public servants are doing the common good – that their actions are in the public interest.

In a book entitled “The Debate about Stabilization Policy” (*Modigliani*, 1986, pp. 7 & 36 - 37) *Modigliani* first states that the disagreement of Keynesians and monetarists about stabilization policy is due primarily to disagreements about the values and stability of certain parameters, “and to no less a degree to differences in *social philosophy and attitudes*.” These differences arise because:

monetarists on the whole are characterized by a profound mistrust for government and of government authority which permeates all their views. Governments tend to be dishonest, or at least, self-serving and short-sighted and in any event are too inept to be trusted to use correctly discretionary power in the pursuit of difficult stabilization policy. Hence, they should not be entrusted with that responsibility or endowed with the necessary power.

³ However, *Tobin* did discuss the political feasibility of a monetary rule, and argued that democratic governments are forced to take responsibility for “real macroeconomic performance”, and hence must direct monetary policy towards that goal. This is questionable. Fiscal policy in the U.S. has, except on rare occasions, not been directed towards macroeconomic stability, so why assume that the public will insist that monetary policy be so directed? Moreover, the example of the Bundesbank shows that a central bank's efforts can be focused on price stability, a goal that is consistent with at least some types of monetary rules.

After thus pointing out the importance of the political assumption *Modigliani* does not refer to it again directly. He returns to it only indirectly when he cites his evidence that stabilization policy has actually been effective, thus implying that the political obstacles to effective stabilization policy have been overcome. This evidence consists of two claims. The first is that there were three periods of relatively stable money growth in the U.S. in the postwar period, and that in two of them income was highly unstable. Second, business cycles have been less severe in the postwar period when stabilization policy was used, than they were prior to World War II. Both of these pieces of evidence are rather casual, and hence it seems surprising that *Modigliani* does not discuss what he calls the monetarist “social philosophy and attitudes” directly. If in fact – and this has been challenged – two periods of stable monetary growth had unstable income growth, while in a third period stable money growth was accompanied by stable income growth, this has hardly a large enough sample to establish firmly that stable monetary growth results in unstable income growth.⁴ And the greater stability of the U.S. economy in the postwar period can be attributed to monetary growth being more stable in the postwar period when bank failures no longer decreased the money supply as they had done prior to the establishment of the FDIC in 1934.⁵

In summary then, Keynesians have not attempted to justify their political assumption. Perhaps this is because they find the monetarist criticism of this assumption too unconvincing to be worth answering since they know that central banks are staffed by competent and dedicated people. Let us see therefore if monetarists’ rejection of the Keynesian political assumption really is unconvincing. Since the assumption that the central bank operates efficiently and in the public interest may be valid for one country, and invalid for another, it must be evaluated in a specific national context. Hence the following discussion is directly applicable only to the United States, and is not necessarily applicable to countries in which the central bank has less independence. A major advantage of discussing central banking in the U.S. rather than in another country is that the Federal Reserve reveals much more information about itself than do other central banks.

⁴ *Friedman* (in *Modigliani* and *Friedman*, 1977) has challenged *Modigliani*’s selection of periods of stable monetary growth. The question at issue is whether the first or second derivative of the money stock should be used to measure monetary growth.

⁵ *Christina Romer* (1986) has argued that in the U.S. cyclical instability prior to the Great Depression was not much greater than in the postwar period, but *Nathan Balke* and *Robert Gordon* (1986) provided evidence that contradicted her findings. *Modigliani* (1977) also argued that postwar cycles have been less severe in countries other than the U.S., but *Sheffrin* (1987, p. 6) in his analysis for several European countries found no “no dramatic decrease in volatility” except for Sweden.

V. The Plausibility of the Keynesian Political Assumption

Monetarists have questioned in two ways the assumption that Fed officials are competent and dedicated enough to make discretionary policy stabilizing. First, they have made an historical argument: monetary policy has been inept in many actual situations. (This is relevant both to the debate about a monetary rule, and to the debate about using a monetary target, because an inept central bank should be tied down by a monetary target.) Indeed, much of the debate about a monetary growth-rate rule consists of Keynesians pointing to the potential good that countercyclical monetary policy could – in principle – accomplish, while monetarists point to the harm that discretionary monetary policy has actually done in the past.

Second, *Friedman* (1982) points to certain factors that cause the Fed to be inefficient. These are political pressures, a readiness of the Fed to act in its self-interest, and the inefficiencies that result from the absence of a “bottom line.” To this one can add the time-inconsistency problem. Given one’s strong priors that Fed policy-makers are neither evil nor incompetent, for *Friedman’s* case to be plausible one must show that yielding to political pressures, acting in accordance with the Fed’s self-interest, and inefficiencies due to the absence of a bottom line, do not require either evil intentions nor incompetence.

VI. The Relevance of the Historical Evidence

There is widespread agreement that the Fed has made many errors, e.g. raising the discount rate sharply in 1921, permitting the money stock to fall rapidly in 1929 - 33, and generating too high a monetary growth rate in the 1960s and 1970s. Keynesians have two replies. First, a monetary growth-rate rule would also have led to wrong policies at times, and second, the Fed has presumably learned from its mistakes and will not repeat them. Neither of these two responses are entirely convincing, but neither can be entirely dismissed.

The most obvious example of the damage that a monetary growth-rate rule would have done is the sharp deflation that would have resulted from the adoption of a, say 4 percent monetary growth-rate rule in 1980. The *Lucas* critique does not allow one to say unequivocally how velocity would have behaved had a monetary rule been in effect, but it seems plausible that M-1 velocity would not have behaved so very differently from the way it actually did, that is declining by 16 percent between 1981 and the end of 1986. Given the previous 3 percent trend of velocity this is approximately

equivalent to a one third drop in velocity relative to trend. And had a monetary growth rate rule been instituted in say, 1980, it might well have been based on the assumption of a 3 percent trend.

But the sharp decline in velocity in the 1980s is not as good a stick with which to beat the case for a monetary rule as appears at first. Most, though admittedly by no means all, of the decline in the trend of velocity was due to the sharp decline in interest rates. Had a 4 percent monetary growth-rate rule been adopted in, say 1960, the inflation rate, and hence nominal interest rates and velocity, would not have risen as they actually did, and then would not have fallen so much the 1980s. Moreover, there exists a variant of the monetary rule that avoids most of the damage done by a change in the trend of velocity. This is a rule that adjusts the monetary growth rate in accordance with prior changes in velocity. (See *Meltzer*, 1987, *Mayer*, 1987 a)

Other examples of periods when a monetary growth-rate rule would have worked badly are the oil shocks of 1973 - 74 and 1979 - 80. But would a rule have been worse than the policy actually followed by the Fed? In the four quarters after both oil shocks the growth rates of M-1 were slightly lower than they had been in the preceding four quarters. This seems hardly an improvement over what a monetary rule would have done. Admittedly, *Craine, Havenner and Berry* (1978), using simulations with the Fed's MPS model found that for the period 1973 III to 1975 II actual policy was superior to a rule. But such a simulation is subject to the *Lucas* critique. Moreover, it is hard to say how accurate model simulations are. That models forecast well does not mean that their simulations are accurate too, because forecast employ aids, such as add-factors, that are not available for simulations. Moreover, had a monetary rule restrained the U. S. inflation rate prior to the oil shocks, these shocks might not have occurred, or been much milder. (See *Trehan*, 1986)

The Keynesian claim that the Fed has learned from its experience, so that past Fed errors are irrelevant for a monetary rule obviously has some validity; the Fed will surely not do again what it did in the Great Depression. However, it is less clear whether it has learned from other, less dramatic errors. *Friedman* (1982) has argued that there are consistent threads running through many Fed errors, the implicit acceptance of the real bills doctrine, an overemphasis on money market conditions and interest rate stability, and an underemphasis of the growth rate of money.

Hence, the evidence from the Fed's past errors does not compel one to accept the case for a monetary rule, but it is evidence that certainly deserves to be taken seriously and not be dismissed with a casual remark about the

Fed's staff being capable. However, to be a convincing refutation of the Keynesian political assumption, evidence that Fed policy has been inept in the past needs to be supported by an explanation of what makes the Fed follow wrong policies.

VII. Political Pressures as Explanations of the Fed's Errors

Whether or not the central bank should be more or less closely controlled by elected officials is a complex issue. (See *Mayer, 1976*) Perhaps independence is inconsistent with the democratic ethos, perhaps the difficulty of coordinating fiscal policy and the monetary policy of an independent central bank makes central bank independence undesirable, and perhaps the danger of a political business cycle is more severe if the central bank is independent because the public is then less aware of the potential for the political manipulation of monetary policy.⁶ Whether or not independence for the central bank is – on the whole – appropriate cannot be discussed here. What will be discussed is just one side of the balance sheet on central bank independence because part of the monetarist case is that political pressures do distort discretionary monetary policy.

Political pressures can distort monetary policy in several ways. First, there is the possibility of the central bank being forced to undertake a policy that is destabilizing. The most dramatic example of this is the political business cycle. But the evidence for the existence of a political business cycle in the United States is at best mixed. That various tests of the political-business-cycle hypothesis have come to different conclusions is hardly surprising for two reasons. First, the hypothesis is amorphous; is a political business cycle supposed to occur in all elections, or only presidential elections, or else in only those elections in which an incumbent president stands a good chance of loosing? Second, data are scarce. Since the 1956 election (the first postwar election after the Fed was released from the constraint of supporting government security prices) there have only been seven presidential elections. In addition, the issue is not only whether there is a political business cycle at every election, or at the majority of elections – the type of issue for which regression analysis is most suitable, but also whether a political business cycle ever occurs. Suppose, for example, that a political business cycle occurs only in one fifth of all elections. Regression tests are then likely to reject the hypothesis that there is a political business cycle. However, the destabilization that such an occasional political business cycle would cause

⁶ For an ingenious argument that it may be desirable to have monetary and fiscal policy uncoordinated see *Alan Blinder (1983)*.

might more than offset the stabilizing effect that discretionary monetary policy has at other times.

Second, quite apart from the political business cycle, elected officials can bring pressure on the central bank, pressure that might force it to adopt a wrong policy. This is so even in the U.S. with its relatively independent central bank. *Robert Weintraub* (1978) has shown that every major change in the general stance of U.S. monetary policy occurred when a new president with different views on monetary policy took office, and every time such a president did take office, there was a change in monetary policy.⁷ *John Woolley* (1984, p. 111) attributed a somewhat lesser, but still significant role to presidential wishes, writing: Rather than conclude that presidents generally get the monetary policy they want, it would be more accurate to say that only infrequently are presidents extremely unhappy with the monetary policy they get. Moreover, as *Thomas Havrilesky* (1987) has shown, for the period September 1979 to December 1984, criticism by Administration officials of the prevailing monetary policy tended to result in adjustments to that policy. And *Kevin Grier* (1986) has shown that congressional pressure also influences the Fed.

Third, political pressures also affect monetary policy in a less direct, but no less important way. As *Robert Hetzel* (1987) has shown the Fed is engaged in a continual attempt to build political coalitions that are stronger than those of its enemies.⁸ It therefore has to bend with the wind. Moreover, *Hetzel* points out, in such an environment the Fed cannot afford to have an explicit and consistent framework of analysis because such a framework would at times imply policies that the Fed does not feel strong enough to follow. Hence the Fed frames its policies in an unstructured, ad hoc way because it then does not have to admit, even to itself, when it is departing from an appropriate policy to make political concessions. This view of Fed policy-making is corroborated by *Raymond Lombra* (forthcoming, p. 6) who concludes that such seemingly technical Fed actions, as widening the target ranges for aggregates, or shifting the emphasis accorded to different aggregates, cannot be understood as purely technical adjustments, that “to blame only the Fed for the evolution of policy and associated economic outcomes, is to accept the dubious proposition that the Fed is independent.”

⁷ Subsequent to the period *Weintraub* studied Chairman *Volcker* was appointed and reappointed by presidents *Carter* and *Reagan*, neither of whom were probably in agreement with the policy that he followed. However, they realized that these policies were needed to reassure financial markets, and hence the *Volcker* episode does not contradict *Weintraub's* conclusions in any relevant sense.

⁸ The Fed is involved in many political battles in Congress because as a bank regulator it frequently asks Congress to pass certain laws, and not to pass others.

Thus, the political environment of the Fed affects monetary policy in an indirect way as well as in a more direct way. Perhaps the net effect of this influence is good because it forces the Fed to be more responsive to the public's wishes, but perhaps the opposite is the case, and political pressures prevent U.S. monetary policy from being stabilizing. Which of these hypotheses is correct is an issue that needs investigation, and the latter hypothesis should not be dismissed without discussion as it is by Keynesians.

VIII. The Fed's Self-Interest as an Explanation

Another, related, explanation for Fed inefficiency is that in many situations the Fed acts in its own self-interest. This explanation does not require Fed policy-makers to be "evil" people who consciously adopt a too expansionary (or too contractive) policy because this policy benefits the Fed itself. The argument is more subtle. It is that the Fed's self-interests biases it towards following particular procedures, and that these procedures then generate destabilizing policies. No conscious trade-off between stability and the Fed's self-interests is required, just an unwillingness to see that certain procedures that help the Fed to maintain its prestige and autonomy make it more difficult to pursue stabilizing policies.

Moreover, at times, protecting the Fed's autonomy could actually be more important than adopting a policy that would stabilize income somewhat better, and hence such a seemingly self-interested policy does not require that policy-makers are driven by self-interest. For example, if the Fed faces a trade-off between either lowering interest rates temporarily, and thus allowing a 2 percent rise in the inflation rate, or else having Congress take to itself the power to set interest rates, then the Fed probably should choose the former. Admittedly, the Fed has never faced such an extreme threat, but it would hardly be surprising if it takes the threats that it does actually face more seriously than do its academic critics, and also at least somewhat more seriously than is warranted.

Friedman (1982) cites several examples of Fed actions he considers motivated by the Fed's self-interest. One is "the enormous resistance of the Fed to moving to monetary aggregates" because aggregate targets permit "a far more effective monitoring of performance and accountability for achieving targets than money market conditions." (*Friedman*, 1982, p. 115) A second one is the system of lagged reserve requirement, (in force until 1983) that the Fed thought would keep more banks in the Federal Reserve system by making the Fed's reserve requirement easier for banks.⁹ The Fed's concern with

bank membership, argued *Friedman* (1982, p. 115), results “from the prestige, sense of importance, power, and effective lobby that the system gains by supervising many thousands of banks and other financial institutions. . . . Member bank support of the Fed’s actions has played a major role in giving the Fed influence in Congress.”

A third example given by *Friedman* are the massive defensive open-market operations by which the Fed tries to offset the impact on reserves of market factors, such as currency drains. *Friedman* argues that these open market operations impose substantial transactions costs on the Fed and could be avoided by staggering reserve requirements. *Friedman* (1982, p. 116) stated that the Fed uses defensive open-market operations because it provides Fed officials “with a sense of importance”. Another examples is the Fed’s delay in publishing its *Directive* (the FOMC’s instructions to the New York Federal Reserve Bank for future open-market operations). This, *Friedman* (1982, p. 116) attributes to the delay in publication giving Fed officials a “sense of importance” and providing “very good jobs to ex-officials who are hired by firms in Wall Street because they are believed able to read the tea leaves and figure out what the Fed is really doing.”

How convincing are these examples? Can these Fed actions be explained by objectively-grounded beliefs rather than by self-interest? The Fed’s focus on interest rates prior to October 1979 cannot be explained with the *Poole* paradigm by a belief that the IS curve is more predictable than the LM curve. The Fed was, in large part, trying to stabilize the federal funds rate rather than to move it to the level required by the *Poole* paradigm. But it *might* be explained by the Fed overestimating the damage caused by sharply fluctuating interest rates. The Fed’s deemphasis of the monetary growth rate since 1982 could – rightly or wrongly – be due to the erratic behavior of velocity.

Until October 1979 the Fed’s reluctance to abandon lagged reserve requirements can readily be explained without invoking self-interest. The Fed was paying only lip service to monetary targeting and was primarily concerned with keeping the federal funds rate stable. Hence, the greater control over money provided by contemporaneous reserve requirements would have done little good. However, this alternative explanation does not fit the period October 1979 to mid or late 1982 when the Fed was more concerned with the monetary growth rate.

⁹ Member banks can withdraw from the Federal Reserve System. Lagging the reserve requirement helps banks because they know at the start of the reserve-maintenance period the amount of reserves they have to keep since they know their deposits in the prior period.

The use of defensive open-market operations might perhaps be defended on the argument that the resulting transaction costs are minor compared to the costs of letting reserves fluctuate substantially – this is a difficult technical issue. In any case, *Friedman's* self-interest explanation is subject to the objection that the Fed governors or FOMC participants who decide whether the Fed should use defensive open-market operations are not the ones who gain from it much prestige, or good jobs upon retirement. And the case for publishing the Directive right away is much weaker than *Friedman* suggests. (See *Mayer*, 1987b)

This is not to deny that self-interest can influence Fed policy. Apart from the just-discussed examples cited by *Friedman*, public-choice economists have a number of papers (most of them reprinted in *Toma* and *Toma*, 1986) arguing that the Fed is driven by self-interest. This literature is much too extensive to be discussed here. But it should not be dismissed on the argument that Fed officials are “honorably men”.

IX. The X-Inefficiency Explanation

In his explanation of Fed behavior *Friedman* (1982, p. 114) alluded to X-inefficiency writing: “I believe that the fundamental explanation for the persistence and importance of bureaucratic inertia in the Federal Reserve System is the absence of a bottom line.” This lack of a bottom line could explain Fed mistakes in several ways. First, Fed officials are not forced to articulate their goals and to formulate carefully thought-out trade-offs. As *Lawrence Roos* (1986, pp. 772 - 73), a former president of the St. Louis Federal Reserve Bank, put it:

Never once in my participation in meetings of the Federal Open Market Committee (FOMC) do I recall any discussion of long-range goals of economic growth or desired price levels. ... Instead of seeking a few achievable goals the Federal Reserve is supposed to solve all sorts of problems including inflation, unemployment, lagging real output growth, high interest rates, balance of payments disequilibrium, volatile exchange rates, depressed stock prices, a sagging housing industry and the world debt crisis. ... This kind of thinking hampers the workings of the FOMC. For within the FOMC, there were usually as many goals as there were chairs around the table. In my experience at the Fed, I cannot recall any significant ranking of objectives or [discussion] if the diverse goals considered were mutually consistent either with one another or with the policy actions being considered. ... I recall no consensus on long-range goals nor do I recall serious efforts to set policy on other than the shortest time horizons.

In such an environment the coexistence of capable and dedicated policy-makers and erroneous policies presents no puzzle.¹⁰

Second, the absence of a bottom line not only protects the Fed from criticism by others, but also limits the extent to which it can learn from its own experience. If one does not have to face a bottom line one is not forced to admit that one has made a mistake.

Another potential source of X-inefficiency is that policy-makers may have in their utility function a feeling of having avoided mistakes.¹¹ Such a “minimum regrets” argument in the FOMC’s utility function could distort policy-choices in several ways. It could bias policy-makers towards using vague targets and procedures whose success cannot be measured. It could also explain the “money-market myopia” for which *Brunner and Meltzer* (1964) have criticized the Fed, because its money-market goals can be achieved much better than the goal of stabilizing GNP. A minimum regrets theory might also explain what seems to be the Fed’s tendency to pay insufficient attention to the lag of monetary policy. If the choice of a policy is focused on what GNP will be at the time when the policy will become effective, then policy-makers will sometimes have to admit to themselves that a wrong forecast caused them to adopt the wrong policy. The pain of having to admit such a mistake is avoided by simply disregarding the lag in the effect of monetary policy and focusing policy on current conditions. Ignoring the lag in the effect of monetary policy may well generate less cognitive dissonance, and hence prove more acceptable, than worrying about forecast errors. As *George Akerlof and William Dickens* (1982) suggest, cognitive dissonance may be an important factor in explaining behavior.

The potential importance of X-inefficiency can be seen from the minutes of the FOMC.¹² Anyone who comes to those minutes with the expectation that Fed policy-making reflects the analytic sophistication of the Fed’s staff will be gravely disappointed; the FOMC’s discussion is a blend of casual analysis and casual empiricism, rather than of economic theory and econometric estimates.¹³ Its level is well illustrated by the following statement by Chairman *Arthur Burns* (FOMC, 1974, pp. 83, 103 - 104)

¹⁰ It might seem that Fed officials could shift to a more efficient way of making policy. But the need for political compromises (*Helzel*, 1987), as well as an attempt – discussed below – to “minimize regrets’ militate against a change.

¹¹ I am indebted for this suggestion to *Richard Thaler*.

¹² The FOMC minutes are available until March 1975 when the FOMC ceased taking minutes. They are not actual verbatim minutes (for example, they are worded in the third person singular), but are detailed enough to be used as though they were verbatim minutes.

¹³ For studies of Fed policy-making that used the FOMC minutes see *Brunner and Meltzer* (1964) *Lombra and Moran* (1980) and *Mayer* (1982).

Income velocity was a far more important variable than the rate of growth of the money stock. ... He had an uneasy feeling that too much emphasis tended to be placed on the behavior of the money stock and too little on the income velocity of money – which, as he had observed earlier, was subject to tremendous fluctuations. Fundamentally, velocity depended on confidence in economic prospects. When confidence was weak, a large addition to the money stock might lie idle, but when confidence strengthened, the existing stock of money could finance an enormous expansion of economic activity.

Regardless of whether such casual analysis is, as *Hetzel* (1987) has argued, the result of political pressures, or the result of X-inefficiency, it does make it more likely that the Fed will follow the wrong policy. No firm evidence is available on whether other central banks employ similar casual analysis, but it seems plausible that they do.

X. The Time-Inconsistency Problem

The time-inconsistency issue is now the most frequently-discussed problem of central-bank motivation, and apparently many economists consider the central bank's time-inconsistency to be one of the best, if not the best justification for a monetary rule. But monetarists, unlike rational expectations theorists, have not emphasized time-inconsistency. There are good reasons for this. First, the standard excess-inflation solution of most time-inconsistency models is not the only possible solution. Since time-inconsistency leads to undesirable results a welfare maximizing central bank should not initiate the time-inconsistency game (See *Leijonhufvud*, 1986). Of course, if the public expects the central bank to play that game, and hence anticipates inflation, then the central bank should follow an inflationary policy. But in a rational expectations model the public might also anticipate correctly that the central bank will not play this game, and hence not expect inflation.

Second, the FOMC minutes strongly suggest that the Fed does not make policy in a way sophisticated enough to take into account the externalities of increasing output above its equilibrium level. The standard response to this type of objection is, of course, to invoke the “as if” principle, and to argue that a theory must be tested, not by its descriptive realism, but by the accuracy of its predictions. The time-inconsistency hypothesis, however, fails such a prediction test. It predicts that a central bank will generally follow inflationary policies. But leaving aside the war years and the immediate postwar years the Fed has followed clearly inflationary policies only for about fifteen years (from around 1965 to 1979) in the seventy-three years of its existence.

However, *Poole* (1986) has described a much more plausible version of the time inconsistency problem. In this version the FOMC does not plot to raise output above the equilibrium level, but response to pressures that the public exerts on politicians. And the public wants the government to deal with the particular problem that is currently most pressing. Hence, when unemployment is high the Fed is pushed to adopt policies that are too expansionary, and at those times when the public worried primarily about inflation it is pushed towards too restrictive policies.

XI. Conclusion

In summary, the monetarist-Keynesian debate about monetary policy has gone astray, probably due in large part to economists' preference for addressing models rather than issues. The monetarists' preference for a single target variable, money, and for a stable growth rate of money, is based on their rejection of the Keynesian political assumption. Keynesians have ignored this, and acted as though the dispute were entirely a matter of pure economics, rather than of political economy.

Ignoring the political component of the monetarist case against the use of multiple targets and against countercyclical policy would be justified only if the monetarist criticism of the Keynesian political assumption were obviously incorrect. But it is not. The history of discretionary monetary policy, the dangers of political pressures and the potential for central bank X-inefficiency, all argue for not taking the validity of the Keynesian political assumption for granted. This does not mean that it is necessarily invalid in the sense of being so inaccurate that it cannot support the Keynesian policy conclusions. I have presented no evidence that it actually is all that inaccurate, but have advocated instead that its validity be treated as a serious problem, and not be taken for granted.

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Zusammenfassung

Die Debatte über die Politikempfehlungen der Monetaristen

Der geldpolitische Streit zwischen Keynesianern und Monetaristen hat sich nicht auf eine zentrale Frage zu konzentrieren vermocht, nämlich die politische Annahme der Keynesianer, daß der Zentralbank in dem Sinne vertraut werden kann, daß sie effizient und im öffentlichen Interesse handelt. Dies ist der Grund für Auseinandersetzungen über die Verwendung nur einer einzigen Zielvariablen, die Verwendung von Geldmengenwachstumsraten als solche Zielvariablen und die Wünschbarkeit einer stabilen Geldmengenwachstumsrate. Wenn man dem politischen Ansatz der Keynesianer folgt, dann sind ihre Politikempfehlungen höchst plausibel. Lehnt man sie ab, dann sind es die der Monetaristen. Während die Monetaristen wiederholt ihr Mißtrauen gegenüber der Zentralbank zum Ausdruck gebracht haben, haben die Keynesianer die Argumente der Monetaristen ignoriert. Dies wäre nur dann gerechtfertigt, wenn die politischen Annahmen der Keynesianer augenfällig richtig wären.

Dies ist jedoch nicht der Fall aus Gründen politischer Pressionen, des Eigeninteresses der Zentralbanken und des Potentials an X-Ineffizienz. Folglich sollte mehr Energie auf die Prüfung der politischen Annahmen aufgewendet werden.

Summary

The Debate About Monetarist Policy Recommendations

The dispute between Keynesians and monetarists about monetary policy has failed to focus on a central issue, the Keynesian's political assumption that the central bank can be trusted to operate efficiently and in the public interest. This underlies disagreements about the use of only a single target variable, the use of the monetary growth-rate as that variable, and the desirability of a stable monetary growth rate. If one grants the Keynesian political assumption, then Keynesian policy recommendations are highly plausible, if one rejects it, then the monetarist ones are. While monetarists have repeatedly stated their distrust of the central bank, Keynesians have ignored this part of the monetarist case. This would be justified only if the Keynesian political assumption were obviously correct. But this is not the case, due to political pressures, the central bank's self-interest and the potential for X-inefficiency. Hence, more effort should be devoted to tests of the political assumption.

Résumé

La discussion sur des recommandations de la politique monétaire

La discussion entre les Keynésiens et les monétaristes sur la politique monétaire s'est concentrée finalement sur un résultat central: la politique keynésienne a présupposé que l'on peut faire confiance à la banque centrale d'opérer de façon efficace et dans l'intérêt public. Ceci est à la base de divergences d'opinions en ce qui concerne l'utilisation d'une seule variable visée, l'emploi du taux de croissance monétaire comme «la» variable et le désir d'avoir un taux de croissance monétaire stable. Si l'on admet la présomption politique de Keynes, les recommandations de cette politique sont extrêmement plausibles, si on la rejette, celles des monétaristes le sont. Alors que les monétaristes ont déclaré à plusieurs reprises leur méfiance à l'égard de la banque centrale, les keynésiens ont ignoré cette partie de la théorie monétaire. Ceci serait uniquement justifiable si la présomption politique keynésienne était manifestement correcte. Mais, ce n'est pas le cas, à cause des pressions politiques, de l'intérêt personnel de la banque centrale et du potentiel d'inefficacité. Il faudrait donc tester davantage la présomption politique.