

BOOK REVIEW

A HISTORY OF THE FEDERAL RESERVE, VOLUME 2: BOOK 1 (1951–1969), BOOK 2 (1970–1986)

ALLAN MELTZER

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Arthur Burns, Federal Reserve chairman (1970–1978), delayed Murray Rothbard's doctoral dissertation at Columbia University in the mid-1950s. Rothbard (1969) later observed "one of the curious aspects" of Burns' "rise to the pinnacle of power" under Republican President Richard M. Nixon is "that, among all economists," he "was preeminent as the supposedly value-free "scientist," the technician, the man who eschews politics and ideology." Yet Burns' "scientific" and "value free" outlook, Rothbard noted, "turns out to be simply marginal wheeling and

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maneuvering within the broad frames of reference" set by "the American political *status quo*." No one who reads Volume 2 of Allan H. Meltzer's monetarist Fed history will ever see Burns through the "value-free" lens again.

Burns, in the mid-1950s, served as Council of Economic Advisers chairman under another Republican, President Dwight D. Eisenhower. Meltzer explains that Burns, in 1956, an election year, wanted the Fed to ease at "the first sign of slower growth in January." (p. 135) Ike "remained in the background but encouraged the effort," (p. 135) which continued into 1957 (p. 153). When Vice President Nixon sought the White House for the first time in 1960, Burns warned him in February a recession was likely if the Fed did not ease (p. 198n). Nixon brought his request to an Eisenhower cabinet meeting in March, but nothing was done (p. 206n) and he lost the election to Democrat John F. Kennedy. Nixon blamed his defeat on Fed policy under Chairman William McChesney Martin, Jr. After Nixon became president in 1969, he schemed to replace Martin with Burns. Martin opposed Burns' appointment, arguing he "lacked administrative and personal skills and, as an economist, lacked sufficient breadth about banking and financial markets" (p. 575n). Yet Burns became Fed chairman in February 1970. In 1971, Nixon recalled "his experience in 1960, when Burns warned... about tight Federal Reserve policy." Nixon did not "want the same mistake again," telling Burns, "Unemployment is always a bigger issue than inflation" (p. 791). Burns was "unusually partisan," meeting with Nixon on a regular basis (p. 21). Burns toadied to Nixon at a private March 19, 1971, meeting, telling him, "And I have done everything in my power, as I see it, to help you as President, your reputation and standing in American life and history (p. 792). Burns was one of 15 presidential advisers plotting at Camp David the weekend before Nixon's infamous Aug. 15, 1971, announcement abolishing U.S. dollar-gold convertibility (p. 763). Burns was committed to Nixon's 1972 reelection, and was able to get help from other FOMC members to ease (p. 788). Burns, after meeting Nixon again Dec. 22, 1971, "worked to get higher money growth" (p. 796). The 1972 FOMC meetings "became the subject of charges and claims about Burns' efforts to expand money growth to help President Nixon's campaign for reelection" (p. 796). Meltzer writes, "The presidential tape recordings and

letters and the Ehrlichman notes leave little doubt that President Nixon urged Burns to accelerate money to aid his election and that Burns agreed" (pp. 801–802). Surveying this vast evidence trove establishing the Fed chair's utter lack of independence, Meltzer argues Burns "was the most politically involved chairman since Marriner Eccles in the 1930s," (p. 38) sacrificing the central bank for Nixon. One consequence was the Great Inflation of the 1970s, which Meltzer, like the Austrian School blames on the Fed.

Volume 1 of Meltzer's history blamed the Great Depression on Fed policy errors, primarily "an incorrect theory-the real bills doctrine." Meltzer established the Fed as "an institution prone to *political* influence, not the independent central bank proclaimed by its court intellectuals" (Kaza, 2005). Volume 2 presents more evidence of political pressure, some harvested from presidential library archives, and a monetarist interpretation of how Fed policy errors caused, in Meltzer's words, the Great Inflation, which peaked at 14 percent in 1980. Fifteen years passed before above average growth and low inflation (pp. 472–473). Meltzer contends the Great Inflation was a monetary event caused by three factors-the beliefs of Martin while Fed chair (1951–1970), the absence of a relevant theory, and Fed institutional arrangements (p. 478).

Chairman Martin "had no interest in economic theory and did not find it useful" (p. 17). Meltzer explains, "He opposed attempts to control inflation by controlling money growth" (p. 17). Martin reduced Fed independence because he believed the central bank could not control inflation if the political administration in power ran large deficits.

His view of the central bank was "independent within government," a phrase that Meltzer explains meant "the Federal Reserve would not fail to support Treasury financing operations" (p. 35). The Fed had to assist with federal debt finance following the 1951 Accord that freed the central bank from its subsidiary role to the U.S. Treasury and made it co-equal. Martin's view was that the Fed was a creature of Congress, which created the deficit the Treasury had to finance. The Fed shared that responsibility, and had to balance it against its responsibility for preventing inflation, which Martin "disliked" and "verbally" opposed but "supported" and "increased" through policies that "could not allow the bond market to be disorderly" (pp. 178–179). One example was Operation

Twist. "Pressure from the (JFK) administration to increase purchases of long-term debt remained strong" (p. 323). Martin cooperated but faced political pressure from successive administrations. President Lyndon B. Johnson, a Democrat, did not want to cut spending, raise tax rates, or have the Fed tighten in 1965 (p. 449). Johnson was trying to finance the Vietnam War and his Great Society welfare programs through money supply growth. When Martin tightened later in the year, LBJ accused him of "harming his presidency," cursing at the Fed chair at a meeting at his Texas ranch (p. 458). LBJ, for his own selfish populist reasons, believed a little more inflation was the price of permanently lower unemployment. The pressure on Martin continued into 1966, and an LBJ task force later proposed weakening the reserve banks' role by excluding them from the FOMC. Martin learned coordination worked one way: the Fed adjusted its actions to the political administration in power. The Fed, in Meltzer's work, is shown time and again as an institution that wilts in the face of political pressure. "Regrettably," Meltzer observes, "the record does not show either a consistent avoidance of short-term pressures or avoidance of inflationary pressures from elected officials" (p. 19). The criticism of Martin lacks some context. Martin was the son of a Fed official. His father helped write the Federal Reserve Act. Martin's consensus-seeking with politicians, which Meltzer criticizes, is another piece in a long evidentiary trail, starting "about 1900" (Rothbard, 1999) that reveals the Fed as a *political institution*, not the value-free monetary automaton sought by monetarists.

Meltzer praises the Fed's economics staff, whose monetary policy was "more complete than mainstream academic views" in the 1950s (p. 79). One example is a 1954 Board of Governors statement, though Meltzer has little to say about the central bank's narrow parameters of debate, limited to Keynesianism, and, grudgingly, monetarism. St. Louis, the monetarist outpost, wanted a more aggressive program to stop inflation in the late 1960s. Meltzer blames "the simple Keynesian model, augmented by price and wage controls to reduce inflation with lower social cost," flawed and "based on faulty reasoning;" and "inadequate" Fed independence (759–760). Keynesian Phillips curve inflation forecasts contained errors, leading Meltzer to observe, "The simple explanation of why inflation persisted and rose on average through the 1970s is that the Federal Reserve did

not sustain actions that would end it" (p. 1005).

The fixed-rate Bretton Woods system, with the dollar pegged to gold at \$35 per-ounce, "might have continued," Meltzer acknowledges, "if price adjustment had occurred promptly in response to domestic policy choices, differences in productivity growth, changes in the extent of capital mobility, and the like" (p. 689). If Nixon and the Fed wanted to maintain the fixed exchange rate system, they had to either devalue the dollar against other currencies or deflate. They were not ready for either choice. Nixon did not have much interest in international economics, and was unwilling to see finance as a binding constraint on his foreign or defense policies (p. 733n). Bretton Woods, Meltzer concludes, "broke down because no major country or group of countries was willing to subvert domestic policy to improve international policy" (p. 754). Gottfried Haberler, appointed by Nixon to chair a panel made the case for wider bands, increased exchange rate flexibility and an end to capital controls. Milton Friedman made the case for floating rates (p. 732) and won the debate. The dollar has steeply declined in value since 1971.

Meltzer credits Democratic president Jimmy Carter for appointing banker Paul Volcker to chair the Board of Governors and, in 1979, the Fed. Volcker pursued "practical monetarism," recognizing that ending inflation required monetary control, either by targeting reserve growth or an interest rate. "After 1979, "practical monetarism" replaced what remained of Keynesian analysis" (p. 1229). Meltzer helped found the monetarist Shadow Open Market Committee but concedes that practical monetarism suffered from three problems. First, monetarism is a medium- to long-term theory of inflation. Second, short-term money growth rates are relatively variable and difficult to forecast. Third, timing was poor. Meltzer argues the Fed experimented with monetarism simultaneous to financial deregulation, making "it difficult to estimate how much money growth to permit" (p. 1229).

By spring 1986, the 12-month average rate of consumer price increase had fallen to about 1.5 percent, the lowest rate since the early 1960s (p. 1195). "For an economist," Meltzer observes, "it would be ideal to conclude that the Federal Reserve successfully applied modern economic theory to control inflation. Alas, it was not true. Members of the FOMC did not have a systematic

approach based on analysis and evidence." Instead, the "eclectic" Volcker simply "did what seemed to him right at the time" (pp. 1207–1208). The Fed was not a Delphic oracle after all.

There are other reasons for those toiling in the Austrian vineyard to read Meltzer's work. *Apoplithorismophobia* (Thornton, 2003), the fear of deflation, another Keynesian bugaboo is dispatched in sections on the mid-1950s and early 1960s. In the first period, Meltzer explains, "The economy continued its recovery and, as in several earlier periods of modest deflation, output rose" (p. 116). In the second, "The recovery (1961) occurred during a period of deflation." Meltzer writes, "This experience does not support the prevalent view that monetary policy is impotent in deflation. As in earlier periods of deflation, the economy recovered" (p. 325). Meltzer concludes, "There is no evidence of the monetary impotence that many economists suggest comes with deflation. Monetary actions remained effective despite the alleged zero bound on nominal interest rates often cited as a source of problems in economic models with a single interest rate" (p. 116). Meltzer also explains the Fed "did not distinguish between nominal and real interest rates, a problem after inflation rose" (p. 7). He also notes that congressional pressure for low rates was bipartisan (p. 1109).

But Meltzer, like other monetarists, fails to understand that political institutions like the Fed cannot be immune to political pressure, including oversight. It is perfectly legitimate for Members of Congress, as long as there is a Fed, to insist that the institution be subject to audit. U.S. Rep. Ron Paul (R-Texas), today, and Rep. Wright Patman (D-Texas), in an earlier era, supported audits as public policy. Patman's 1955 audit proposal "alarmed the Board" (pp. 226–227). But Patman, a committee chairman, saw his role as oversight (p. 402n) and his actions, like Paul's, forced the Fed to grudgingly become more responsive. The Board of Governors, in response to criticisms raised at Patman's 1964 congressional hearings began quarterly meetings with academic economists (p. 463), a welcome development.

Arthur Burns, loyal to Richard M. Nixon, was rewarded with political threats. Nixon, the only president to resign the White House sent Burns a letter, in January 1972, marked "eyes only." It praised the Fed chair's efforts to "increase money growth" and expressed "absolute confidence" in Burns private pledge to ease.

Then Nixon revealed his politician's fist. "What could happen out of all of this," he wrote Burns, "is that a major attack on the independence of the Fed will eventually develop. I do not want this to happen—particularly I do not want it to happen when the Chairman of the Fed is a man in whom I have such enormous confidence and for whose economic advice I have such great respect" (p. 800). Ultimately, the only way to eliminate pressure from politicians like Nixon, and preserve monetary independence is to abolish the Fed. This was the course charted by Rothbard. To believe otherwise, i.e., in the possibility of a "value-free," "neutral," or "apolitical" Fed is political naïveté.

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