What Should Guide *the* Fed?

By Reuven Brenner

A new and improved Bretton Woods agreement.

I received some three hundred comments, both public and directly into my mailbox, about both my recent *TIE* article ("The Story of Risk," Winter 2022) and the illusion of the Federal Reserve's power to forever control rates, and by coincidence, my op-ed in the *Wall Street Journal* published at the same time ("Inflation and the Fog of War," April 15). The latter narrowly focused on the fact that during transitions from "war" or "war-like" times to "normal" ones, price indices are unreliable guides for Fed policies, whereas the *TIE* article, being broader in scope, suggested that even monetary experts either do not know the facts or are unaware of the limitations and grave mistakes of academic theories underlying policies—admissions that their own originators admitted, Milton Friedman prominent among them.

Allow me to state some facts first, about which there is no disagreement, and later quote Friedman himself being wrong about his rigid monetarism, and all the methodology he pursued in his academic writings to reach that rigid conclusion about quantity of money targeting being the solution for the Fed.

Start with reminders of the monetary and fiscal landscape of 1951, when U.S. President Harry Truman wanted to pay for the Korean War with the Fed continuing to accumulate Treasuries and keeping interest rates low as it did during World War II (and later following the 2008 crisis and the recent "Covid war"). The Federal Reserve chairman at the time, Marriner Eccles, during the Open Market Committee meeting February 6–8, 1951, objected to doing so and stated:

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We are not in a war. We do not now have deficit financing. The situation is not comparable in any degree with the situation that confronted us in 1941 … Under those conditions, it would have been impossible to finance the wartime deficits of that size under a restrictive and tight money policy … The situation today is exactly the opposite. We have had for the last four or five years an aggregate budgetary surplus of nearly $13 billion. [Note: to put this number in perspective, during the five years after Pearl Harbor, the public debt went up from $50 to $280 billion]. You only protect the public credit by maintaining confidence in their Government and in its securities to the extent the public will buy and hold those securities. … We have permitted an increase in the money supply of this country by more than 8 percent since Korea. That was not done … for the purpose of carrying out our responsibilities, but … was due entirely to our efforts to carry out the demands or requests of the Treasury.

Notice one difference between the situation then and now—surpluses by 1951, but large deficits now.

The second difference is that the 1951 document is explicit about the fact that the change in monetary policy requires coordination with a drastic change in Washington's fiscal policies. It states:

The problem of [Korean] war finance … cannot be solved by minor adjustments in fiscal policy, in debt management policy, or in monetary and credit policy. We need a complete reappraisal … [otherwise it would] destroy confidence, generate friction and economic strife, impair the value of the dollar, dissipate the value of savings … impose an intolerable burden upon fixed income groups… and arrest the flight of dollars into hedges against inflation.

A second document of the Fed on that occasion, addressed to the Board of Governors, notes explicitly that "the rush to buy houses and farms" and the desire to convert dollars into equities were all symptoms of fears of inflation.

The contrast with today's Fed is sharp: The Fed makes no mention of either the looming deficits, or any coordination to stabilize the country's finances. Neither does it make any reference that shifts to hedges—houses in particular—would imply a radical reconsideration of ever being guided by rigid price indices, that the president of the Cleveland Fed suggested that the Fed should eventually go back to few years down the line.

Stabilizing the dollar should be the Fed's anchor.

Jump to the 1980s. Whereas much attention is justly focused on Chairman Paul Volcker deciding to have the Fed be guided by monetary aggregates, commentators forget that by the fall of 1982, "the Federal Reserve shifted back to its approach of targeting the price rather than the quantity of money." With good reasons, as targeting various money supply aggregates did not have the desirable effects.

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True, the M1 growth rate fluctuated between 5 percent and 15 percent in the late 1970s and early 1980s and those were high inflation rate years. But then the M1 growth rate was again in the 15 percent range a decade later—without inflationary impact. M2 did not offer better insight, and by July 1993, Chairman Alan Greenspan testified to Congress that the Fed would no longer use monetary aggregates to guide FOMC policy:

At one time, M2 was useful both to guide Federal Reserve policy and to communicate the thrust of monetary policy to others. The so-called "P-star" model, developed in the late 1980s, embodied a long-run relationship between M2 and prices that could anchor policy over extended periods of time. But that long-run relationship also seems to have broken down with the persistent rise in M2 velocity.

Surprisingly, advocates of money supply measures as a guide for the Fed neglect the radical decline in M2 velocity from the stable 1.8 between 1960–1990, hovering around 2 during the 1990s, and now down to around 1.2, suggesting that even with high rates of growth in M2, the—badly—measured price levels may well stay stable (as the shift to hedges the 1951 Fed was aware of were out of sights and minds four decades later).

As to those adhering to Milton Friedman's quantity theory, they forget both that Friedman was explicit assuming velocity to be stable, and second—to his great credit—he admitted in a June 6, 2003, *Financial Times* interview

the following: "'The use of quantity of money as a target has not been a success,' concedes the grand old man of conservative economics. 'I'm not sure I would as of today push it as hard as I once did.'" Moreover, in a surprising—but forgotten—article in the *New York Times* on July 4, 1999, when asked what was his single biggest academic blunder, he admitted it was translating his ideas into Keynesian language, in order to refute the latter. It is surprising it took so long to admit that, since in many of his writings he paid attention to words, stating that economists just give names for their ignorance—but without any idea what they mean, and should have been aware of the old Italian adage *"traduttore, traditore"*—"translator, traitor."

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Notice too that the 1980s actually implemented the policies the Federal Reserve advocated in 1951, the new fiscal policies allowed to absorb some of the liquidity sloshing around. The Economic Recovery Tax Act of 1981 slashed the highest rate from 70 to 50 percent, and indexed the brackets for inflation. Then the anticipated Tax Reform Act of 1986 expanded the tax base and dropped the top rate to 28 percent for tax years beginning in 1988, and capital gains tax rates, that the Tax Reform Acts increased in 1969 and 1976, were capped at 20 percent in 1981.

The differences with 2022 cannot be sharper: government deficits are looming, increased taxes and evermore regulations are on the horizon (the latter often substitute for taxation, just being less visible and harder to translate to numbers).

Can then monetary policy focusing on rates and disregarding the lessons and contexts of both 1951 and 1980s bring about the desired stability?

That is unlikely, as there are other differences too. In 1951 and in 1980, the U.S. population was much younger, there was far less hard-to-change political government spending commitments, and domestic education and careers were more a matter of meritocracy—all impacting expected growth rates now. During the 1950s in particular, the United States also saw a large influx of educated young people escaping a war-ravaged Europe, and in later decades it continued to be magnet for those critical "vital fews" from around the world.

What can then guide the Fed now?

The world bond market cap stands at $120 trillion and that of the United States $46 trillion, with the world equity market cap in the same range and that of the United States at $52 trillion. While the Federal Reserve may set rates or pursue other guides in such a world, with floating exchange rates its policies are unlikely to have the desired effects.

The notional value of outstanding derivatives in June 2021 was around $600 trillion—most of it related to foreign exchange and interest rates, much needed in a world of volatile exchange rates so as to allow companies to stay in their lines of business rather than be subject to central bankers' fads and exchange rate fluctuations. With capital flowing to the United States following uncertainty now in Europe and much of the rest of the world, the yield curve becomes less reliable too as a guide.

What can then guide the Federal Reserve now if the goal is to restore financial stability domestically? Commercial societies are based on contractual agreements. Stabilizing the U.S. dollar, which was Volcker's explicitly emphasized goal, and should be the Fed's now, would restore such stability not only within the United States, but would rebuild the much discussed global "financial architecture." How to get there? A renewed Bretton Woods agreement—including two crucial clauses that were left out from the original—appears to be the solution. Until that is achieved, stabilizing the dollar should be the Fed's anchor. ◆

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