The Federal Reserve Chairman as Hero: Our Defense against Monetary Excesses?

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Introduction

Over the past 55 years, the politicization of monetary policy has required the evisceration of formal institutional constraints on monetary excesses, namely the elimination of the gold reserve ratio, a reduction in the (decentralized) power of the Federal Reserve banks, and a diminution in the strength of private-sector representation[1] within the Federal Reserve system.

Correspondingly, over the same time span, power within the system has shifted to the Federal Reserve Board and particularly to its chairman. The authority to contain monetary excesses that typically stem from political pressure on our central bank now resides largely in the strength of the anti-inflationary persona of the chairman. Thus, our society's traditional defenses against inflation have been transferred from formal institutions to the will power of a single person, the Federal Reserve chairman.

In exchange for greater influence over monetary policy, politicians have had to pay more and more lip service to Federal Reserve autonomy. Politicians' apparent bequeathal of greater autonomy to the central bank is not entirely self-sacrificing. It appears to relieve the politicians of responsibility for periodic economic misfortunes, many of which are traceable to political manipulation of monetary policy (Kane 1982, 1990). As a consequence of that realignment, the

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[1]Federal Open Market Committee (FOMC) members with career experience at Federal Reserve banks and in the private sector have generally been considered to have a more conservative attitude toward montary policy. Their voting behavior at the FOMC over the past 40 years seems to support that view (Havrilesky and Schweitzer 1990).

anti-inflationary posture of the Federal Reserve chairman has taken on heroic proportions. It has become an absolute political necessity that the chairman appear to be very conservative. Nevertheless, because the chairman's exposure to political bashing has perforce increased, our nation's defense against inflation has actually grown more fragile. Thus, it is no small irony that the more resounding the media's celebration of the sound money posture of a Paul Volcker or an Alan Greenspan, the greater the ultimate danger of monetary excesses.

The Increasing Politicization of Monetary Policy

Whether they promised to narrow or widen the after-election distribution of after-tax income, political campaigns of the past four decades have featured redistributive agendas. As the distribution of voting rights broadened relative to the distribution of earned income in the 1950s and 1960s, politicians were presented with glowing incentives to extend their power by promoting egalitarian income redistributions. John Kennedy's New Frontier and Lyndon Johnson's Great Society each featured a panoply of programs that promised to reduce income differentials. The leveling was reversed in the late 1970s when financing the redistributions of the previous decade created a middle- and upper-income taxpayer backlash. Astute politicians seized the moment by promoting status quo ante tax cut redistributions; the Kemp-Roth tax cuts are a good example.

It is widely recognized by public choice theorists that in a democracy direct transfers to rent-seeking interest groups are politically dangerous. Therefore, indirect transfers abound. Our monetary policy institutions are an important part of the indirection that envelops government redistributive programs. Modern macroeconomic theory teaches that, in order for monetary policy to have effects on interest and exchange, as well as unemployment rates, it must be able to surprise market participants. Thus, uncertainty about the way monetary policy will respond to outside pressures is essential.

Redistributive programs will gain political support to the extent that their adverse sectoral consequences can be made palatable. One way that politicians can do that is by publicly insisting that their redistributive programs serve high public purposes, such as fairness and justice. Another way is by draping their redistributive agendas in the mystique of macroeconomic externalities. For example, the New Frontier/Great Society redistributions of the 1960s were legitimated by appeal to Keynesian multiplier effects, and the tax cut redistributions of the 1980s were legitimated by allusion to supplyside growth effects. The conferral of legitimacy on an administration's redistributive programs is one of the most important functions of its economic advisers and their research networks in academia.

Politicians who find it difficult to make their redistributive programs palatable may subsequently attempt to mask the adverse consequences by influencing monetary policy. Variations in government expenditures and taxation invariably affect interest and exchange rates. Disincentives for productive effort that arise from government tax and transfer programs may also have adverse effects on growth and unemployment rates. When interest groups affected by the adverse consequences of redistributive policy generate sufficient flak, there is pressure on the Federal Reserve to "do something" (Hetzel 1990). Pressures can flow either directly, from interest groups, or indirectly, from interest groups through politicians.

Two kinds of evidence support the hypothesis that shifts in monetary policy are motivated by government redistributive programs' effects on interest and exchange rates. First, the historical record shows that the great money supply growth expansions under Presidents Johnson, Nixon, Carter, and Reagan were preceded by signals to the Federal Reserve to do something about adverse movements in interest or exchange rates that were the direct result of redistributive programs. Second, the growth rate of the money supply, as a dependent variable in estimated reaction functions, is significantly affected (statistically) by changes in the social expenditures of government, a measure of redistributive policies (Havrilesky 1987).

There is considerable evidence that over the last 40 years political pressure on Federal Reserve officials has grown intense. While continual executive branch pressure on monetary policy did not begin until the 1960s (Havrilesky, forthcoming), the stage for the increasing politicization of monetary policy was set when the Banking Act of 1935 elevated the power of the Federal Reserve Board and the Federal Open Market Committee (FOMC) at the expense of the Federal Reserve banks.[2] The ability to contain monetary excesses was further weakened by Congress's enjoinder to the Fed to promote high employment under the Full Employment Act of 1946. Additional erosion of monetary discipline took place when Congress abolished the ratio requirement of gold certificates to bank reserves in 1966

[2]The 1935 act removed from the individual banks the authority to authorize open-market operations and placed it in the newly created FOMC on which the banks had only minority representation. Despite that shift in the distribution of power, it would be a mistake to think that political pressure on the Federal Reserve did not begin until 1935. In 1935, Carter Glass observed that, as secretary of the Treasury, he dominated the board, as had his predecessors (see Timberlake 1986).

and to Federal Reserve notes in 1968. In 1980, the Depository Institutions Deregulation and Monetary Control Act extended centralized control over the entire financial services sector. The politicization of monetary policy is further reflected in the steady erosion of private-sector influence within the FOMC[3] and in the mounting tension between politically appointed governors and privately selected, more militantly anti-inflationary Federal Reserve bank presidents (Murray 1991). Moreover, the scope of formal interactions between political principals and their central bank agents has greatly expanded, highlighted not only by the requirements of the Full Employment and Balanced Growth Act of 1978 but also by the growing influence of Federal Reserve officials on many aspects of government macroeconomic policy. Given those dramatic institutional changes, it should not be surprising that researchers have uncovered hard evidence of direct and systematic administration and congressional influence on monetary policy (Havrilesky 1988). The denouement of all that is that the politicization of monetary policy has proceeded coextensively with the movement toward an all-powerful Federal Reserve Board chairman.

Apparent Central Bank Autonomy

Greater political pressure on monetary policy is reflected in changes in the terms of trade between the Federal Reserve and the administration and Congress. Politicians have always granted the Federal Reserve a degree of immunity from outside pressure on its monetary policy decisions as well as regulatory domain and budgetary independence. In exchange, politicians have always had their way with monetary policy if necessary and have been able to bash their allegedly autonomous Fed whipping boys whenever anything has gone wrong and they have needed to let off political steam (Woolley 1984). Politicians influence monetary policy either by making politically reliable appointments to the board (Havrilesky and Gildea, forthcoming) or by signaling their preferences (Havrilesky

[3]That is revealed, for example, in the trend in the private- versus public-sector career characteristics of FOMC members. Over the 1960–88 period, the average years in private banking and private industry of FOMC members had negative trend coefficients that were significant at the 0.01 level. For further detail, see Havrilesky and Schweitzer (1990). Of course, at the same time that private-sector influence on the FOMC was decreasing, formal private interest group presence within the Federal Reserve bank directorates was increasing. That is reflected in the stipulations of the Federal Reserve Reform Act of 1977. Nevertheless, unless Federal Reserve bank authority on the FOMC is increased, that heightened private-sector representation on the directorates cannot reverse the trend toward the centralization of monetary power.

1988). Recent research suggests that the degree of monetary policy responsiveness to such signaling depends on the political vulnerability of the chairman (Havrilesky, forthcoming). Federal Reserve leaders are obliged to tolerate, and periodically to succumb to, the pressure and to accede to the bashings, even as they play their roles as oracles of sound money and sound banking.[4]

Given that symbiosis, greater political pressure on Federal Reserve Board officials is not costless to politicians. In exchange, they have had to pay lip service to Federal Reserve autonomy.[5] In short, the greater the political pressure on the Federal Reserve, the greater the power of the chairman, and the more pronounced politicians' apparent concessions to Federal Reserve autonomy. Nevertheless, those concessions are not real. When 75 directors of Federal Reserve District banks were recently asked if the Federal Reserve is more vulnerable to a loss of autonomy today than 10 years ago, 43 said yes (Harrison 1991).

Implications for the Modeling of Monetary Policy

This paper has argued that after several generations of politicization of monetary policy, our nation's defense against inflation has devolved to the chairman of the Federal Reserve system. Thus, it is not surprising that each chairman (with the exception of William Miller) at least appears to have been more conservative than his predecessor. Unfortunately, media celebration of the chairman as an anti-inflationary hero is unlikely to protect this awesome responsibility from future political bashers bent on monetary profligacy.

Scholars and researchers should not ignore the changes. They should be skeptical of models that posit a mythic policymaker who independently formulates macroeconomic (intermediate targets and goals) strategies or interacts game theoretically with atomistic market participants, or both. The latter models display obeisance to the mechanistic formalism of a particular game-theoretic/rational expec-

[4]Private bankers are also part of the symbiosis. They receive favorable regulatory treatment from politicians and their Federal Reserve overseers and can also influence monetary policy if necessary but, given the popular aversion to bankers in politics, must avoid the appearance of doing so. Bankers also must come to the defense of the Fed whenever it is politically beleaguered and are, of course, expected to make generous campaign contributions to politicians, especially those involved with monetary and financial regulatory policy.

[5]Those concessions are illusory. An increase in political influence constitutes a decrease in genuine autonomy. That the Federal Reserve is not as autonomous as central banks in Switzerland and Germany is reflected in indices of relative central bank autonomy (see Alesina 1988). A number of empirical studies show that the less politicized (the more autonomous) a nation's central bank, the better its inflation performance.

tations paradigm but have flimsy institutional premises (Persson and Tabellini 1990). Fundamentally, they ignore the public choice aspects of monetary policy that feature rent-seeking interest groups and portray politicians in the executive and legistlative branches as self-interested principals and central bankers as career-maximizing agents (Kane 1982, Woolley 1984). Public choice models recognize that uncertainty, misdirection, and the attendant social costs of the Fed's obfuscating, market participants' uncovering, and interest groups' lobbying for policy changes are fundamental parts of the wasteful rent seeking that permeates modern monetary policy. They do not mistake ceremonial genuflection at the icon of Federal Reserve autonomy that is a part of that misdirection for genuine central bank independence and public interestedness.[6] Public choice models explain the selection of chairmen and governors as the result of interaction among presidential electoral ambitions, the chairman's and governors' reappointment and career ambitions, and congressional oversight. So modeled, the selection of governors is a problem in choosing the political support-maximizing blend of reliable partisan and representative members of the board (Havrilesky and Gildea, forthcoming). The design of fruitful and practicable monetary reform is more likely to emerge from realistic multiple principals/multiple agents public choice models than from the institutionally naive game-theoretic genre.

Conclusion

Redistributive fiscal policies have required the increased politicization of monetary policy. This politicization has called for a weakening of formal institutional constraints on monetary excesses, the removal of the gold reserve ratio, and an increase in the power of the Federal Reserve Board, particularly that of its chairman. Given the symbiosis that exists among politicians, the Federal Reserve, and the financial services community, if politicians are more frequently to have their way with monetary policy, they must, in turn, grant more apparent autonomy to the chairman.

[6]Game-theoretic models would applaud the transfer of power to the apparently autonomous chairman and away from formal constraints as the substitution of a discretionary conservative central banker for precommitment to monetary rules on the grounds that rules are more easily broken than the resolve of the central banker (see Persson and Tabellini 1990, pp. 33–55). In contrast, public choice modeling would suggest that an ostensibly conservative central banker, being so subjected to the carrots and sticks of interest groups and politicians, is a far weaker defense against inflationary excess than even a breakable monetary rule.

What will come of the present state of affairs is not difficult to predict. We have placed much of our institutional defenses against monetary excesses in the hands of one person, the chairman of the Federal Reserve. Because the chairman is apparently so autonomous, he can easily be blamed by politicians. Thus, his anti-inflationary authority is conspicuously fragile. Therefore, depending on his political vulnerability, given a sufficiently strong economic perturbation or sufficiently acute presidential disfavor, even the most resolute chairman will relent.

Because radical monetary reform is politically impossible unless an inflationary disaster occurs, it is unlikely that we will be able to abandon the current fiat money regime or impose inviolable money growth rules on it. Given those constraints, perhaps the best monetary reform that can be hoped for would have to be piecemeal. One practicable piecemeal reform might be to impose meaningful restrictions on political pressures on monetary policy and to enact penalties on central bankers who succumb to those pressures.[7] Another practicable piecemeal reform would be to legislate marginal increases in private-sector representation on the FOMC, not to benefit special interests but to check inflationary political pressures. Yet another practicable reform would be to lengthen the term of the chairman to reduce his political vulnerability.

In order for even those piecemeal reforms to be enacted, public choice reasoning suggests that they would have to generate sufficient benefits for some of the powerful actors in the monetary policy process. Perhaps if they gained genuine independence and relief from outside pressures, Federal Reserve officialdom and its constituency in the financial services sector would support such reform. In addition, perhaps promises of improved inflation performance and less wasteful rent seeking in monetary policy would generate support for reform from other sectors and from voters in general. Finally, even some politicians would support such reforms to the extent that they would gain relief from responsibility for monetary policy. In that manner, we can re-establish some formal institutional defenses against monetary excesses.

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[7]Some analysts such as Kane (1990) favor reforms that would place the Federal Reserve more directly under political control on the grounds that such reforms would reduce politicians' ability to disclaim responsibility for monetary misfortunes. In my opinion such gains would be outweighed by the inflationary losses, uncertainty, and wasteful rent seeking that would be likely to arise from a more complete politicization and

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centralization of monetary authority.

Full Privatization of Currency in a Nearly Conventional Money and Banking System

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Introduction

Full privatization of currency is a reform that deserves serious consideration. Unfortunately, it is often taken to mean replacing a single government fiat money with multiple private moneys, each denominated in a different unit of account (Klein 1974, Hayek 1978). Currency privatization appropriately refers to the private issue of hand-to-hand currency: bank notes and token coins. Those notes and coins can all be denominated in a common unit of account.

The existing literature on private currency assumes free banking. Sometimes the emphasis is on historical banking systems that combined private currency with free entry and requirements for bond collateral (Rockoff 1974, Rolnick and Weber 1983, King 1983). At other times the emphasis is on historical banking systems that combined private currency with no restrictions on branching or reserve holdings (White 1984, Selgin 1988a, Dowd 1989, Glasner 1989, White 1989). But one common characteristic of the literature is the absence of a central bank and monetary policy.

Currency privatization deserves consideration on its own merits and requires an analysis of institutions that combine the full privatization of currency with an otherwise conventional money and banking system. Most important, a central bank must be able to implement monetary policy.

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