The Most Dangerous Idea in Federal Reserve History: Monetary Policy Doesn't Matter

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The hundredth anniversary of the founding of the Federal Reserve is a natural time to reflect on the record of U.S. monetary policy. It is widely agreed that this record is far from perfect, and that there have been some major failures of monetary policy over the past century. Our thesis is that overly pessimistic views about the power of monetary policy have been a critical source of these failures.

There is little doubt that the opposite problem—an overinflated belief in the power of monetary policy—has also contributed to important policy errors. Most famously, policymakers in the mid-1960s believed that they faced a long-run inflation-unemployment tradeoff, and thus that monetary policy could move the economy to a sustained path of very low unemployment and low inflation. This belief led them to pursue highly expansionary policy, starting the economy down the road to the inflation of the 1970s (for example, Romer and Romer 2002 and Primiceri 2006). The record of such errors has led some to argue that perhaps the most important attribute of a successful central banker is humility (for example, Booth 2012).

In this paper, we present evidence that an unduly *pessimistic* view of what monetary policy can accomplish has been a more important source of policy errors and poor outcomes over the history of the Federal Reserve. At various times in the 1930s, faced with the Great Depression, Federal Reserve officials believed that the power of monetary policy to combat the downturn or stimulate recovery was minimal. In both the mid- and late 1970s, faced with high inflation, policymakers believed that monetary policy could not reduce inflation at any reasonable cost. And there is evidence that in the past few years, faced with high unemployment and a weak recovery, monetary policymakers believed that policy was relatively weak and potentially costly. In each episode, these beliefs led to a marked passivity in policymaking.

The next three sections discuss the link between pessimistic beliefs and policy inaction in the 1930s, the 1970s, and the past few years, respectively. The final section concludes by arguing that being a good central banker appears to require a balance of humility and hubris.

I. The 1930s

The most significant error in the history of the Federal Reserve surely occurred in 1929–33, when the money stock fell 26 percent, the price level declined 25 percent, and output decreased 27 percent. There is vast evidence that an overly pessimistic assessment of the power of monetary policy to combat the downturn was a critical source of this error (Friedman and Schwartz 1963, Meltzer 2003, and many others). Many Federal Reserve officials believed that expansionary policy would not be effective and that it might involve substantial costs. The result was inaction in the face of the largest downturn in American history.

One early episode showing monetary policymakers' pessimism about what they could accomplish occurred in the summer of 1930, when the Federal Reserve Bank of New York proposed expansionary actions. New York's proposal was opposed by most of the other Federal Reserve banks, and so little was done.

The opponents of expansion proffered two main arguments that it would be ineffective. First, and crucially, the main indicators of the stance of policy that they used—nominal interest rates, banks' excess reserves, and borrowing from the Federal Reserve—implied that policy was already highly expansionary. They therefore thought that monetary policy had done all it could. For example, one opponent argued, "With credit cheap and redundant we do not believe that business recovery will be accelerated by making credit cheaper and more redundant."[1] Another referred to "the fruitlessness and unwisdom of attempting to depress still further the abnormally low interest rates now prevailing." Second, they believed that the cause of the downturn was not monetary but lay in excesses in the 1920s, and thus that the downturn could not be solved by monetary policy. One policymaker said,

> The consequences of … an economic debauch are inevitable. We are now suffering them.
>
> Can they be corrected or removed by cheap money? We do not believe that they can. … [T]here is no short cut or panacea for the rectification of existing conditions.

Policymakers also saw two costs to expansion, related to the two reasons they viewed expansion as unproductive. First, they believed that an expansion that had little impact would damage their credibility, and so make later expansion less effective. As one put it,

> [With] an abundance of funds in the market, … it should be the policy of the Federal Reserve System to maintain a position of strength, in readiness to meet future demands, as and when they arise, rather than to put reserve funds into the market when not needed.

Second, they feared that expansion could trigger renewed speculation and inflation. For example, one bank governor said, "Cheap money is a stimulant, … but a headache will follow if the dose is large enough, and persisted in. It encourages over-borrowing."

These beliefs prevented significant action not just in 1930, but throughout the downturn. Consider, for example, the decision to end a brief period of expansionary open-market operations in 1932. Hsieh and Romer (2006, pp. 169–72) document the reasons that George Harrison (governor of the Federal Reserve Bank of New York, and one of the architects of the program) gave for the decision:

> When the figures of member bank reserves are sufficiently high …, we shall probably have done our part. If the commercial banks can't or don't use the credit which we provide, that is another problem.
>
> It was thought best … not to use our ammunition until the chances of effective response from the banking and business community would favor the success of our undertaking.

These ideas persisted into the recovery. For example, the expression that at some point further monetary easing is ineffective because "one cannot push a string" appears to have originated in Congressional testimony in 1935 by Marriner Eccles, the governor (that is, head) of the Federal Reserve Board. Similarly, in 1937, the Federal Open Market Committee (FOMC) believed that "the existing volume of excess reserves and of supplies of private capital is abundant at this time at low rates," and therefore that "effective action to meet and overcome the present business recession should be taken outside the field of the System's various monetary powers."

In addition, the view that monetary expansion could lead to inflation even when the economy was far below capacity took on special importance in the mid-1930s. Policymakers were concerned that expansion "might well add unwise stimulus to the inflation of prices" and that "a further increase in excess reserves of member banks might give added impetus to existing inflationary tendencies."

Consistent with these beliefs, the Federal Reserve was largely passive in the recovery, just as it had been during the downturn. The monetary base rose rapidly during much of this period, but the increases were almost entirely the result of gold inflows and the Treasury's decision to not sterilize them, rather than of Federal Reserve actions.

The Federal Reserve's major policy initiative in this period—the doubling of reserve requirements in 1936–37 and working with the Treasury to sterilize gold inflows at the same time—was motivated by fear of inflation in a still-depressed economy. Policymakers believed that banks' excess reserves could "create an injurious credit expansion," and therefore "decided to lock up this part of the present volume of member bank reserves as a measure of prevention."[2]

[1] The sources for all the quotations and data used in the paper are given in the appendix.

[2] Of course, the pessimistic views we have described were not the only source of the policy failures in the 1930s. Meltzer and Friedman

II. The 1970s

Another major failure of Federal Reserve policy occurred in the late 1960s and the 1970s, when inflation rose erratically from low levels to near 10 percent. In two parts of this era, Federal Reserve officials believed that inflation was very unresponsive to economic slack, and thus that monetary policy was an extremely ineffective way to fight it.[3]

The first part of the era when this view prevailed was roughly from 1971 to 1973. After inflation failed to fall in the mild recession of 1969–70, Federal Reserve chairman Arthur Burns and other policymakers concluded not that the natural rate was higher than they had previously believed, but that inflation was almost impervious to high unemployment. Federal Reserve documents record that in June 1971, Burns expressed the view that:

> [O]f late one found that at a time when unemployment was increasing prices continued to advance at an undiminished pace and wages rose at an increasing pace. …
>
> In his judgment a much higher rate of unemployment produced by monetary policy would not moderate [wage-cost] pressures appreciably.

In July, he testified that "even a long stretch of high and rising unemployment may not suffice to check the inflationary process."

As discussed by Romer and Romer (2002), these views led the Federal Reserve to not use conventional monetary policy to combat inflation. For example, in May 1971, the economist making the official staff presentation to the FOMC said,

> The question is whether monetary policy could or should do anything to combat a persisting residual rate of inflation …. The answer, I think, is negative. … It seems to me that we should regard continuing cost increases as a structural problem not amenable to macro-economic measures.

The belief that monetary policy would not be effective in controlling inflation caused policymakers to advocate incomes policies, such as wage and price controls, instead. For example, in June 1971, Burns testified,

> [A] substantial increase of unemployment has failed to check the rapidity of wage advances or to moderate appreciably the rise of the general price level.
>
> With increasing conviction, I have therefore come to believe that our Nation must supplement monetary and fiscal policy with specific policies to moderate wage and price increases.

At the FOMC meeting the same month, Burns's views were summarized as:

> He thought the Administration had been much too slow to recognize the need for an effective incomes policy. He had urged that action be taken in that area and intended to continue doing so.

The second part of the 1970s when beliefs about the ineffectiveness of policy were prevalent occurred under the chairmanship of G. William Miller in 1978 and 1979. Shortly after becoming chairman, Miller testified,

> Our attempts to restrain inflation by using conventional stabilization techniques have been less than satisfactory. Three years of high unemployment and underutilized capital stock have been costly in terms both of lost production and of the denial to many of the dignity that comes from holding a productive job. Yet, despite this period of substantial slack in the economy, we still have a serious inflation problem.

Other policymakers held similar views. For example, in May 1979, Governor Henry Wallich, generally regarded as one of the most anti-inflationary FOMC members, said, "We also have evidence that inflation in the American economy is much less variable than it is in other countries and is, therefore, much harder to bring down." And at Miller's final meeting in July 1979, the staff presentation stated, "we expect that rising unemployment will do little to damp inflation," and that "[f]or monetary policy alone there seems to be little in the way of policy options which would yield substantially improved results during the next year or two." During the discussion, the economist in charge of the presentation listed several reasons that "we wouldn't expect to get the same price response from very weak markets" as had occurred just a few years before.

This humility about their powers again

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and Schwartz show how views about the proper role of monetary policy, including the importance of defending the gold standard and of meeting credit demand rather than promoting macroeconomic stability, had important effects on policy. In addition, Friedman and Schwartz document how the fractured power structure of the Federal Reserve in the first part of the decade favored inaction over action.

[3] Nelson (2005) documents similar beliefs in the United Kingdom in this era.

caused monetary policymakers to not pursue anti-inflationary policy, but instead to continue to stimulate the economy (Romer and Romer, 2002). Miller testified in March 1979, "Real interest rates … still appear to remain low by historical standards and thus continue to facilitate an expansion of overall demands."

These views also led monetary policymakers to again advocate nonmonetary steps to combat inflation. At his first FOMC meeting in March 1978, Miller argued that monetary policy was not the best way to fight inflation, saying that if the administration did not "take some more believable steps in fighting inflation …, inflation is going to be left to the Federal Reserve and that's going to be bad news." The official summary of the meeting said, "It was noted that an effective program to reduce the rate of inflation had to extend beyond monetary policy." That same month, Miller testified that conventional policies "need to be complemented by programs designed to enhance competition and to correct structural problems."

Thus, in both the 1930s and the 1970s, undue pessimism about what monetary policy could do led to Federal Reserve inaction and highly undesirable economic outcomes.

III. The Past Few Years

The last several years have been another time of dismal macroeconomic performance. The economy suffered its largest postwar recession in 2007–09. Since then, unemployment has remained very high, and has consistently been projected to remain so for years. And in contrast to the 1970s and early 1980s—but similar to the 1930s—the high unemployment has occurred at a time of low inflation, with core inflation and the Federal Reserve's inflation forecasts generally below its inflation target.

It is clearly too soon to reach firm conclusions about recent monetary policy. Much of the record of policymakers' thinking is not yet available. More importantly, there has not been enough time to confidently assess what monetary policy could and could not have accomplished.

Nonetheless, it seems hard to assign pessimism about the power of monetary policy a large role in the crisis itself. Before the crisis, monetary policymakers appear to have believed that they would be able to largely counteract the macroeconomic effects of a large fall in house prices. And during the crisis, they believed they had the ability to prevent a collapse of the financial system, and acted aggressively to do so.

There are, however, intriguing parallels between policymakers' beliefs in the period from roughly the end of the recession to the latter half of 2012 and beliefs in the 1930s and 1970s. Monetary policymakers in each period have to some extent believed that their tools were not very effective and potentially costly.

In the recent period, the strongest views of this type have been among some of the presidents of the regional Federal Reserve banks. Indeed, at times some have expressed views similar to ones from the 1930s. For example, one argued against additional action on the grounds that, "Why would the Fed provision to shovel billions in additional liquidity into the economy's boiler when so much is presently lying fallow?" Another argued that "a zero-rate policy increases the risk of misallocating real resources, creating a new set of imbalances or possibly a new set of bubbles." A third argued that "the supply of bank reserves is already large enough to support the economic recovery," and that "further monetary stimulus runs the risk of raising inflation in a way that threatens the stability of inflation expectations."

In addition, some bank presidents have attributed high unemployment to structural problems, and have therefore doubted the ability of monetary policy to reduce it without triggering inflation. For example, one stated, "Most of the existing unemployment represents mismatch that is not readily amenable to monetary policy." Another said:

> You can't change the carpenter into a nurse easily …. Eventually … [p]eople will be retrained and they'll find jobs in other industries. But monetary policy can't retrain people. Monetary policy can't fix those problems.

Among the leading figures on the FOMC—chairman Ben Bernanke, vice-chair Janet Yellen, and president of the Federal Reserve Bank of New York William Dudley—the view that monetary policy tools are not very effective and potentially costly has been milder and more nuanced, relative both to the views described above and to those in the

1930s and 1970s. Nonetheless, there is evidence that it has been present. It appears to have had two key elements.

One is that the power of the tools is limited. The language that these monetary policymakers have used to describe what their tools could accomplish has consistently been measured. In October 2012, for example, Bernanke said that "we expect our policies to provide meaningful help to the economy," but that "monetary policy is not a panacea" for "tackl[ing]," among other things, "the near-term shortfall in aggregate demand." Similarly, in November 2011, after identifying "a dearth of aggregate demand," Yellen also said that "monetary policy is not a panacea." The same month, Dudley said, "although a stimulative monetary policy is essential for recovery, it may not be sufficient."

The second element has been the belief that the tools involve costs. Probably the most explicit statement of this view was made by Bernanke in August 2012. He listed four potential costs to nontraditional policies: they "could impair the functioning of securities markets," "reduce public confidence in the Fed's ability to exit smoothly from its accommodative policies," create "risks to financial stability," and cause "the possibility that the Federal Reserve could incur financial losses."[4] Similarly, Dudley said in November 2011 that nontraditional tools entail "costs as well as ... benefits," and went on to detail the costs he perceived.

Policymakers have been explicit that these considerations have muted their policy response. In October 2012, Bernanke said that "the Federal Reserve has generally employed a high hurdle for using" nontraditional tools. In April 2012, Yellen said, "The FOMC's unconventional policy actions …, in my judgment, have not entirely compensated for the zero-bound constraint." These statements are consistent with the fact that Federal Reserve policy in recent years has been less aggressive than some analysts have urged (for example, Gagnon 2009).

Another parallel with the earlier periods—particularly the 1970s—is that concern about the effectiveness of their tools has led monetary policymakers to advocate nonmonetary measures. In September 2012, after saying that monetary policy "is not a panacea" for addressing tight financial conditions and high unemployment, Bernanke said, "We're looking for policymakers in other areas to do their part." Using very similar language in November 2011, Yellen elaborated on her view that monetary policy alone could not solve an aggregate demand shortfall by saying that "it is essential for other policymakers to also do their part." And in January 2012, the Federal Reserve sent Congressional leaders an unsolicited white paper discussing "current conditions and policy considerations" concerning the housing market and housing policy.

Thus, concern about the power of policy has limited the Federal Reserve's response to the very weak economy. Whether that concern has reflected unwarranted pessimism or a wise assessment will not be known for many years, if ever.

Two pieces of evidence, however, are at least suggestive of unwarranted pessimism. The first is the analogy to the Depression. Then, as in the past few years, nominal interest rates were very low, and many attributed poor economic conditions to a speculative boom and bust rather than to monetary causes. Yet the modern consensus is that the beliefs that monetary expansion would be ineffective and potentially costly were mistaken. Second, the Federal Reserve's decision in September 2012 that it was appropriate to use its tools more aggressively, even though its economic outlook had improved since the previous meetings, suggests that policymakers may now think they had been underestimating the effectiveness of the tools, or overestimating their costs.[5] But both pieces of evidence are clearly far from definitive.

[4] Bernanke's conclusion was that "the costs of nontraditional tools, when considered carefully, appear manageable"; and, as we discuss below, his speech came shortly before a decision by the FOMC to use the tools more forcefully. Nonetheless, the speech provides an unusually clear discussion of the costs that policymakers perceived.

[5] For example, the Summary of Economic Projections in September 2012, when the FOMC decided to make greater use of the tools, involved a considerably lower level of unemployment, and a similar rate of decline in unemployment and a similar path for inflation, than the projections in November 2011, when it decided to take no substantial new action.

IV. Conclusion

The view that hubris can cause central bankers to do great harm clearly has an important element of truth. A belief that monetary policy can achieve something it cannot—such as stable low inflation together with below-normal unemployment—can lead to the pursuit of reckless policies that do considerable damage.

But the hundred years of Federal Reserve history show that humility can also cause large harms. In the 1930s, excessive pessimism about the power of monetary policy and about its potential costs caused monetary policymakers to do little to combat the Great Depression or promote recovery. In critical periods in the 1970s, undue pessimism about the potential of contractionary monetary policy to reduce inflation led policymakers to do little to rein in the Great Inflation. We have stressed that it is too soon to reach conclusions about recent developments. But, faced with persistent high unemployment and below-target inflation, beliefs that the benefits of expansion are small and the costs potentially large appear to have led monetary policymakers to eschew more aggressive expansionary policy in much of 2010 and 2011. In hindsight, these beliefs may be judged too pessimistic.

The approaches of two largely successful Federal Reserve chairmen—William McChesney Martin and Paul Volcker—also suggest that the value of humility in a central banker may be overstated. Both came into office believing that monetary policy could accomplish a great deal, and both used policy aggressively. For example, Volcker undertook a highly successful disinflation program because, as he stated at his confirmation hearings, "I don't think we have any substitute for seeking an answer to our problems in the context of monetary discipline."

One possible conclusion is that central bankers should have a balance of humility and hubris. They need a sound knowledge of both the limitations and the powers of monetary policy. That is, the most important characteristic to look for in central bankers is not their inherent optimism or pessimism about the effectiveness of monetary policy, but rather their understanding of how the economy works and the possible contributions of policy.

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