In Search of Monetary Stability:
Comment on Otmar Issing

By Allan H. Meltzer
Carnegie Mellon University and the American Enterprise Institute

Otmar Issing has given us another of his fine, non-dogmatic statements of monetary policymaking as seen by a former academic and successful policymaker. I regard as the heart of his statement the need to balance models and judgment. Policymakers should use a model or rule but must recognize as best one can the information in incoming data. The rule is meant to guide action, not to bind the policymakers.

Part of Issing's paper describes and defends the evolution of procedures at the European Central Bank. He highlights the uncertainty about data at the start. Would the consolidation of quasi-independent policies of the new members introduce structural adjustments as described in Robert Lucas's famous paper? No one could know, so at the start judgment was critical.

With early success, the Bank became more willing to accept that the models were not misleading. But Issing and is staff looked for reassurance by monetary variables like growth of M_3 and other Ms that are known to be causes of inflation. Judgment again.

To the academics obvious question: Why is money growth not part of the model? Issing's answer seems to be that there is more than one model, the money data is used to check on the implications of econometric models, and there are several Ms. My answer is not inconsistent. The response to money is more a response to the maintained growth rate than to quarterly changes. And as Milton Friedman pointed out, the lag in response is variable.

For me the most striking difference between euro policy and dollar policy comes in the role of politics. The Maastricht treaty gave much greater independence to the central bank than the Federal Reserve experiences. I know from previous discussion with Otmar Issing that politicians try to influence central bank policy frequently. The Bank is charged with maintaining price stability. It does not ignore economic conditions, but it focuses on achieving low inflation more consistently than the Federal Reserve. Repeatedly, Issing emphasizes that the ECB aims at the medium-term.

Through most of its postwar history, the Federal Reserve accommodated Congressional and administration concerns to a much greater extent than the European Central Bank. It kept the long-term interest rate fixed until March 1951 despite rising concerns about inflation. In the 1960s, it "coordinated" policy with the administration. Chairman Martin often explained that the Federal Reserve was "independent within the government." He explained that he would not challenge Congressional budget decisions. He would help to finance them. He financed the rising deficits of the Johnson administration and the start of the Great Inflation. His successor Arthur Burns supported Nixon administration policy that was most concerned about an unemployment rate above 4 percent. Typically Burns blamed inflation on labor unions, the welfare state and other non-monetary causes. He did not want to permit small recessions. Shortly after he left, the United States endured a deep recession to reduce inflation. This cost paid for Federal Reserve errors. It should have taught us that avoiding small recessions later required acceptance of a larger recession to end inflation.

Paul Volcker and his successor Alan Greenspan were the most independent chairmen in modern Federal Reserve history. Once inflation fell to 4 percent or less these chairmen directed policy action to maintain both economic stability and low inflation. The economy experienced low inflation and three of the longest expansions in U.S. economic history punctuated by mild recessions.

The current Federal Reserve seems spineless. Under pressure from Congress and the financial markets, it abandoned its balanced medium-term strategy to give priority to avoiding possible recession. Its short-term forecast was wrong. Growth is slow, but the often predicted deep recession has not come. Instead we have a return of inflation and a loss of credibility and independence. In March, the Fed began to lend on relatively illiquid mortgages in exchange for Treasury bills. It abandoned its long-standing policy of avoiding lending on relatively illiquid assets. Previous exceptions had always been for small amounts. Two days after the Chairman of the Banking Committee and some other Senators proposed that the Fed lend on student loans, Chairman Bernanke announced that it would.

These are worrisome precedents especially when the same Senate chairman refuses to confirm three appointments to the Board of Governors. He wants to change the Federal Reserve's focus in a way that would further reduce independence.

Issing points to one major difference between the two banks. The ECB monitors money growth. The Federal Reserve ignores it. One reason for the difference is that the ECB has a medium-term strategy. In the 1970s and again now, the Federal Reserve gives much more attention to current developments and forecasts of near-term events. Its forecasts are often subject to relatively large errors.

Contrast the recent behavior of the two banks. The Federal Reserve panicked in January responding to the risk of a possible recession and ignoring inflation. It underestimated inflation and overestimated recession. Both forecasts were wrong. The ECB maintained its medium-term policy to achieve price stability. The Federal Reserve now faces the problem of reversing its activism in a slow growing economy during an election year. If it had monitored money growth, it might have acted differently. After years of “fine tuning,” the Bank of England also adapted a medium-term strategy.

One reason the Federal Reserve ignores money growth is that it gives excessive attention to near-term events and models of quarterly response. Long ago monetarists accepted that money growth has no useful information about near-term response to money growth. As Issing emphasizes, this is not a reason for ignoring the medium- and longer-term effects on inflation that research has documented for decades. He predicts that central bankers will again find a place for money growth in their analysis.

Two issues require more discussion. One is the measure of inflation. The other is the response to asset price changes.

Economists have not agreed on the definition of inflation. Monetarists define inflation as the maintained rate of change in a broad-based price index. Others include all changes in the index. Monetarists describe an energy shock or a harvest failure as a change in a relative price. Others include these relative price changes in inflation.

Should central banks respond to relative price changes and excess demand changes in the same way? A central bank is in the money business. It can directly produce less money growth but not more energy output. To reverse the price level response to an energy price change, it must force other relative prices to fall. This is costly; it reduces output growth. It seems more consistent with maintaining price level stability than preventing inflation. A monetarist policy of inflation control would accept the temporary increase in reported inflation and explain why it does. The central bank cannot do much directly about oil price increases. It is not good social policy to add recession to the wealth loss from the energy shock. A better policy would reduce domestic tax rates to offset the effect of the oil tax increase.

Surely it is late to begin discussion of the proper monetary response to non-monetary events, but I believe the problem has been ignored too long.

Issing dissents from the "Jackson Hole strategy" of not interfering with asset price increases until the crisis comes. Then the central bank cleans up the debris as best it can. Issing asks whether having the full crisis is the best policy. But he leaves open what the central bank is capable of doing that is effective and less damaging.

For years, Karl Brunner and I struggled with models in which asset prices and credit markets have a large role. Credit market behavior and asset price changes are parts of monetary analysis that most models ignore. (I should except the BIS from that statement.) I agree with Issing that this is a failure of the models that becomes most important at times of rapidly rising asset prices. What to do?

The first problem is to decide whether asset price changes are a response to real force or expected inflation. This is not an easy calculation to make, but once it is made the central bank's response seems obvious. The calculation is difficult because so called bubbles can best be labeled after they end. Much of the theory of bubbles developed in models where there are no transactions. Prices rise because everyone expects them to rise.

The rise in stock prices in the late 1990s differed. Some sold the securities that eager buyers bought. The sellers must have had different expectations. Further all security prices did not rise rapidly. Much of the rise occurred in assets believed to benefit from new technology, an expected technological change that the central bank can only prevent by imposing its judgment. This does not seem defensible to me. However, if the analysis of a model with asset prices implies that inflation will follow, the central bank should act on that knowledge.

The second recent surge in asset prices came from the housing sector. The Federal Reserve erred. It predicted deflation and overstated the effects of a small deflation. It remains a puzzle for me why one would expect deflation in an economy with a depreciating currency and a relatively large budget deficit. My work on Federal Reserve history suggests that there were seven deflations in Federal Reserve history, some as large as a 20 percent decline. Only one, the Great Depression, was a disaster. It differed from the others mainly because money growth fell more than the price level and continued to fall until 1933. Expectation of continued deflation was correct in 1929-32.

The Federal Reserve's error did not require markets to invest in low quality assets. That was their error abetted by two other errors. One is the Basel Accord that requires increases in reserves if banks increase risky assets. The banks followed the first law of regulation: Lawyers write regulations but bankers circumvent costly regulations. Lawyers ignore the incentives implied in new regulation. The second error is the incentives faced by market participants. Why did the MBA alumni of the world's leading business schools buy and sell first dot-com securities and later low quality mortgages. The compensation system rewards them and their supervisors for doing just that. Failure to participate may bring satisfaction later but most likely from the unemployment queue.

One must always recall that financial markets lend long and borrow short. Crises will occur, but a better compensation scheme and greater concern for the incentives induced by regulations can reduce the risk inherent in financial markets.

Otmar Issing has given us a very clear statement of what he learned and taught in his central role at the Bundesbank and the European Central Bank. He is clear about what we know but not dogmatic. He is clear also about much that we do not know. However, he does not explain why the ECB permits inflation to remain above its 2 percent target.

Having completed a lengthy history of the Federal Reserve's achievements and errors during almost 75 years, I feel compelled to add a bit about error. The Federal Reserve and others made many errors. It pains me to recognize that most of them were widely believed and advocated by academic economists. Examples? The real bills doctrine, fiscal and monetary policy coordination, cost-push inflation, the reliability of the Phillips curve, and the dismissal of excess monetary growth as a cause of inflation.

Issing's paper suggests we should be cautious in abandoning old truths and accepting new ones or overstating the certainty of our knowledge. I agree.