

Lessons from a History of the Federal Reserve: A First Look

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Tomorrow evening we will hear Alan Greenspan talk about some parts of his role as the nation's and the world's leading central banker. Anticipating that event, I thought I would talk tonight about the organization he heads, some of the things they have done, and some of the people who led it.

We all know the Federal Reserve as one of the most prestigious institutions in Washington, a pillar of strength and a symbol of stability. The Federal Reserve Chairman is often described as the second most important government official, surely outranking the Vice President in prestige if not in protocol. No one cares where the Secretary of State sits when the President gives the State of the Union address, but when the Chairman of the Federal Reserve sat next to the President's wife, there was much speculation about the apparent meaning.

It was not always so. I expect few people in this room (other than Chris or possibly Herb Stein) could identify Charles Hamlin, Daniel Crissinger, Roy Young, or Eugene Meyer or say what they have in common. Washingtonians might guess from the fact that Eugene Meyer is on the list that they all had something to do with the Washington Post. That would be wrong. They were all predecessors of Alan Greenspan as heads of the Federal Reserve. Current readers of the Post may find it surprising that

Eugene Meyer was a Republican, appointed by Herbert Hoover.

The Federal Reserve is 82 years old. For much of its history it was not a central bank. If the Republicans had won the 1912 election, we probably would have had a central bank, but the Democrats won. Woodrow Wilson became President on a platform that opposed the money trust and Wall Street dominance of money matters. Representative Carter Glass of Virginia became Chairman of the House Banking Committee. Glass was eager to remind people, for the next 20 or 25 years, that he wrote the Federal Reserve Act. He should not have been so proud. What we got was a strange hybrid, a mixture of private and public management operating with very unclear lines of authority, and with very little centralization. Each of the 12 Reserve banks was semi-autonomous.

The system was initially guided by two main principles. One was the international gold standard. The other was the commercial lending principles of the Bank of England. Alas, by the time the Federal Reserve began operations -- almost a year after the act was passed -- World War I had started. The international gold standard ceased to function and was never fully restored. The first principle had very little influence over what the Fed did.

The second principle lasted a bit longer, but it did not survive unchanged from the depression of 1920-21. The Federal Reserve produced a steep post-war inflation followed by an even faster deflation. Prices fell by 40% or more in a few months. This produced distress in large sections of the country, particularly the agricultural regions. One of the many people who went bankrupt was a Kansas City haberdasher named Harry Truman. This became important because, as President, Truman had

to decide what to do 25 or 30 years later when faced with the post World War II inflation.

The failure of the two original, operating principles was recognized both internally and externally. Something had to be done. The original act gave the Federal Reserve a 20 year life. The first 8 years had produced an economic debacle and a political disaster. The farmers and ranchers believed that the Federal Reserve had done just what they most feared: squeezed the agricultural and small commercial interests hard by tight money for the benefit of bankers and Wall Street.

The Fed developed a new set of operating procedures and learned to be more responsive to the economy. The years from 1923 to 1929 are the best period in the Fed's history to date. Output grew rapidly. Prices were stable, and the stock market boomed. There were two recessions during these years, but they didn't last long. In 1927 Congress forgot about the bad start and rewarded the Fed's improved performance by granting a permanent charter.

The Federal Reserve had two main challenges during the 1920s. Highest priority went to economic growth and price stability. Then, as now, there were bills in Congress to charge the Fed with responsibility for maintaining stable prices. The Fed always opposed these proposals, and they were not adopted.

The second main objective was to restore the international gold standard. By 1928, most of the European countries and many others had gone back to some kind of gold standard. Then, as now, capital moved relatively freely from one country to another.

If the clock could be stopped in July 1929, the Federal Reserve's

record would look great. Industrial production was rising more than 10% a year in 1929, with no sign of inflation. Most of the world was on the gold standard. Unfortunately, the six fat years were followed by ten extremely lean years. The international gold standard, that the central banks had worked so hard to establish, broke down. While no one blames the Federal Reserve entirely for the start of the great depression, there is general agreement that the Federal Reserve made the depression deeper and longer than it had to be. Large parts of the banking and financial system failed. There was no deposit insurance, so the losses were borne by depositors and, when the banks failed, by the shareholders. There was no unemployment insurance, so the unemployed had to fend for themselves. In the winter of 1933, 25% of the labor force was unemployed.

One result of the great depression was new legislation that centralized power in Washington. Congress, in effect, blamed the dispersion of authority and responsibility deliberately built into the Federal Reserve Act for the failures in the early 1930s. Over the next thirty years, Washington gradually acquired its dominant role in monetary management that we know today.

The Federal Reserve's second set of operating procedures had produced an even greater debacle than the first set. The principal reasons for this second debacle lay in the principles that guided Fed policy and in the failure to adjust market interest rates for changes in inflation. The result was inaction during the decline based in part on the failure to distinguish between market rates and real rates of interest.

For the next 12 years, the Federal Reserve did very little. During the 1930s, they spent many of their meetings deciding how to divide up the

income from their holdings of government bonds. During the war, they were under the thumb of the Treasury. Since Secretary Morgenthau thought that Federal Reserve Chairman Eccles believed that he was much smarter than Morgenthau, Morgenthau insisted that the Fed stay completely under Treasury control.

The main exception to the Fed's passivity in these years were decisions in 1936 and 1937 to tighten money. This resulted in the relatively deep 1937-38 recession. That set back is the main reason that the economy had not recovered fully from the great depression at the start of World War 2.

In 1951 the Federal Reserve got a new chairman and an old set of challenges. The new chairman was William McChesney Martin, Jr. Martin served as Fed Chairman longer than anyone in its history. When he left office in 1970, he had been chairman for 19 years, about 1/3 of the Fed's history up to that time.

Martin had been a boy-wonder. He grew up in a banking family. His father was President of the St. Louis Federal Reserve Bank in the 1920s and during the depression. Martin had become president of the NYSE in 1933, at age 31, succeeding Richard Whitney who had resigned to spend a few years in Sing Sing prison.

Martin told this story about his early days at the Exchange. Shortly after he took the job, President Roosevelt asked him to come to Washington. Martin was convinced that Roosevelt had some drastic action in mind. He lay awake on the train all night trying to think what he would say to protect the stock exchange against the fate that he assumed awaited it.

Arriving at the White House, he was taken to meet Roosevelt. On entering, he said, "Mr. Roosevelt, I'm Bill Martin, the new president of the stock exchange. I understand you want to see me, and I'm scared to death."

Had he planned it, he couldn't have done better. The President smiled, patted him on the back and was soon calling him Billy. He had met his first big challenge.

When Martin came to the Fed, the Fed faced the same two problems it had faced in the 1920s -- keeping prices stable and restoring convertibility at fixed exchange rates to currencies after more than 20 years of depression and war. This is a difficult and, at times, impossible, challenge. The reason is that very often the steps taken to maintain fixed exchange rates conflict with the goal of price stability. A choice between the objectives is often pressed by events on the central bank.

Once again the Fed failed on both counts. By the time Martin left office, inflation was above 5% and the Bretton Woods system of fixed exchange rates was in its last days. Yet, we now look back on the Martin years as years of sustained high growth and reasonable price stability -- at least until the late 1960s. And we value Martin's performance for a good reason. Compared to what came after, his term looks very good. This is especially true if we stop in 1965 before Martin, against his better judgment and with some resistance, helped to finance the Vietnam war and the start of the Great Society by debasing the currency and inflating.

How did this happen? How did the conservative banker become an inflationist? Martin began his tenure at the Fed by restoring the old operating procedures and methods that had been used in the 1920s. As

time passed, many of the old staff left, replaced by a new staff, trained in Keynesian economics. The Treasury, the Council of Economic Advisers in the Kennedy and Johnson years also held these views, and they were widely held in the academic community, in the Congress and elsewhere. Martin was unlikely to have been fully convinced, but he allowed himself to be persuaded to keep interest rates from rising enough to choke off the inflation before it got started. He was helped to this decision by President Johnson. At one point, Johnson invited Martin to his ranch where he tried to persuade him not to raise interest rates. Martin raised interest rates, but much too slowly to hold money growth at a non-inflationary level. Once again a main reason was the failure to recognize the effect of inflation on interest rates. This time, the Fed misinterpreted historically high market interest rates as "tight money." Inflation was under way.

The third set of principles produced the third debacle in Federal Reserve history. The economy had fifteen years, 1965 to 1980, of rising inflation, rising average unemployment, and a falling dollar.

If there is a single worst failure as Fed Chairman in my history, it is -- alas -- our own Arthur Burns, in several ways the worst Fed Chairman, to date. Burns was not an inflationist. Quite the contrary. If we judged him on what he wrote and said, instead of what he did, his record would be outstanding. He was the most distinguished scholar ever to serve as Chairman. He knew a great deal of monetary history and the history of business cycles. And he had a steady stream of correspondence from his old friend Milton Friedman who wrote him repeatedly about the mistakes he was making.

Why did he do it? I'm not convinced I have a full explanation but I have a start. First, Burns suffered from the arrogance of the distinguished academic. He thought that where lesser persons might fail, he could manage to control events well enough to avoid the consequences of his policies. He was wrong. Second, we know from the Nixon and Haldeman diaries that, though President Nixon did not care much about economic events, he cared a great deal about where the economy would be in November 1972. Nixon had been warned by Burns in 1960 that a recession would hurt his chances. He believed the 1960 recession had cost him victory in a close election. He did not want to repeat that experience. Arthur Burns accommodated the demands and got the rest of the Federal Reserve to go along. Inflation moved from mild to moderate to double digits.

After 15 years of rising inflation followed by 15 years of slowing inflation, prices are now 5 times their level of 1965. Other countries have inflated also, but the dollar lost 70% of its early postwar value against the yen and the Swiss franc and almost as much against the mark. This was part of the price for learning an old and a new lesson. The old lesson is that inflation doesn't solve any real problems for very long and makes others worse. The new lesson is that Keynesian economic ideas failed badly in practice. They became a recipe for instability, inflation, and a bloated public sector.

In the past 15 or 16 years, inflation has been brought from 12 or 14% to 2 or 3%. We are approaching the end of the era of disinflation. It would be nice to conclude that these achievements resulted from the triumph of systematic application of economic theory over political

pressures and a banking mentality. Alas, it is not so. Inflation was reduced by rampant eclecticism that gradually slowed money growth. Although recent policy actions have been successful, in avoiding recessions while reducing inflation, particularly in the Greenspan years, there is as yet no coherent body of principles at the Federal Reserve that Alan Greenspan can pass on to the successor who must replace him, probably no later than the last year of President Clinton's new term.

This absence of principles is more of a problem in the U.S. than in other low inflation countries like Switzerland, Germany or even New Zealand. In each of these countries, the central bank relies on an operating system that is predictable to outsiders and that gives general guidance to the responsible officials about what they must do and, within broad limits, when they must do it.

I come to the end of this capsule history with two reflections. First, the Federal Reserve is one of the most prestigious institutions of government. It has great esteem and, currently, high credibility. Yet only 19 of its 82 years of existence could be described as meeting the performance test for any central bank -- to bring increased stability to output and to prevent inflation or deflation.

Some will think this unfair. Part of the time, the Fed was captive of the government's wartime policies. However, that would explain only 6 or 7 years. If we include part of the postwar adjustment, we might stretch that number to 15 years. We would still be left with the two great economic mistakes of this century -- the great depression of the 1930s and the great inflation of the 1970s. Together, they occupy 42 years of the Federal Reserve's existence -- about half its lifetime.

To repeat, if we stopped time in July 1929, we would remark on how well the Fed had done recently and believe, as people then believed, that the Fed had learned to manage the economy well enough to prevent a major catastrophe. But, the Fed continues to target interest rates, a source of its major mistakes in the past.

Looking abroad raises some doubts about central bankers. For half a decade the Bank of Japan has followed a deflationary strategy, broadly similar to the Fed's policy in 1929 to 1933, at great cost to its citizens. And the European central banks, driven by their governments, have clung to a fixed exchange rate and marched toward monetary union despite slow growth and rising unemployment rates. Fortunately, a fluctuating exchange rate partly insulated the U.S. economy from the worst effects of these mistaken policies. Also, unlike the 1920s, we have followed a more open trading policy.

Perhaps the new openness at the Fed, and their greater willingness to talk about what they are doing will help to keep the economy stable by giving markets better and more timely information. Market reactions often are a stabilizing influence, but they cannot be expected to do the Fed's job, as experience in Europe and Japan demonstrates.

My second observation repeats an earlier comment, so I will be brief. The Federal Reserve operates by consensus. After 82 years, it still lacks a developed framework to get from its assessment or evaluation of the economy to its goals. It moves without much clear rationale, using what I have called rampant eclecticism. And it continues to rely on market interest rates as its policy indicator. In the last 4 or 5 years, it has been extremely successful. We all hope it will continue to succeed for, as it

succeeds, we benefit. After 82 years, one should ask for and expect a stronger reason for confidence.