

MONETARY CONTROL AND THE POLITICAL BUSINESS CYCLE

William Poole

Introduction

This paper might equally well be entitled, "Political Control and the Monetary Business Cycle." The observations I will offer reflect 25 years of following current events and studying economic policy and a recent period of government employment of two and one-half years. My observations are meant to be subject to empirical testing, but that task lies outside the scope of this paper.

In casual conversations on economic policy, questions about the objectives and motives of the policymakers almost always arise. Along the spectrum of published work on economic policy, ranging from abstract theoretical models to newspaper editorials, the mix of objective analysis and subjective speculation about the policymakers' motives changes. Scholarly work by economists, though not by historians, usually avoids analysis of motives; the objectives of the policymakers are taken as given. Conversely, editorial writers often speculate about the policymakers' motives, and if those motives are judged "bad" the policy actions themselves are judged bad and objective analysis of policy deemed irrelevant.

I myself have always been uncomfortable when discussing motives, for they are ordinarily not directly observable and subject to empirical verification. Moreover, it is very easy for policymakers to believe that they have been unjustly attacked when observers discuss their motives, for the policymakers may know that they did not have the intentions ascribed to them.

In a paper on the interplay of politics and economics in the determination of Federal Reserve policy I cannot avoid discussing the

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policymakers' motives. However, my commentary on motives should be interpreted quite strictly in an "as if" sense. Economists are accustomed to analyzing business behavior under the assumption that business firms produce at the point where marginal cost equals marginal revenue, and the fact that many businessmen deny they have any such intention or motivation in making their production decisions is irrelevant to the predictions of the economic theory based on the profit-maximizing assumption. My comments on the motives of policymakers should be interpreted in exactly the same "as if" sense; sometimes the calculations are conscious and well understood by the policymakers and sometimes they are not. I also want to emphasize that the behavior of the Federal Reserve is similar in many respects to the behavior of other government agencies and, for that matter, divisions of large private firms.

The paper is divided into five major sections. In the first I discuss the role of motives in public debates about policy, and in the second the objectives of the Federal Reserve System. Issues concerning policy myopia are taken up in the third section, and political gaming is discussed in the fourth. A final section contains some overall comments and conclusions.

Public Debates on the Policymakers' Motives

The role of policymakers' motives in public policy debates is underappreciated in scholarly work on economic policy. Motives are ignored because they are unobservable and would not seem to have any relevance to assessment of the objective effects of policy. But the role of motives ought to be examined more thoroughly because of their influence on public policy debates and on market expectations about future policy actions.

The motives of the policymakers are important for market participants because an understanding of the reasons for particular policy actions may provide information useful in predicting future policy actions. The great importance of predicting future policy actions is probably the reason why there are so many Washington seminars and "insider" newsletters purporting to uncover the "real story" behind policy actions that are themselves readily observable.

The rivalry among competing agencies, personalities, and political parties often leads to a great emphasis on the motives of the competing parties. Newspapers and their readers often seem more interested in the rivalries themselves than in the policy issues. Public perceptions of policy actions and assessment of the performance of agencies is very often dependent on issues of motivation. If the

policymakers' motives are judged to be good ones, policy failures are often excused. Conversely, policy successes may be criticized if the motives are judged to be poor. For example, policy successes are often criticized as being "opportunistic."

Beyond the predictive value of understanding motives, public debates often focus on motives because the technical aspects of policy are ordinarily extraordinarily difficult to understand. Indeed, the implications of many policy actions are so complicated that it is difficult to explain them even to well-trained experts in the field. It is not surprising that public policy debates in the Congress and the op-ed pages of newspapers often focus on motives by default.

Because the electorate emphasizes motives, so also must the policymakers. Monetarist critics of the Federal Reserve often find themselves frustrated by this emphasis in the public policy debates. Efforts to put the debate on a basis that intelligent laymen can understand by emphasizing basic and first-order monetary effects gets nowhere because economists both within and without the Federal Reserve System argue that such analysis is "simplistic." But the layman cannot understand highly sophisticated economic arguments. Thus, the debates easily turn to matters of motivation; economics per se has little to offer on this subject, and the Federal Reserve defends itself by insisting that it is well-meaning, which it is, and interested only in serving the public interest. And that is where the debate then rests.

The Objectives of the Federal Reserve System

Officials of the Federal Reserve System pursue the traditional policy objectives laid out in the economic policy literature. These are the objectives of low inflation, full employment, financial stability, and so forth. At a personal level, Federal Reserve officials with very few exceptions care deeply about these objectives and often find themselves agonizing over the policy choices they must make. Many Federal Reserve officials have long careers in the System, and serve at very substantial financial sacrifice. There are, of course, compensations in the form of higher expected future income from employment after leaving the System, from extensive travel, and so forth, but it would be a misuse of language to ignore the deep sense of responsibility felt by most Fed officials by claiming that these compensations show that these officials in fact serve for purely "selfish" reasons.

Federal Reserve officials, almost without exception, have a deep conviction that Federal Reserve independence is essential to achiev-

ing the traditional economic objectives. Thus, maintaining independence from direct and continuous political control is itself an objective of the Federal Reserve System. Pursuit of this objective may at times lead the Federal Reserve to take policy actions that it knows are not in the interest of furthering the traditional economic objectives. The issue here is essentially the same as the possible conflict for the firm in pursuing short-run versus long-run profit maximization. There is certainly nothing wrong in principle about trading short-run economic performance against improved long-run economic performance. Indeed, economists are constantly emphasizing the dangers of policy myopia. The issue is not one of principle but of whether policy actions to further political independence in fact have the effect of improving long-run economic stability.

Another motivation for Federal Reserve officials to maintain political independence is to enjoy an easier and more comfortable life. It is perfectly natural for the Federal Reserve to want to maintain some of the comforts it enjoys compared to the typical government agency. This "bad" motive, though surely operative, is greatly overstressed in many of the debates about Federal Reserve independence precisely because it is such an easy shot by Federal Reserve critics. It is also, in my opinion, a criticism without much merit. The turnover rates among middle-level Federal Reserve employees suggest that the comforts of Federal Reserve employment are not all that great, and direct knowledge of the differences between Federal Reserve employment conditions and those of the civil service suggest that the Federal Reserve has been able to avoid only a few of the worst features of the civil service employment system.

The "Number One Problem" Syndrome

Public discussion of economic policy in the Congress and newspapers is dominated by the "number one problem" syndrome. Policymakers are expected to cure whatever it is that most afflicts the economy at the moment. This phenomenon is not quite the same as the one economists call "myopia." As generally discussed, myopia involves excessive attention to the short-run effects of policy, with too little attention being paid to the remote and/or long-run effects of policy. Because the effects of monetary policy show up first on employment and output, and only later on inflation, monetary policy myopia can be expected to impart an inflationary bias to the economy.

Myopia can explain a policy bias over time but cannot readily explain changes in policy over the course of the business cycle. Myopia fits the typical conditions in the early stages of a cyclical

expansion when emphasis on raising employment can lead to excessively high money growth because the longer-run inflation costs are too heavily discounted. But an explanation involving myopia does not fit the situation where the Fed maintains a restrictive policy well into a recession. For example, monetary policy was very restrictive throughout 1974 as unemployment rose, and it was not until late 1974 and early 1975—only shortly before the business cycle trough in March 1975—that the Fed changed its policy stance. (After the cycle peak in November 1973, the Fed did not cut its discount rate until December 1974; the discount rate, of course, is not itself important except as a symbol of Fed intentions.) Similarly, Fed policy remained on a very restrictive course through the middle of 1982 despite the continuing rise of unemployment after the cyclical peak in July 1981.

In both of the above examples, public concern over inflation was so high that a very substantial increase in unemployment was required to switch the focus of concern away from inflation and toward unemployment. The policymakers' own views play a role here, but the constraint provided by public attitudes should not be underestimated.

The syndrome is in part the result of public misconceptions about economic policy. It is a fact of arithmetic that increasing money growth one year requires reducing money growth in some other year if the trend rate of money growth is not to rise. With high probability, higher average money growth will raise the inflation rate; thus, higher money growth in the short run will raise inflation unless there is an offset in the form of lower money growth later. Would the Federal Reserve have raised money growth in a year such as 1977 if it had been required at the same time to provide a plan for an offsetting reduction in 1978 or 1979? Conversely, would the Federal Reserve have been willing to forsake a period of lower money growth in a period such as 1981 if the price of doing so were a commitment not to permit higher money growth in some subsequent year?

This problem is not, of course, peculiar to the Federal Reserve. Would the Congress have been willing to cut tax rates in 1981 if it had been required either to cut spending at the same time or to legislate specific future tax increases or spending reductions?

The government can avoid commitment to future policy offsets because there is just enough truth to statements insisting that future offsets may not be necessary. Tax reductions need not be offset by future tax increases if there is sufficient economic growth to provide high enough revenues to cover the level of government expenditures. Changes in money growth need not be offset in the future if there are lasting changes in the income velocity of money.

The problem with the monetary policy claim is not that the appropriate velocity offsets *never* occur, but that they are infrequent and that on the average velocity and money growth change in the *same* direction. But offsetting changes in velocity do occur just often enough, as in 1975 and 1982–83, to make plausible Federal Reserve pursuit of monetary policies that do not involve commitment to offsetting money growth changes in the future. Occasional policy successes, therefore, are used to justify a procyclical monetary policy driven by a political process dominated by myopia and the number one problem syndrome.

Public concentration on the number one problem tends to push policymakers into time-inconsistent policies. In the literature on this subject time inconsistency is usually explained in terms of policymakers bidding for votes by breaking implied or actual past commitments. Common examples are rent control—there are more voting tenants than voting landlords; inflationary policies that reduce the real value of outstanding debts, transferring wealth from creditors to debtors; and the imposition of special taxes such as the windfall profits tax on oil.

Policymakers often feel aggrieved when they are charged with deliberate pursuit of time-inconsistent policies; to them the process often seems to be one of being forced by the politics of the situation to take such actions as a defensive matter. Politicians out of power press for adoption of time-inconsistent policies. Those in office find that they must respond in order to retain political support. The fundamental problem is not that devious officials plot these damaging policies but that they are driven to pursue them by the political appeal of such policies when political opponents offer them to the electorate.

However clear public officials may be in their understanding of the undesirable characteristics of the policies they are pursuing, it is nevertheless necessary that the policies be justified in the court of public opinion. Some justifications are genuine and some are stratagems designed to deflect criticism. In the case of time-inconsistent policies, it is essential that the inconsistency be hidden. Inconsistencies can be hidden by providing justifications involving great technical complexity and by insisting that rules, standards, and regularities designed to eliminate time inconsistency are undesirable because they reduce “flexibility” and eliminate optimal responses to changed circumstances.

Without rules and standards, there is great difficulty in demonstrating time inconsistency in public debates. The unwillingness of the Federal Reserve to adhere to a clear money growth rule reflects in

part its difficult situation in these public debates. If the Federal Reserve were to adopt a rule before such a rule were generally supported in the body politic, how could it defend itself when political opponents attacked and argued that there would be manifest advantages to a different monetary policy? It must be emphasized that the essence of this problem is that the short-run gains really do exist. It is not easy to enter public debates on the side of an unchanged policy when unemployment has risen by several million over the last few months and your arguments depend on asserted long-run gains and abstract principles.

The observable consequences of the poor public understanding of monetary policy issues are several. There is a lag in adjusting monetary policy to changed business conditions. This lag produces the procyclical behavior of the money stock and of the spread between the federal funds rate and the discount rate. The procyclical behavior of monetary policy has been known for many years, but there is no sign whatsoever that the process is changing. The knowledge that economists have accumulated about the economics of this process has had little or no effect in changing the policy process itself. As a nation, we continue to make the same monetary policy mistakes over and over and over again.

There is a peculiar market expectations constraint on the way monetary policy is adjusted. When inflation is high, the Fed believes that it cannot allow interest rates to fall "too" quickly until unemployment has replaced inflation as the number one problem. Otherwise, market expectations about monetary policy would be violated and Fed credibility would suffer as it appeared that the "fight against inflation" was being abandoned. That appearance would create political problems for the Fed and might add to the difficulty of bringing down inflation in an orderly way. Similarly, when unemployment is the number one problem the Fed must tread gingerly in allowing interest rates to rise for fear that "too" big a change will lead to market expectations that the policy might not be politically sustainable.

Market expectations interact with the political constraints on policy. Roughly speaking, perhaps the best way to put the point is that maintaining political support requires that policy "look right"—policy must not be grossly counter-intuitive to the conventional intuition.

Finally, monetary policy often has asymmetrical characteristics that reflect the interplay of Fed intentions and market and political expectations. When unemployment is the number one problem, errors in controlling the money stock on the low side tend to be soon offset by higher money growth, but errors on the high side are not offset by lower money growth. In the terminology of the monetary targeting

literature, base drift is asymmetrical with the upside deviations of money from target being accommodated and the downside deviations being offset. The same process is at work when inflation is the number one problem. In this case, base drift runs in the other direction, but for exactly the same analytical reasons. Examples of such periods are the second halves of 1974 and 1981.

These asymmetries are sometimes incorporated quite explicitly in the policy directive sent by the Federal Open Market Committee (FOMC) to the open market desk at the Federal Reserve Bank of New York. The desk may be instructed to accommodate money growth on the high side but to move promptly should money growth be lower than projected, or vice versa. When the market learns that the FOMC has introduced an asymmetrical instruction into the policy directive, interest rates may jump discretely up or down. The reason is that the asymmetry is equivalent to the Federal Reserve saying that it will, for example, permit interest rates to rise readily under certain circumstances but not to fall readily. That information changes the near-term expected value of money market interest rates by changing the shape of the probability distribution of interest rate changes.

Although the Federal Reserve would never make a flat announcement that interest rates should rise, an asymmetric policy instruction is the operational equivalent of such an announcement. The FOMC does not release to the public the policy directive adopted at one meeting until after the next meeting, at which time the new directive supersedes the old one. Nevertheless, it seems likely that the way in which the open market desk conducts open market operations provides clues to astute Fed watchers when an asymmetry has been introduced to the directive. Otherwise inexplicable interest rate changes may occur when the market guesses that the Fed has introduced or eliminated an asymmetry in its open market operations.

Political Gaming

Much of what is said and done in Washington can be understood only within the context of political gaming—the thrust and parry, move and countermove, of political rivals and agencies as they attempt to improve their political positions. Actions that seem peculiar become perfectly clear once the inside story of personal rivalries and of the deals that are struck becomes known.

One of the most obvious features of political gaming is the practice of scape-goating. The common human trait of resistance to admitting mistakes is especially important for government agencies. The polit-

ical power and even survival of agencies depends on maintaining an image of competence. No one should underestimate the potential for quirky and fundamentally unimportant episodes to affect an agency's image and therefore its public support. All agencies, including the Federal Reserve, do their best to avoid damaging incidents, to take credit for the good things that happen, and to blame others, either openly or by inference, for the bad things that happen.

It is extremely difficult to obtain from the Federal Reserve a simple yes or no answer to a question such as: "In retrospect, and all things considered, would it have been better for the U.S. economy if M1 growth had been one percentage point lower than it actually was each year 1977-1979?" However, it is also worth emphasizing that questions of this kind are rarely asked of the Federal Reserve by the Congress.

Several reasons come to mind as to why such questions are so rarely asked. For one, a member of the Congress who pressured the Fed to hold interest rates down in the late 1970s is in a poor position to ask now why money growth was not lower. For another, members of Congress may want to retain their freedom to scape-goat the Federal Reserve in the future.

The present arrangements for congressional oversight of the Federal Reserve serve the political interests of both the Fed and the Congress because these arrangements permit both bodies a relatively easy escape from answering hard questions and taking real positions on important monetary policy issues. The present extensive congressional oversight hearings provide the appearance of careful congressional scrutiny of Federal Reserve policy without in fact changing very much what the Federal Reserve actually does.

There are considerable political rewards for the politician who takes on a "bad" agency and wins a highly visible battle. However, to win these political battles the public must have concerns about the competence of an agency, and the critics must maintain a "reform" image. However, the game is a tricky one because anyone attacking a "sound" agency may be viewed as irresponsible and as acting simply for "political" reasons. Such a person may be easily discredited by the agency claiming that the attacker is irresponsible and simply scape-goating. As emphasized earlier, the political combat is carried on largely at the level of intentions, motives, and integrity; the merits of a case are of distinctly secondary importance.

Over the years the Federal Reserve has been extraordinarily successful in maintaining the high ground in these political debates. One of the reasons is that many of the attacks on the Fed *have* been irresponsible. The focus of these political attacks is almost always on

the level of interest rates, and the Federal Reserve has been extremely successful in fending off such attacks.

One of the principal stratagems pursued by the Federal Reserve has been to avoid appearing responsible for interest rate changes. After the Treasury-Federal Reserve Accord of 1951, the Fed adopted the "bills only" policy in its open market operations. By confining its open market interventions to the short end of the maturity spectrum, the Fed was able to claim that it had nothing to do with fluctuations of long-term interest rates. Increases in bond yields could not be the Fed's fault. That policy reduced a possible pressure point on the Fed to resume the pegging of long-term interest rates.

Federal Reserve market intervention to control short-term interest rates became increasingly explicit after the Accord. Starting in 1967 the FOMC set narrow limits on day-to-day fluctuations of the federal funds rate, and the numerical "tolerance range" for the funds rate was published with only a short lag after the mid-1970s. In October 1979 the Federal Reserve moved to a system it described as "non-borrowed reserves" control. Under this system much wider day-to-day fluctuations in interest rates were permitted, and the Fed insisted that interest rates were being set entirely by market forces.

After 1979 controversy grew about interest rate volatility, the high average level of interest rates, and the protracted 1981–82 recession. Responding to this criticism, in the fall of 1982 the Fed changed its policy procedures again by adopting what it described as a "borrowed reserves" target.

Under this new policy the day-to-day behavior of the federal funds rate has been almost identical to that under the earlier policy of explicitly pegging the funds rate in the short run. This outcome is not surprising. It is well known in the academic literature that if the bank borrowing function is stable a borrowed reserves target is *identical* to direct targeting of the federal funds rate. Nevertheless, the Fed has been at pains to insist that the policies followed after the fall of 1982 have not involved close control over money market interest rates on a day-to-day basis.

In addition to conducting open market operations in ways that minimize the appearance of influence over interest rates, the Federal Reserve has continuously emphasized the role of non-monetary causes of interest rate changes. This approach reflects the genuine professional views of the members of the Board of Governors and its staff. At least since the Accord, the Board has put much more emphasis on the role of budget deficits in determining nominal interest rates than monetarists think appropriate. There is a genuine difference of professional opinion here, but having said that it is also fair to observe

that monetarists do not fare well on the Board staff. The monetarist emphasis on the role of inflation and inflation expectations—both of which are largely the result of money growth—in determining nominal interest rates is a threat to the institution. In public speeches and congressional testimony, Federal Reserve emphasis on fiscal policy influences on interest rates makes effective use of public myths about budget deficits to deflect attention away from Federal Reserve policy.

In all of these ways the Federal Reserve has been successful over the years in blunting the charges of critics who assert that the Fed is responsible for an unduly high level of interest rates. The defense appears credible to the public by virtue of the fact that the financial institutions themselves seem more directly involved with interest rate determination than does the Federal Reserve. For this reason the critics of high interest rates have often found the financial institutions a more tempting target of their charges than the Federal Reserve. Federal Reserve officials have on occasion made comments that tend to support these views and have rarely come out with ringing defenses of financial institutions when rates are rising. After all, if the institutions are not to blame, who is? There is no point to encouraging political enemies to ask that question.

The one visible interest rate set by the Federal Reserve is the discount rate. Here again the Fed has played its hand very successfully. Discount rate changes generally follow changes in market rates, making it possible for the Fed to claim that the discount rate is being adjusted to maintain alignment with market rates. However, the Fed has insisted on maintaining independent control over the discount rate—rather than tying it to market rates—in order to have a visible policy instrument to adjust when it appears necessary to broadcast a message about Fed concern and action to deal with unfortunate economic conditions. When the cry is abroad to “do something,” a change in the discount rate is the ideal policy action.

These comments should most definitely not be read as reflecting a view on my part that the Federal Reserve should target interest rates. The point is that political pressures on the Federal Reserve are concentrated on interest rate issues. Barring scandal—and the Fed has an excellent record of avoiding both the actuality and appearance of scandal—the institution is politically safe as long as interest rates are trending down. In reconciling a sound monetary policy with the political realities, interest rates are *the* issue. To the extent that the Fed can avoid taking responsibility for interest rate changes it can avoid being backed into a political corner where it might be forced to attempt to limit interest rate increases. Its success in this

enterprise is responsible for monetary policy being as good as it has been. Monetarist critics, of course, believe that policy could have been much better.

As part of its effort to maintain its independence, the Federal Reserve engages in extensive efforts to explain economic conditions as being the result of disturbances beyond Federal Reserve control. Federal Reserve speeches and testimony generally devote far more space to analysis of fiscal policy and non-monetary influences on economic conditions than to monetary analysis. Space devoted to monetary analysis is ordinarily concentrated on why money demand shifts and other irregularities require a "flexible" monetary policy.

The Federal Reserve has been so successful over the years in maintaining the political high ground that alternative views are usually greeted skeptically in the public debates. Federal Reserve views are in fact often correct, and where they are not they always have a ring of great plausibility. Moreover, administration and congressional criticisms of the Fed are generally dismissed on the ground that they are politically motivated.

For a recent example of this phenomenon, the Reagan administration has quite obviously been on the political defensive on the budget deficit issue, and everyone knows that there is political advantage for the administration to deny that budget deficits cause high real rates of interest. Consequently, the administration's position that budget deficits are not responsible for high real rates of interest has lacked credibility and has been dismissed out of hand by many observers. Indeed, the case has been so lacking in surface plausibility and the political motivations for making it have seemed so obvious that many observers have never even considered the possibility that the position might have merit. The substantive conclusion has been decided on the basis of the administration's motives. For these reasons, the administration's attempts to pin the interest rate tail on the Federal Reserve donkey have never gotten very far in the public debates.

Another aspect of political gamesmanship has made it relatively easy for the Fed to maintain the high ground. On the principle that the "enemy of my enemy is my friend" the political party out of the White House almost always has an incentive to side with the Fed. The Fed has been very successful in pursuing policies that do not provide an opportunity for both political parties to line up on the same side of an issue with the Fed on the other side. For example, when interest rates are rising in a presidential election year the Fed almost invariably permits money growth to rise also. The party out of power can then attack the party in power for rising interest rates,

and the party in power cannot deflect blame to the Federal Reserve by pointing to falling money growth. Conversely, when interest rates fall in a presidential election year, money growth usually falls also so that the opposition party cannot charge that the Fed is rigging the election for the party in power.

Discussing these political gaming issues almost always has an unseemly air about it. My purpose is not to disparage the Federal Reserve System, but to direct scholarly attention to how this process works. Successful political leaders and successful agencies must engage in political gaming. That is what politics is all about. Economists should not discuss economic policy entirely under the assumption that politics does not exist, or is unworthy of scholarly attention. There are, presumably, laws to political behavior in democracies, and those laws should be regarded as constraints that are every bit as important to the policymakers in pursuing their objectives as are the constraints imposed by the structure of the economy.

Conclusion

I am convinced that under the present institutional arrangements controlling monetary policy decisions there is no reason to expect that we have seen the last of stop-go monetary policy. I cannot predict whether the next episode will be stop or go. The case for go is that during the present business cycle expansion we have not yet seen a period of flat real growth and/or rising interest rates that could lead to great pressure on the Federal Reserve to raise money growth. Slow real GNP growth in 1962 and 1976 led to monetary policy decisions that accelerated money growth and eventually led to inflation. Rising interest rates in 1967, 1972, and 1977 led to higher money growth that accelerated inflation.

The case for stop is that the memory of the recent inflation is still very strong. Many observers are now willing to take risks on the side of restrictive monetary policy rather than take the chance of reigniting inflation. With these attitudes, a decline of inflation expectations leading to a decline of interest rates could generate excessively low money growth because of Fed concerns that interest rates not fall "too" rapidly. In the late 1950s public attitudes toward inflation produced a monetary policy biased on the side of restriction. The result was that the recovery from the 1957-58 recession was aborted by very low money growth in the second half of 1959. Later, of course, the memory of the back-to-back recessions in 1957-58 and 1960-61 created an inflationary bias to monetary policy.

There must be a better way. Greater congressional control over day-to-day monetary management would not, however, be useful. The political process that has given us a procyclical monetary policy operates with a vengeance at the congressional level. We need monetary rules and standards rather than new management.

Some observers believe that greater Federal Reserve independence would prevent the political interference with monetary policy of the type described in this paper. But I do not see how anyone committed to democratic government could advocate a central bank completely free of democratic political controls. Greater independence is a nonstarter; it should not happen and it will not happen.

The crux of the matter, I believe, is that relying on political will and good management to improve monetary policy is like relying on the social responsibility of firms to clean up pollution. Just as the responsible firm in a pollution-prone industry will be driven out of business by less responsible firms, so also may responsible political officials be driven out of the political marketplace by less responsible officials when certain kinds of policy decisions are made on a case-by-case basis.

If this view seems farfetched, consider the position of the Federal Reserve System if, during a period of rising interest rates, the President were to make a strong public statement insisting that the Fed should not increase the discount rate. Is it imaginable that the Federal Reserve would increase the discount rate the very next day? Is it unimaginable that the President, or some other important official such as the Speaker of the House of Representatives, might correctly see short-run political advantage to making such a statement?

This example is not farfetched. In December 1966 there was a highly public battle between President Johnson and Federal Reserve Chairman Martin. If Johnson had attacked the Federal Reserve before the discount rate increase instead of after, the Fed would almost surely have delayed its action. For another example, it is well known that the Federal Reserve had great misgivings about President Carter's 1980 request that the Fed impose credit controls. Could the Federal Reserve have defied President Carter by refusing to impose controls? Could the Federal Reserve have cut its discount rate in September 1974 when President Ford was convening his "Whip Inflation Now" meeting in Washington?

The answers to these questions are obvious. And it is important to note that in the event of Federal Reserve defiance of the President or Congress the public debate would turn away from the merits of the policy action itself to the power of the Federal Reserve. In these situations the only responsible thing for the Federal Reserve to do

is to acquiesce to the greater political power and to muddle along making the best of a bad situation. After a time, a changed climate of opinion opens up room for maneuver. The Federal Reserve can then argue that changed economic conditions rather than defiance of the President or the Congress justifies changing policy. But this process is obviously not without its costs. Needed policy actions may be delayed, and policy may for a time feed an inflation or depress an already contracting economy.

The end result of this political process is a sequence of monetary policy outcomes characterized by myopia and time inconsistency. These are not the results intended by the Federal Reserve, but at an abstract level they can be analyzed "as if" they were. This process will continue until a policy rule of some sort replaces policy discretion. I see no basis for a rule other than one specifying control of some monetary aggregate within some bounds. Only a rule constraining the creation of money can lead to a determinate price level and an end to the procyclical monetary policy that has afflicted the U.S. economy for so many years.

AVOIDABLE UNCERTAINTY AND THE EFFECTS OF MONETARY POLICY: WHY EVEN EXPERTS CAN'T FORECAST

David I. Meiselman

If Federal Reserve goals were clearly stated or understood, which they are not, we would have a much more informed and confident basis for making predictions about Fed actions. The absence of stable, predictable targets, goals, and rules results in general inability to understand and to predict Federal Reserve behavior. It thereby leads to general inability to forecast and predict the consequences of Fed actions, such as the money stock, inflation, interest rates, and the like. Inability to forecast and to predict Fed behavior, much of which is caused by the Fed itself, results in increased and *avoidable* uncertainty that is both costly and pervasive.

An Application of the Heisenberg Principle

Much of the recent research in monetary economics emphasizes the crucial importance of policy surprises on economic outcomes. For monetary policy, this means that fully anticipated money growth affects only the price level, essentially only the real value of money, itself. It is unanticipated money growth that alters interest rates and the real variables that cause real effects, including business cycles. This is how the rational expectations view leads to an emphasis on a money supply rule, especially a rule consistent with stable prices. But, such a rule would then limit, even deny, the Federal Reserve's ability to affect financial markets and real economic outcomes such as employment and output.

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This is why, lacking a monetary rule, market uncertainty about current and future Fed policies augments the impact of policy actions, themselves, precisely because each action has a larger surprise component. This also means that the Federal Reserve has strong, compelling incentives to increase uncertainty about its policies and actions in order to enhance its own economic and public policy role and power. This may also be why the Fed is so determined to prevent or sabotage any monetary rule, including rules constraining money growth to the slow, stable, and predictable path that the early Reagan administration supported but has since abandoned.

This also explains the essentially universal inability to consistently forecast Fed policies. Given the impact of monetary policy surprises on financial and real variables, it also helps to explain the parallel general inability to make dependable short-term forecasts of financial markets and business conditions, particularly given the difficulty, perhaps the impossibility, of knowing what policies and forecasts have already been discounted and adjusted for in financial and other markets. It may also explain the variable lags in the observed effects of measured monetary change.

The usual scientific investigation attempts to uncover nature's secrets and to make natural phenomena predictable. The Heisenberg Principle aside, most of the time nature does not act any differently when it is observed. This paradigm is surely inappropriate for scientific investigations of the Federal Reserve and other agencies controlled by human beings whose behavior is not independent of the investigator and of public understanding. Indeed, once observed, behavior tends to change. Thus, it seems to me that a variety of the Heisenberg Principle—that the act of observation itself changes the observed phenomenon—applies to the formation of and response to monetary policies.¹

Because increased uncertainty in policy surprises increases instability, the Federal Reserve creates or at least adds to the very problems it purports to solve. Survival of the Federal Reserve in its current discretionary form would seem to require destabilizing the economy, a form of crisis-creation control. Of course, some well-intentioned observers, noting the persistence of instability and inflation, confuse cause and effect when they contend that we need the Federal Reserve discretion to dampen stability and to battle inflation.

¹It would seem that this same principle applies in other areas of economic policy as well.

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The Enigmatic Fed

Turning more specifically to Poole's (1986) paper, I have a wide area of agreement with it. I share his conclusion that a policy rule rather than discretion is desirable, that the rule should be a monetary aggregate within some bounds, and that "only a rule constraining the creation of money can lead to a determinant price level and to an end to the procyclical monetary policy that has afflicted the U.S. economy for so many years."

I also share some of Poole's puzzlement about Federal Reserve "motives." He admits that, after 25 years of studying the Fed and monetary policy, with distinction, not quite grasping the Fed's motives. Most scholars, including those who have been Fed watching for even more than 25 years, share the same puzzlement.

Indeed, the poor record of forecasts of Fed behavior and the frustration of dedicating a lifetime to research trying to predict the Fed and still having to admit a high degree of failure reminds me of the anguished remark of Sigmund Freud. The story goes that after a lifetime of actual, or claimed, success in uncovering the mysteries of the human psyche Freud was lead to exclaim about the other half of the human race, "After over 50 years of research into the human soul there is one question I have never been able to answer. What does a woman want? Dear God, what does she want?"

Poole asks, "What does the Fed really want?" His answer seems to be: First, the Fed wants independence. Independence is one of the dominant, if not the dominant, goal of the Fed's institutional behavior. After close to three-quarters of a century since the 1913 Federal Reserve Act, the Fed has been uniquely successful in achieving and maintaining the goal of independence. But what else does the Fed *really* want?

Poole mentions "lack of scandal." The Fed appears to have done very well on this score, too, even down to the absence of tell-tale signs, even allegations, of foreign source cuff links among members of the open market committee. If the complete truth were known, I suspect that fewer than the average (for government employees) number of Fed pencils turn up in Federal Reserve employees' homes. If there is any scandal, it would have to be about monetary and regulatory policies rather than missing pencils or lavish perquisites for Fed employees.

Poole also asserts that the Fed also wants to be viewed as "well-meaning . . . and interested only in serving the public interest." My impression is that on this count, too, the Fed usually comes up with a high score. Many people, even most people who matter, believe the Fed has good intentions.

But good intentions are not enough. As the old epigram goes, the road to hell is paved with good intentions. Nor is it enough to state, as the 1968 bumper sticker did about Hubert Humphrey, "He Cares." We do not choose our brain surgeons this way, and even social workers do not choose their automobile mechanics for the mechanics' caring qualities. Nor should we choose central bankers mainly for their caring qualities, either.

Results matter. Judged by the traditional, as distinct from personal or institutional, policy objectives Poole lists, such as low inflation, full employment and financial stability, actual Fed performance has ranged from fair to calamitous failure.

In view of the Fed's generally poor record, the greater puzzle is why the Fed has such a great reputation. Inflation, interest rates, and unemployment are currently down from peak levels, and we are in the third year of a business cycle expansion. The Fed now looks better, or at least not as bad, as they did a few years ago. Thus, much criticism of the Fed has been muted, and so have calls for fundamental change in our monetary arrangements.

The improved results are welcome. However, I do not believe that they are permanent or more than still another passing phase in our monetary history. Given the absence of any fundamental change in incentives (which is what Poole may mean by "motives") or any significant change in constraints or in understanding, the same institution is likely to exhibit the same general pattern of behavior leading to the same generally unsatisfactory pattern of results. Consider also that there has been little change of personnel at the Fed even after the entire first term of a president widely understood to hold economic and monetary policy views markedly different from his predecessor. It is difficult to hold out much possibility of change resulting from new presidential appointments if the results of four years of a Reagan presidency were the reappointment of Carter's appointee, Volcker, and the appointment of but two of seven Fed governors, the marginal impact of which remains to be seen. And, the Fed staff is essentially unchanged, too.

A Political-Bureaucratic Institution

Bear in mind that the Fed is not a university. Neither is the Fed a research institute, nor is it a think tank. And the Fed is surely not a caring, loving parent. The Fed is not singularly devoted to stable prices, nor to full employment, nor to any other economic goal or set of goals precisely because it is a political, bureaucratic institution with political, bureaucratic goals, which are essentially neither eco-

conomic nor altruistic. Thus, the Fed is best analyzed as a political, bureaucratic institution, using the best tools at our disposal, including the public choice analysis.

As a political institution the Fed must choose among alternative combinations of goals and alternative sets of policy instruments and targets. These goals shift from time to time. To survive, and the Fed is an outstanding survivor, the Fed's goals, as well as their instruments and targets, also change as circumstances, including political considerations, change.

This is why I suspect that one reason there has been very little conflict between the Fed and the White House is that the Fed typically gives the White House close to whatever monetary policy the White House wants. Hence, the "political monetary cycle" emerges as a creature of the existing democratic-activist monetary regime.² The arrangement also suits the Executive Branch because the president can more readily blame the Fed when things go wrong and accept credit for good results.

To prevent conflict with the Congress, the Fed has been very successful in a combination of ploys. First is to keep Congress in the dark. To confound the Congress, the Fed typically is successful in diverting attention from money and bank reserves that the Fed does control to fiscal policy, which the Fed does not control.

Second, the Fed engages in artful compromise and gaming, but never gives up essential prerogatives, especially independence. The Fed has endured with independence, by statutory independence of the Executive Branch, but not of the Congress, because Congress has never really exercised its constitutional authority and responsibility for monetary policy. And, under present circumstances, I have difficulty seeing how Congress could, even if it wished to do so. Like the White House, the Congress is not wholly an unwilling or an unwitting accomplice of the Fed in these exercises because present arrangements enable the Congress to shed responsibility for the results of Fed actions. Indeed, virtually all of the legislative and oversight attention of the banking committees, themselves, is directed to financial market structure, housing, regulation of financial institutions, and the like rather than the Federal Reserve's conduct of monetary policy *per se*.

The Fed's Dread of Accountability

I return to the puzzlement of what the Fed really wants. I believe that there is a solution to the apparent paradox. The solution to the

²See Meiselman (1984).

paradox is as follows. The Fed dreads accountability. The Fed resists a rule, and the Fed wants to make sure that its own actions cannot be successfully forecast or predicted. We have learned that anticipated changes in money affect only prices. The ability to surprise markets gives the Fed enormous ability to alter a wide range of economic and financial circumstances.

This very lack of policy predictability enhances the power and importance of the Fed. If we could predict Fed actions, that power, and the Fed's ability to change real variables, would correspondingly diminish as markets would then discount future Fed actions along lines elaborated by rational expectations theorists and others. Thus, uncertainty about current and future monetary policy and money growth is a necessary condition for significant Fed power and authority.

Both to enhance their own power and to protect themselves from accountability and a diminution of their impact, the Fed must remain a puzzle, even to those who devote their lives to studying the Fed. For, as soon as its policies can be predicted, the Fed will change to make itself and its policies unpredictable once again, that is, unless and until required to do so by statutory or constitutional change. This is why, it seems to me, predictable monetary actions and a monetary rule are essential. This is also why the Federal Reserve battles a monetary rule with such vigor and determination.

The lack of a systematic and hence predictable monetary policy and general inability to predict and to forecast Fed behavior itself creates the uncertainty that gives real effects to changes in nominal money. It thereby results in real power to the Fed far beyond its ability to control the price level, alone.

Finally, many formal critiques of monetary policy, especially those derived from a rational expectation orientation, conclude that systematic monetary policy has no real effects and alters only the price level. These "irrelevance" analytical results apply to a world of perfect certainty and require the presence of known, predictable and hence discounted Fed acts, including predictable future money. If the best and the brightest, and the most specialized, including Poole, cannot accurately predict what the Fed will do, how can the market as a whole dependably discount future Fed policies? The absence of systematic, predictable monetary policy renders this "irrelevance" analytical result substantively irrelevant. Moreover, it is highly unlikely that the Fed would ever voluntarily give up the discretion and the uncertainty that result from Fed policies that give the Fed such power and prominence and shield it from accountability.

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