A Monetarist History of the Fed

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Economist Allan Meltzer has written a two-volume history of the American central bank that is both a treasure trove of new source material and a second great monetarist historical manifesto.

Reviewed:

- Meltzer Allan H., 2003, *A History of the Federal Reserve, Volume 1 1913-1951*, The University of Chicago Press, 800 p.

- Meltzer Allan H., 2009, *A History of the Federal Reserve, Volume 2, Book 1, 1951-1969*, The University of Chicago Press, 682 p.

- Meltzer Allan H., 2009, *A History of the Federal Reserve, Volume 2, Book 2, 1970-1986*, The University of Chicago Press, 629 p.

Few institutions come in for as much scrutiny as the central bank of the United States: the Federal Reserve System, commonly known as "the Fed." Financial markets and journalists pore over the least of its announcements and panic at every rumor touching its decisions. Economists regularly formulate theories rooted in studies of American economic policy. Congress at times covets the bank's powers, giving rise to virulent debates like the one aroused by Senator Dodd's recent proposal to curtail the powers of the Fed because of its inability to predict the financial crisis. The Fed's responsibility for the current crisis has become a matter of debate: its former chair, Alan Greenspan, has been accused of pursuing too easy a monetary policy and of blind belief in free markets. Attacked today for numerous failings, Greenspan was nevertheless for nearly twenty years considered a "magician" or even a "guru" by some and routinely praised by financiers as well as congressmen. When his autobiography was published in 2007, it was as eagerly awaited as that of a rock star. Allan Meltzer's history of the Fed will no doubt meet with a very different reception, yet no one can fail to recognize the importance of this work, which attacks a myth of American economic and political history in the twentieth century and offers a frequently ferocious critique of the actions of the Fed.

The publication in late 2009 of the two books of the second and final volume of *A History of the Federal Reserve* (covering the period 1951-1986) completes the most ample study to date not only of the American central bank but of any central bank. If we include the first volume (covering the period 1913-1951 and published in 2003), it is now possible to examine the work as a whole and appreciate its conception and originality. Meltzer, a specialist in monetary theory and policy,[1] spent fifteen years writing this work, for which he enlisted the help of some fifteen assistants to sift through the massive archives without which the book could not have been written. The result is more than 2,000 pages filled with details, anecdotes, figures, graphs, and invaluable historical analyses that have no parallel for anyone interested in monetary and financial theory or the political history of the United States.

To see these volumes as merely an historical summa brimming with useful data and interpretations, however, would be to miss Allan Meltzer's principal ambition. *A History of the Federal Reserve* should be seen for what it is: the second great historical work of monetarism. The first, *A Monetary History of the United States*, published in 1963 by Milton Friedman and Anna Schwartz, provided historical justification for the monetarist theories of Friedman and his disciples. Meltzer would not have written his book had it not been for this example: he frequently situates his arguments in relation to those of Friedman and Schwartz yet never refers to classic histories of other central banks, such as those of Richard Sayers and John Clapham for the Bank of England or Alain Plessis for the Bank of France under the Second Empire.[2] Owing

[1] Meltzer actually began this project in the mid-1960s only to set it aside before returning to it thirty years later. In the meantime he became a leading monetarist economist, whose chief theoretical contributions have been collected in Karl Brunner and Allan H. Meltzer, *Money and the Economy: Issues in Monetary Analysis*, Cambridge, 1993. A critic of Fed policy since the 1970s, Meltzer in 1973 created the Shadow Open Market Committee, which critiques and offers alternatives to the policies adopted by the Federal Open Market Committee, which sets monetary policy for the Fed.

[2] See John H Clapham., *A History of the Bank of England*, 2 volumes, Cambridge University Press, 1944; Richard Sayers, *The Bank of England*, 3 volumes, Cambridge University Press, 1976; Alain Plessis, *Une histoire de la Banque de France sous le Second Empire*, 3 volumes, Droz, 1983-1987.

to the length of the work, we cannot here summarize its contents or enter into detailed discussion of Meltzer's theses.[3] We will simply outline the main contributions[4] and then consider the ways in which the author's monetarist convictions shaped his underlying approach and serve as the basis for his interpretations of monetary history.

A Monetarist Re-Reading of the history of the United States

With the help of largely unpublished archives, *A History of the Federal Reserve* adds considerably to our understanding of major events in the history of the United States and the world, including, in particular, the Great Depression, the operation of the Bretton Woods system, and the "stagflation" of the 1970s. By examining the transition from a system of semi-autonomous regional banks to one increasingly centralized in Washington, along with relations between the administration, the Congress, and the Fed, Meltzer's work also helps us to understand major changes in the federalist structure of the United States and the role of the federal government over the course of the twentieth century. Finally, the study of monetary policy sheds new light on America's position in the world and on the system of international relations: for instance, the work reveals the reasons for the development of a market in bankers' acceptances and explains how Fed policy in the 1920s helped to foster an international role for the dollar and for U. S. banks. It also brings out the contradiction between domestic policy objectives and the central role of the United States in the Bretton Woods System after World War II (as exemplified, in particular, by the refusal to devalue the dollar in relation to gold, which Meltzer analyzes at length).

What is distinctive about this work is that once the facts are laid on the table, they are interpreted in a monetarist framework. Meltzer does not set out to prove that monetarist theories are correct and rarely troubles to compare them with other plausible hypotheses, but he does offer a consistent and comprehensive interpretation of history based on monetarist principles. The fundamental principle of monetarism is that money is neutral in the medium-to-long run,

[3] This has been done for the first volume in a 25-page review by Michael Bordo, "Review of A History of the Federal Reserve.Volume I (2003) by Allan H. Meltzer," *Journal of Monetary Economics*, vol.53, p. 633–657.

[4] In dealing with a work of this sort, readers may find it useful to consult certain passages or chapters dealing with a particular subject or period. This is made easier by the ample index and bibliographies accompanying each volume as well as by the author's care to summarize the main events and arguments at the beginning and end of each chapter. It is unfortunate, however, that there is neither a detailed table of contents nor a chronology. A recapitulation of sources at the end of the work would also have been useful for historians and preferable simply to including sources in the bibliography, especially since many of them are unpublished.

which implies that price stability should be the primary objective of monetary policy. From a theoretical point of view, it follows that inflation is defined by a permanent change in the level of prices and not by temporary short-term fluctuations, that the demand for money is stable, and that the difference between the nominal and real rates is fundamental for analysis (and that policy should be guided by the latter). From a political point of view, monetarists condemn state intervention as a cause of inflation. For them, price stability (which requires a credible monetary policy) is the best way of ensuring full employment and economic growth.[5]

In subjecting the history of the United States to a monetarist analysis, Meltzer is following in the footsteps of Friedman and Schwarz, in that the purpose he ascribes to historical analysis is not only to identify long-term trends but above all to formulate judgments of the economic policies that were adopted at various points in time. The goal, in other words, is to derive theoretical and political lessons from history. But if Friedman and Schwartz's main concerns were the monetary mass and the banking and financial system, Meltzer's is rather the decision-making process at the Fed. For him, "the history of an institution is a record of successes and failures."[6] And in his view the Fed's history is mainly one of failure, since failure occupies more than 30 of the 73 years studied in the book: the Great Depression of the 1930s and the Great Inflation, which Meltzer, offering an unorthodox and provocative chronology, sees as beginning in 1965. Beside these failures, only the periods 1923-1928 and 1952-1964 find grace in Meltzer's eyes, because in those periods, price stability—the fundamental tenet of monetarism—was not neglected. The work's essential point is that "the two principal sources of policy errors resulted from political interferences or pressure and mistaken beliefs."[7]

In the best-known chapter of *A Monetary History of the United States* (chapter 7), which remains an essential reference today, Friedman and Schwartz argued that the Great Depression

[5] Monetarist principles are summarized and explained at several points in the work, in particular in chapter 2 of volume 1, and chapters 1 and 8 of volume 2 (vol. 2, book 2, pp. 1014-1018). For a critique of the application of monetarist theory to monetary policy, see esp. Paul Krugman, "Who Was Milton Friedman?", *New York Review of Books*, Feb. 2007 (http://www.nybooks.com/articles/archives/2007/feb/15/who-was-milton-friedman/) ; Alan Blinder, *Central Banking in Theory and Practice,* MIT Press, 1998, and Jean-Paul Fitoussi, *Le débat interdit*, Seuil, 2000. For a more specific critique of the monetarist interpretation of the 1929 crisis, see esp. Peter Temin, *Did Monetary Forces Cause the Great Depression?* Norton, 1976, and Barry Eichengreen and Peter Temin, "The Gold Standard and the Great Depression," *Contemporary European History* 9, 2 (2000), p. 183-207. http://isites.harvard.edu/fs/docs/icb.topic467999.files/October%2022%20and%2027%20-%20Trade%20Money%20and%20Finance/Eichengreen.pdf

[6] « The history of an institution is a record of successes and failures », vol. 2, t. 1. p. 40.

[7] « The two principal sources of policy errors resulted from political interferences or pressure and mistaken beliefs », vol. 2, t. 2, p. 1217.

was the result of Fed policy. The first volume of Meltzer's work confirms this hypothesis, while showing, contrary to Friedman and Schwartz, that the errors of the 1930s continued rather than departed from the ideas and practices of the 1920s. The second volume does not refer directly to Friedman and Schwartz, whose study ended in 1960, but rather assumes the monetarist mantle by centering its analysis on the charge that the "Great Inflation" of the 1970s was also a result of central bank policy, which granted priority to full employment over price stability and relied for guidance on the defective Keynesian theory that was widely accepted at the time.

A Series of Errors?

Some readers may find it irritating that the author so frequently indicts the institution he is studying and constantly reiterates the tenets of monetarism (the crucial role of a stable demand for money, the difference between real and nominal interest rates, the impotence of regulation, the dangers of Keynesianism, etc.). Nevertheless, as with Friedman and Schwartz, the work's theoretical and political claims are also its strength; whether or not one shares the author's positions, they compel him to propound stimulating and iconoclastic arguments and highlight his impressive ability to infuse austere and technically complex subjects with genuine interest. Meltzer does not hide his enthusiasm for explaining the complex technical discussions that took place within the Fed, such as the debates on required reserves, on the means of influencing the long-term rate of interest, and on the regulation of bank deposits. He displays a rare talent for synthesizing these debates, grasping their substance, and helping the reader to understand their finer points.

This ability to grasp theoretical and political issues in highly technical debates is particularly clear in the way in which Meltzer relates narrative history and the history of ideas. Once again, it is his monetarist convictions that force him to do so: the goal is always to show that errors of monetary policy were the result of disastrous theories that ignored the basic principles of monetarism.

Meltzer thus ascribes a fundamental role to ideas. To convince oneself of this, one has only to read the first volume of the work. Another historian would no doubt have chosen to introduce his work by describing the state of the American banking and monetary system prior to the creation of the Federal Reserve System in 1913, focusing in particular on previous attempts to create a central bank in the United States. Meltzer takes an entirely different tack, however:

his first chapter is a partial synthesis of nineteenth-century English debates on monetary theory. The next chapter moves directly to the creation of the Fed in 1913. The reason for this iconoclastic choice is that the author wants to familiarize the reader with the various theories on offer at the time, from which the members of the Fed's executive committee might have drawn inspiration so as to avoid the mistakes they made in 1930. The advantage of this approach is that the reader is given what he needs to grasp the fact that the real bills doctrine employed by the Fed was countered by other, more coherent theories that might have prevented mistaken interpretations of the movement of assets between banks. But the drawback of this approach is that it ascribes so much importance to economic theory in the conduct of monetary policy that it leaves out part of the context, in particular the simple fact that the Federal Reserve System was still an "adolescent" of 17 in 1930 and had never faced a financial crisis, and that the American money market was still afflicted with numerous problems due to its youth, most notably a lack of coordination among the twelve regional federal reserve banks.

Finally, among the strong points of Meltzer's analysis, we must include his scrupulous attention to issues of banking and forms of credit, which stems from the theory of monetary transmission that he developed in collaboration with Karl Brunner in the 1960s.[8] This focus is especially valuable because current theories of monetary policy tend to neglect these questions. Meltzer shows that bank credits and deposits are fundamental variables of monetary policy closely watched by central bankers (who at times misinterpreted what they saw) and always a target of monetary policy, along with bank regulation. The interaction between the two stands out especially clearly in Meltzer's analysis of "Regulation Q," which imposed limits on the interest rate that banks could pay on deposits. Regulation Q was linked in particular to decisions concerning changes in the discount rate and to power struggles between large and small banks and between regional and Wall Street banks, as well as to the flight of capital to the Eurodollar market. Meltzer also studies in detail how the Great Depression was transmitted through the banking channel and dissents strongly from the celebrated thesis of current Fed chairman Ben Bernanke,[9] who argued that the Fed's monetary tightening was amplified by a decline in bank loans due to credit constraints on small businesses. According to Meltzer, the decline in the

[8] Summarized in Allan H. Meltzer, "Monetary, Credit and (Other) Transmission Processes: A Monetarist Perspective," *The Journal of Economic Perspectives*, vol. 9, no. 4, p. 49-72.

[9] Benjamin S. Bernanke, 1983, "Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression", *American Economic Review*, vol. 73, p. 257–276.

volume of commercial paper was much larger than the decrease in bank loans to small business, which suggests that the decrease in bank loans was due solely to a decrease in business revenue due to the decline in real balances brought about by Fed policy.[10]

The limits of the monetarist angle

The monetarist prism through which Meltzer sees the history of monetary policy is also the cause of certain errors and oversights, however. First, the importance that he ascribes to the history of ideas and to political relations between the Fed and the government largely supplants administrative history.[11] In particular, the fact that what is usually called the central bank of the United States is in fact a system of federal banks comes in for very little analysis in terms of the theory of organizations. To be sure, Meltzer discusses the power struggles between New York and Washington within the Federal Reserve system, the progressive centralization of the system, the influence of personalities, and internal conflicts between the committees that make the decisions and the market operators who carry them out, but his analyses of decision-making and administrative processes are nowhere near as extensive as his history of monetary theory. For instance, he never mentions the number of people employed by the Fed; little detail is offered about the operation of the twelve regional federal banks; and there is no discussion of the relation between these banks and regional economies.

The focus on the history of ideas and the primacy accorded to the monetary prism also prevent the author from considering Fed decisions in any framework other than one of simple economic efficiency (which for Meltzer always means price stability). The problem becomes apparent in the author's frequent assertions that the reason why monetary policy went wrong in the 1960s and 1970s was that the government pursued a policy of full employment as defined by the Unemployment Act of 1946. To be sure, the central bank's lack of independence is open to criticism, and one has to acknowledge the exertion of political pressure on the Fed by some administrations (such as the Nixon administration, which leaned on Governor Burns to assist Nixon's campaign for re-election in 1972), but it is hard to deny that in a democracy the representatives of the people are entitled to make the law, which cannot be set aside in the name of economic efficiency defined in a highly theoretical manner. This of course raises the question

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[10] See vol. 1, p. 313-314.

[11] For a contrasting approach, see esp. Elizabeth Hennessy, *A domestic History of the Bank of England, 1930-1960*, Cambridge University Press, 1992.

of the political legitimacy of Fed policy, which Meltzer dismisses with the assertion that the Fed must be credibly committed to price stability. Unfortunately for Meltzer, his contention that Keynesian policies were totally bankrupt is open to serious challenge, casting further doubt on the possibility of defining political legitimacy in terms of economic theory alone.

In the end, it is difficult to overlook a certain gap between the history that Meltzer recounts and the conclusions he draws. These volumes offer a fascinating picture of the complexity of the interactions between monetary policy and political and social issues. It is clear that even if the decisions of the Fed draw on a framework of economic theory, that framework cannot fully determine the outcome because it is never comprehensive enough to yield unambiguous solutions to problems as they arise in real time, all the more so because there are so many factors to be taken into account and expectations matter. Even if the members of the central bank could agree on a unique objective, economic theory, together with available statistics, is never enough to yield a simple, consensual decision about the best way of achieving that objective. Think, for example, of the Fed's recent debates around the question of whether or not the United States is currently in a deflationary situation. Despite this cognitive complexity, Meltzer simply reiterates his belief in the need for price stability as a long-term goal, along with a credible rule for anchoring expectations, and he regards any deviation from such a rule as a failure of monetary policy. In many respects, his interpretation thus banishes any number of non-trivial aspects of monetary policy from consideration and does not really do justice to the complexity of the phenomena at work. He shares with Milton Friedman the old monetarist dream of an "automatic monetary policy" that would simply adhere to a predefined rule. Despite Meltzer's own position on the issue, his absorbing history of more than seventy years of Fed activity will convince many readers that such a rule is absolutely impossible to define. Nevertheless, although the author has chosen to interpret the facts narrowly, the work he has produced is ample enough to allow readers to formulate their own interpretations.

Translated from French by **Arthur Goldhammer.**

Published in laviedesidées.fr 11 October 2010