What Do We Learn from a Century of Fed History?

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Next month the Federal Reserve System will be one hundred years old. There is much to be learned from reflecting on the Fed's Centennial, not least because Fed history places current monetary policy in a revealing historical perspective. And beyond the lessons for current monetary policy, Fed monetary history is a mirror of American democracy; the dramatic changes in the Fed's powers, goals and structure reflect the changing aspirations and institutional norms that have shaped both the Fed and our government over the past century.

The Fed's history has been checkered. It committed severe errors of judgment many times – most disastrously, the monetary collapse that precipitated the Great Depression of the 1930s, the protracted monetary expansion that caused the Great Inflation of the 1960s and 1970s and the growth slowdown that accompanied it, and the extreme easy-money policy of 2002-2005 that helped to propel the housing bubble and collapse of 2007-2009.

Throughout its history, major Fed errors have reflected either adherence to false monetary doctrines, the politicization of monetary policy, or both. As Allan Meltzer's painstaking history of Fed policy discussions shows (see his three volume *History of the Federal Reserve*), the monetary collapse of the early 1930s resulted from conceptual errors that led Fed leaders to believe that what they saw happening in the markets – rising cash holdings by banks and low interest rates – implied that monetary policy was already very loose. In fact, rising cash balances and low interest rates were market responses to accelerating deflation and rising loan default risks that were the result of tight monetary policy.

The Great Inflation of the 1960s and 1970s resulted from a combination of political pressures on the Fed to accommodate large budget deficits by purchasing government debt, as well as mistaken beliefs on the part of Fed policy makers – especially their lack of comprehension that accommodative policy was failing to reduce unemployment because markets were adapting to that policy with rising expectations of inflation.

The hyper-loose monetary policy of 2002-2005 encouraged market participants to underprice risks, which helped to drive the growth in demand for risky mortgages, as several academic studies have shown. Again, The Fed's model of the economy lacked an understanding of the functioning of the financial sector, and failed to foresee the dire consequences of inflating so severe a bubble. The subprime disaster, however, wasn't just the result of that conceptual error. It also reflected the political environment in which the Fed operated as a *regulator*. Although Chairman Greenspan sometimes publicly worried about the government policies that caused Fannie Mae and Freddie Mac to debase underwriting standards in the mortgage market, the Fed did little to expose that debasement. Indeed, in its role as the gate keeper during the bank merger wave, the Federal Reserve Board signed off on hundreds of risk-creating bank mergers that were part of explicit political bargains between megabanks and activist groups – the banks were permitted to merge only after agreeing to billions of dollars of directed credit to those groups in exchange for receiving their political support for proposed mergers. The Fed, afraid of the firestorm from Congress if it objected to these unseemly deals, never raised a finger to stop them. (For more on these arrangements, see Charles W. Calomiris and Stephen H. Haber, *Fragile By Design: The Political Origins of Banking Crises and Scarce Credit*, Princeton 2014.)

What do these historical perspectives have to say about Fed policy today? With respect to current monetary policy, the pattern revealed by history is a major cause for concern. As before, the Fed's current conceptual framework, which guides its current QE3 purchases and its protracted zero-interest rate policy, is deeply flawed. In particular, the majority of Fed policy makers are not attaching sufficient weight to the risks of inflation that will attend a return to normalcy in the banking system (in technical jargon, the reversion of the "money multiplier" to its mean). The Fed has not articulated a credible exit strategy to react to the return to normalcy and is likely, as usual, to be caught behind the curve.

Furthermore, I believe this policy stance reflects not only a conceptual failing, but also a political convenience. The Fed is more deeply politicized now than at any time since the Arthur Burns era. The dangerous mixture of poor analysis and politicized objectives that drive short-termism about unemployment worry me greatly. Even more worrying, the Fed is adrift, operating without any clear rules to guide its unprecedented actions and focused only on near-term objectives (the next quarter of growth, not the next five years). As Allan Meltzer points out, a key error throughout Fed history has been the failure to take a medium-term perspective on meeting its objectives. In the context of inflation risk, this is perhaps the most worrying aspect of all.

What does the history of the Fed tell us more broadly, about the evolution of our democracy, and the way we cope with monetary and regulatory policy challenges? One of the most striking facts about the Fed has been its ability to change its shape and objectives to accommodate the shifting demands of our democracy. The Fed's original purposes and structure bear little resemblance to its current ones. Its primary initial function was to try to compensate for the unique microeconomic flaws of the geographically fragmented unit banking system in the United States by setting up a lending facility that would reduce liquidity risk (the possibility of the banking system getting caught short on cash), a risk that was primarily reflected in seasonal swings in the demand for credit, which were related to the planting and harvesting cycle. Also, the Fed was originally conceived under the gold standard, which constrained its cyclical policy actions by requiring the Fed to maintain the gold value of the dollar. The Fed was also originally conceived as a highly decentralized institution, with most of the power residing in the regional Reserve Banks, not the Board.

After the economic and political shocks of the 1930s and World War II, all of that changed. The combination of a highly centralized (post-1935) Fed structure, the disappearance of any long-term anchor to constrain inflation, and political mandates encouraging the use of monetary policy to boost employment and facilitate government deficit financing produced the Great Inflation of the 1960s and 1970s. Similarly, short-term pressures in 2002-2005 led the Fed to deviate from its prior implicit adherence to a Taylor Rule, which contributed to the housing bubble and the recent crisis.

Ironically, despite colossal failures of the Fed's own making (the Great Depression, the Great Inflation, the Subprime Crisis), the Fed's powers just grow and grow. Now, the new norm is for the Fed to purchase billions of dollars of private securities each month (what most economists regard as fiscal policy), while wielding unprecedented discretionary authority in writing regulation and overseeing the operations of megabanks.

In our democracy, government mistakes, including Fed errors, tend to lead to expansion of the discretionary power of policy makers, including those responsible for prior errors. This vicious cycle of expanding discretionary power in the wake of discretionary errors is a core problem promoting flawed policies and economic instability. What we need are credible rules to guide and constrain monetary and regulatory policies, as a means of avoiding the twin problems of misguided discretion and politicization.

Don't get me wrong. I am not advocating rigid rules, or rules that would tie the Fed's hands in reacting to a true emergency. The point is to require the Fed to state and be accountable to adhering to a clear strategy. We are now in the sixth year of make-it-up-as-we-go-along monetary policy. This must end.

Politicians, of course, generally do not want to force central banks to adhere to transparent rules precisely because constraints on discretion and central bank accountability hobble politicians' ability to make deals, to influence monetary policy makers, and ultimately to get elected. In that sense, the persistence of Fed policy errors simply reflects the institutional structure of our democracy, and its limitations.

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