Myopic Monetary Policy and Presidential Power: Why Rules Matter

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> Independence is central to the Federal Reserve's ability to choose policy actions that achieve price stability. Sacrificing much of its independence, as the Fed often has, permits others to pressure the Fed to achieve other objectives, usually short-term objectives. That is one reason that the Fed responds to short-term events often at the cost of failing to achieve longer-term objectives.
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> —Allan H. Meltzer (2013: 405)

The Fed's Vulnerability to Political Pressure

In the absence of a monetary rule, a central bank is vulnerable to politicization. In the case of the United States, Congress delegated monetary authority to the Federal Reserve in 1913 and has increased the scope of that authority over time, especially following crises. However, Congress has never enacted an explicit rule to guide Fed policy, and it has used the Fed as a scapegoat when things go awry.

By law, the Federal Reserve has a triple mandate to "promote effectively the goals of maximum employment, stable prices, and

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moderate long-term interest rates." In doing so, the Federal Open Market Committee (FOMC) is instructed to "maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long-run potential to increase production" (Section 2A, Federal Reserve Act).[1] That congressional mandate, however, is a weak reed upon which to rest sound monetary policy in a world of government fiat money not subject to any enforceable monetary rule.

In 1978, the Humphrey-Hawkins Act required the Fed to set targets for monetary aggregates and report those benchmarks to Congress twice a year. There was no penalty if the FOMC failed to hit its targets, but the Fed would have to explain why (P.L. 95–523, Sec. 108 (a)). The reporting requirements expired in May 2000 and the Fed no longer pays much attention to the money supply. Instead, the Fed's main policy instrument since the mid-1980s has been the fed funds rate (i.e., the overnight rate at which member banks lend to each other).[2]

This article examines the relationship between Fed policy and presidential power in a fiat money regime in which Congress has delegated significant power and discretion to the Fed. By making the Fed responsible, but not accountable, for achieving full employment and price stability, Congress can shift blame to the Fed when it fails to meet those objectives. In their study of the political history of the relationship between the Fed and Congress, Binder and Spindel (2017) argue that the relationship is one of "interdependence" and that Fed independence is a "myth."

The fact that Congress has given the Fed increased power and discretion means that Congress is evading its constitutional duty to safeguard the value of money and, at the same time, opening the door for presidential jawboning. As Robert Weintraub, staff director for the House Subcommittee on Domestic Monetary Policy from 1976 to 1980, argued: By sanctioning "short-run money market myopia"—that is, lowering the short-run policy rate by expanding the money supply—"Congress weakened its own hand in supervising monetary policy and strengthened the hand of the Executive."

[1]See www.federalreserve.gov/aboutthefed/section2a.htm.

[2]The Fed now sets a target range for the fed funds rate, using interest on excess reserves as the upper limit and the Fed's overnight reverse repo rate as the lower limit. For a discussion of the Fed's new operating system, see Federal Reserve Bank of New York (2008) and Selgin (2018).

Moreover, "money market myopia fitted harmoniously with administration concerns about financing the government's deficits" (Weintraub 1978: 359). He concluded that, without a credible monetary rule, "the President's objectives and plans will continue to be the dominant input in the conduct of monetary policy" (ibid.: 360).

Consequently, in the absence of a credible/enforceable rule, money supply targets are insufficient to overcome presidential ambitions to push for accommodative monetary policy, keeping rates low to finance deficits and stimulate production, at least in the short run. Of course, a strong leader in the White House could push for sound money, as did President Eisenhower; and a strong leader at the Fed, such as Paul Volcker, could do likewise.

For the last 25 years, from President Clinton through President Obama, criticism of Fed policy has usually been in private. But there has been a sea change with President Trump, who has been highly critical of Fed Chairman Jerome Powell for raising rates in 2018, especially the December increase in the target range by 25 basis points to 2.25–2.50 percent (see Smialek 2019). With tensions rising between the White House and the Fed, and with the Fed examining its strategy, tools, and communication practices, it is a good time to take another look at Fed "independence," the relationship between the Fed and president, and the case for a monetary rule to guide Fed policy and reduce the uncertainty inherent in a discretionary government fiat money regime.

Legally, the Fed is independent, but in practice that independence is continuously tested by political pressures for using accommodative monetary policy and credit allocation to win votes. An examination of the evidence reveals that presidents tend to get the monetary policy they desire. The adoption of a rules-based monetary regime could help limit interference in the conduct of monetary policy and improve economic performance.

Fed Policy and Presidential Power: An Uneasy Relationship

In considering the relationship between the government and the Fed, Allan Sproul (1948), then president of the New York Federal Reserve Bank, distinguished between "independence from government and independence from political influence." Most people, he said, accept the idea that the Fed should be held accountable by the government/Congress. However, from a narrow political viewpoint, "The powers of the central banking system should not be a pawn of any group or faction or party, or even any particular administration" (quoted in Meltzer 2003: 738).

That sentiment was recently endorsed by Fed Chairman Jerome Powell when he stated:

> The Fed is insulated from short-term political pressures—what is often referred to as our "independence." Congress chose to insulate the Fed this way because it had seen the damage that often arises when policy bends to short-term political interests. Central banks in major democracies around the world have similar independence [Powell 2019: 1].

History, however, does not bear out this view of Fed "independence." The fact is that, in a purely discretionary fiat money regime, with little congressional guidance, the door is open for presidential power/jawboning to influence Fed policy. We have seen that in the past and see it now.

In his monumental *History of the Federal Reserve*, Meltzer (2003, 2010a, 2010b) provides ample evidence that monetary policy is not free from political influence. Likewise, Cargill and O'Driscoll, in their review of that history, and based on Ferrell's (2010) diary of Arthur F. Burns, conclude:

> The Fed was appropriately constrained by fiscal dominance in both great wars. It was independent under the modified gold standard in the 1920s because of a rule. It gained operational independence after the 1951 Accord, but lost that independence starting with William McChesney Martin in the early 1960s and especially Burns in the 1970s. Paul Volcker and Alan Greenspan reestablished de facto independence in terms of focusing on price stability with an implicit adoption of the Taylor Rule. It has surely lost any meaningful independence under Ben Bernanke [Cargill and O'Driscoll 2013: 431].

It is well known that President Truman continued to pressure the Fed for low interest rates after the 1951 Accord. He disliked Fed Chairman Thomas B. McCabe, who was adamant about ending the pegging of U.S. bond rates and was pressured to step down shortly after the Accord was signed (Meltzer 2003: 712). His replacement, William McChesney Martin, became the longest serving Fed chairman (1951–1970). He believed in Fed independence and survived in office under five presidents by largely following their preferences. For example under President Dwight D. Eisenhower, the Fed pursued a stable money policy with low inflation and moderate long-term interest rates. But under President Lyndon B. Johnson, the Fed was pressured to pump up money growth and achieve lower short-run interest rates.

In October 1955, Martin gave his famous "punch bowl speech," in which he argued that the job of the Fed was to take away the punch bowl (i.e., slow money growth and raise interest rates) when the economy was at peak performance.[3] In that speech, he emphasized the importance of an independent central bank and the limits of monetary policy.

> In framing the Federal Reserve Act great care was taken to safeguard this money management from improper interference by either private or political interests. That is why we talk about the over-riding importance of maintaining our independence. . . . While money policy can do a great deal, it is by no means all powerful. . . . If we ask too much of monetary policy we will not only fail but we will also discredit this useful, and indeed indispensable, tool for shaping our economic development [Martin 1955: 3–4].

As Fed chairman under Eisenhower, Martin spoke out against central planning and price controls. He supported free enterprise and monetary stability:

> The answers we sought to the massive problems of the 1930s increasingly emphasized an enlarging role for Government in our economic life. That role was greatly extended again in the 1940s when the emergency of World War II led to direct controls over wages, prices, and the distribution of goods ranging

[3]The "punch bowl" line was really taken from another writer whom Martin doesn't identify. The exact quote is: "The Federal Reserve, as one writer put it, after the recent increase in the discount rate, is in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up" (Martin 1955: 12).

> from sugar to steel. That experience led to growing concern over the effect of a straitjacket of controls on the economy's productive capacity, and the price that would be exacted in terms of individual liberty if the harness of wartime economic controls were carried over into the postwar years. Such a strait jacketing of the economy is wholly inconsistent with our political institutions and our private enterprise system. The history of despotic rule, of authoritarian rule, not merely in this century but throughout the ages is acutely repugnant to us. It has taken a frightful toll in human misery and degradation.
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> . . . The advantages of a system where supply capacities and demand wants and needs are matched in open markets cannot be measured in economic terms alone. In addition to the advantages of efficiency in the use of economic resources, there are vast gains in terms of personal liberty. Powers of decision are dispersed among the millions affected instead of being centralized in a few persons in authority [ibid.: 4–5].

On the idea that a little inflation is the path to lower unemployment, Martin was clear:

> Allan Sproul, president of the Federal Reserve Bank of New York, put his finger on the fallacy in this contention in testifying before a congressional committee earlier this year when he said: "Those who would seek to promote 'full employment' by creeping inflation, induced by credit policy, are trying to correct structural maladjustments, which are inevitable in a highly dynamic economy, by debasing the savings of the people" [ibid.: 8].

While monetary policy during the Eisenhower administration (1953–61) was characterized by low inflation, the Johnson administration (1963–69) leaned heavily on Martin to keep rates low and maintain the economic expansion via adequate money growth. President Johnson warned that "it would be self-defeating to cancel the stimulus of tax reduction by tightening money" (*Economic Report* 1964: 11).

However, Martin increased the discount rate in December 1965 against the president's wishes and Johnson lashed out at him when they met at LBJ's ranch, even pushing Martin around (Granville 2017). With continued growth in the money supply relative to real output, the Martin Fed helped usher in the Great Inflation (1965–84).[4] As Meltzer (2005: 168) points out, "Martin's acceptance of policy coordination with the [Johnson] administration prevented the Federal Reserve from taking timely actions and contributed to more expansive policies than were consistent with price stability."[5]

When Martin's term ended on January 31, 1970, President Nixon nominated Arthur Burns who served as Fed chairman until 1978. From 1971 to 1973, inflationary pressures grew as Burns accommodated Nixon's demands for lower interest rates and expansionary money growth. In August 1971, President Nixon instituted wage and price controls by executive order in an attempt to contain rising inflation, and he put Burns in charge of the Committee on Interest and Dividends (CID). The primary purpose of CID was to maintain low interest rates. With the cap on wages and prices, Burns could use the Fed's power to create base money to pump up the money supply while not worrying about inflation, and give Nixon the low interest rates he wanted to help him win the election in 1972. Weintraub (1978: 356) correctly calls the combination of wage-price controls and CID "an invitation to disaster."

The gears shifted in 1974 when President Gerald Ford called for tighter monetary policy. But in 1977, President Carter thought inflation was much less an issue than unemployment and called for Burns to shift to easy money once more. It was not Congress that pressured the Fed to accelerate M1 growth in 1977; it was the administration. As Weintraub (1978: 358) argues, "It is not unfair to

[4]It should be noted that, in January 1965, Johnson urged Congress "to eliminate the arbitrary requirement that the Federal Reserve Banks maintain a gold certificate reserve against their deposit liabilities" (*Economic Report* 1965: 12). As Robert Weintraub (1978: 355) notes, removing that constraint would allow domestic monetary policy to be more accommodative, providing cover for Johnson's Great Society programs and the Vietnam War. Congress obliged by passing a bill in March 1965 eliminating the gold requirement for deposits/reserves held at the Federal Reserve Banks, and in March 1968 removed the gold requirement for Federal Reserve notes (Ramage 1968: 8). When President Nixon closed the gold window in August 1971, the last vestige of the gold standard was gone.

[5]Meltzer (2005: 145) blames the persistence of inflation on "political choices, analytic errors, and the entrenched belief that inflation would continue." He notes that, under the sway of simple Keynesian models, those calling for policy coordination accepted the practice of monetizing the debt—that is, having the Fed help finance fiscal deficits (ibid.).

conclude that the Federal Reserve accelerated M1 growth in 1977 above its own target range because it perceived its 'assignment' in the new administration's economic game plan be to resist upward pressures on short-term rates."

It was left to Paul Volcker, whom Carter nominated in 1979 and who remained as Fed chairman until 1987, to restore Fed independence and crack down hard on inflation by raising rates and slowing money growth. In October 1979, Volcker met with the FOMC and changed the Fed's operating system. Instead of managing the day-to-day fed funds rate, Volcker decided to focus on controlling the volume of bank reserves directly, which meant that there would be more variability in the funds rate but better control of the money supply. He stood his ground and pushed the Fed funds rate to a peak of 20 percent in late 1980. Money growth slowed and by 1983 inflation came down from double digits to less than 4 percent (Medley 2013).

Alan Greenspan became Fed chairman in 1987 and followed in Volcker's footsteps, adding credibility to the Fed. When President George H. W. Bush failed to get the Fed to accommodate his wishes for an expansionary monetary policy, he blamed Greenspan for his defeat in the 1992 election, saying: "I think that if the interest rates had been lowered more dramatically that I would have been re-elected president because the [economic] recovery that we were in would have been more visible. . . . I reappointed him, and he disappointed me" (*Wall Street Journal* 1998).

Greenspan prolonged the "Great Moderation," which began under Volcker in 1983 and lasted until 2003. It was a period of relative macroeconomic stability in which the variability of both inflation and output decreased. John B. Taylor (2009) attributed that stability to Fed policy that approximated the Taylor rule.[6] When the Greenspan Fed departed from that rule in mid-2003, the fed funds rate fell to 1 percent and remained at that level until mid-2004, far below the rate prescribed by the Taylor rule (see Taylor 2009: 3, Fig. 1). Although the Greenspan Fed increased the fed funds rate, it continued to be below the Taylor-rule rate until 2006.

[6]William Niskanen (2001) found that the Greenspan Fed adhered to a de facto demand rule from early 1992 to early 1998 by keeping total spending on a steady growth path of about 5.5 percent per year.

Consequently, Taylor (2009) argued that, by holding rates too low for too long, the Greenspan Fed encouraged risk taking and helped fuel the housing bubble.

Likewise, Anna Schwartz (2009: 19–20) has argued:

> The Fed was accommodative too long from 2001 on and was slow to tighten monetary policy, delaying tightening until June 2004 and then ending the monthly 25 basis point increase in August 2006. . . . The rate increases in 2004 were too little and ended too soon. This was the monetary policy setting for the housing price boom.

Schwartz (ibid.: 23) concludes that, "if monetary policy had been more restrictive, the asset price boom in housing could have been avoided."

Greenspan's policy reversal could have been influenced by the need to accommodate President George W. Bush's 2001 tax cut and the deficit that followed. Identifying whether he did it for political reasons under pressure from the administration, however, is difficult.

The global financial crisis greatly increased the power and discretion of the Fed and other central banks. Ben Bernanke, who took over as Fed chairman in 2006, worked closely with the G. W. Bush administration, especially Treasury Secretary Hank Paulson, to restore financial stability and stimulate the economy by unconventional monetary policy—including lowering the fed funds rate to near zero, engaging in large-scale asset purchases (credit allocation), and using forward guidance to encourage risk taking and prop up asset prices. Monetary policy drifted into fiscal policy as the Fed bought trillions of dollars of U.S. debt and mortgage-backed securities. The policy coordination that was evident under Arthur Burns was supercharged under Bernanke.[7] The Fed, of course, had an obligation to provide liquidity to the banking/financial system, but its emergency lending programs and bailouts stretched its powers considerably. The rule of law gave way to the rule of central bankers (White 2010; see also Humphrey 2010).

[7]The president and CEO of the Federal Reserve Bank of New York, Timothy Geithner, was also a key player in the policy coordination process.

In light of the available evidence, it is fair to say that without a credible rule monetary policy is likely to be more myopic and open to politicization than would be the case with either an implicit or explicit rule. As Cargill and O'Driscoll (2013: 429) observe:

> Central bank independence is intimately tied to rules that constrain the central bank to focus on price stability, preferably a legislated rule. Focus on the short term inevitably leads the central bank into the political thicket and the loss of de facto independence. Central bank independence is more easily lost than restored.

President Trump is demanding an accommodative monetary policy from the Fed to keep the expansion going and asset prices rising. He has called Fed policy "very destructive" and wants a cut in the fed funds rate (Salama 2019). The Trump administration's tax cuts have had positive effects on private investment and real economic growth. However, with large increases in spending and no long-run solution to slow entitlement spending, fiscal deficits are mushrooming. Financing those deficits at higher interest rates would be very costly. Thus, the White House is urging Fed Chairman Jerome Powell to keep rates lower for longer and not engage in quantitative tightening by reducing the size of the Fed's still massive balance sheet. So far Powell has maintained his distance from the White House but perhaps not from Wall Street. However, even if Powell acts in the direction wanted by the president that decision doesn't necessarily mean a loss of independence if the policy move is correct—that is, consistent with the Fed's independent pursuit of its mandate.

From our brief review of the politics of Fed behavior, it seems safe to say that the Fed is neither independent within government nor outside the fray of day-to-day politics. It is also questionable whether, as Weintraub (1978: 349) contends, "the dominant guiding force behind monetary policy is the President." Congress may only play a "watchdog role," but presidents don't always get the monetary policies they want. More important, without a guiding monetary rule, and with multiple mandates, both the White House and the Fed will be more focused on the short run than the long run, and politics will play an oversized role.

Reducing Monetary Uncertainty: Toward a Rule-Guided Regime

Monetary rules matter because they help focus monetary authorities on what they can do—influence nominal spending and the price level in the long run—not on what they can't do—permanently raise the level of real income. Without the guidance of a credible rule, monetary authorities face two major problems, as pointed out by Meltzer (2013: 406, 411–12): (1) "Excessive concern for short-term changes causes the Fed to respond to events over which it has little control and largely ignore longer-term changes that it can influence"; and (2) "Excessive attention to short-term changes neglects the distinction between permanent and temporary changes that is central to standard economic analysis."

The introduction of money-growth targets for a brief period in the late 1970s and early 1980s set some limits on the Fed, but they were not sufficiently implemented as a long-term constraint to depoliticize the Fed. Although the Federal Reserve Reform Act of 1977 required the Fed to set targets for "the ranges of growth or diminution of monetary and credit aggregates" and report those ranges to Congress, the legislation lacked real teeth to enforce a monetary growth rule:

> Nothing in this Act shall be interpreted to require that such ranges of growth or diminution be achieved if the Board of Governors and the Federal Open Market Committee determine that they cannot or should not be achieved because of changing conditions [P.L. 95–188, Sec. 2A].

Nonetheless, setting a framework for the conduct of monetary policy (e.g., by requiring the Fed to report money supply targets) helped provide information that allowed fiscal policymakers to better plan their budgets. For example, in July 1977, pursuant to House Concurrent Resolution 133, which was adopted in March 1975 to require the Fed to report money growth targets, Rep. Parren J. Mitchell (D-MD), chairman of the House Subcommittee on Domestic Monetary Policy, held hearings to inquire why the Fed had let money growth exceed the announced target ranges. In questioning Fed Governor J. Charles Partee, Mitchell stated:

> What we have done in this Congress in an effort to get a handle on Government spending is to establish a Committee on the Budget which works in concert with Ways and Means, Appropriations, and all the other major committees. Key to that working relationship is the understanding of monetary policy established early in the year.
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> . . . If there is a commonly agreed on monetary growth policy at the beginning of the year, then all of us—banking, budget, all of Congress—operate roughly within those guidelines established by you and accepted by the Congress. To the extent and degree that you move away from those guidelines, you throw this whole delicate balance out of whack.
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> . . . This is, indeed, in my opinion, disruptive to the fiscal policy planning process and to business and consumer planning as well [U.S. Congress 1977: 50–51; quoted in Weintraub 1978: 357–58].

The 1983–2003 experiment with a Taylor rule helped guide Fed policy under Volcker and Greenspan and gave the Fed more space from the White House and more confidence in its independence. But we can do better. Formal adoption of a legislated rule and effective implementation of a rule would further separate day-to-day politics from monetary policy. The failure of Congress to legislate a rule-based monetary regime, or for Congress or the president to establish a commission to examine Fed performance and alternative monetary rules, is disappointing but not surprising.

The Fed has little incentive to bind itself to a rule and lose discretionary power. Congress and the executive branch, meanwhile, have little incentive to put the Fed on auto pilot and deprive themselves of influencing monetary policy or placing blame for economic instability on the Fed. An example suffices to illustrate the difficulty of reforming the monetary regime or even taking the first step by establishing a presidential commission to consider alternatives to the present discretionary government fiat money regime.

After Ronald Reagan was elected president in 1980, Martin Anderson, a key member of Reagan's campaign staff and later appointed as chief domestic policy advisor, reached out to several influential economists for ideas on what policy actions President Reagan should take during his first 100 days in office. One of those contacted was James M. Buchanan, a pioneer in public choice and constitutional economics, who recommended that Reagan "appoint a presidential commission that would look into the whole structure of our monetary authority" (Buchanan 1988: 32–33).

As Buchanan observed:

> What we have now is a monetary authority that essentially has a monopoly on the issue of fiat money, with no guidelines to amount to anything; an authority that never would have been legislatively approved, that never would have been constitutionally approved, on any kind of rational calculus, no matter what political system. We have an authority that just happened to get there and happened to be in place when we demonetized gold totally and completely over this half century. So I thought it was a good idea to use that presidential commission-type device to get a little publicity, to get a discussion going about the legitimacy of this authority [ibid.: 33].

After sending Anderson a letter in early December, Buchanan heard back from Reagan's "Kitchen Cabinet" expressing interest in the idea for a presidential commission and asking Buchanan to consider chairing it. He then wrote a "position paper" that he sent to the Western White House, but he never heard anything back (ibid.: 33–34). Here's the way Buchanan described it:

> Nothing happened. Absolutely nothing happened. I never heard a word, not one word, from them. I found out months later, that they did seriously consider the idea, but Arthur Burns shot it down. Arthur Burns totally and completely rejected it, and would not have anything to do with any proposal that would challenge the authority of the central banking structure—you don't even question, you don't even raise it as an issue to be discussed [ibid.: 34].

In other words, Burns, a former chairman of the Fed, "had taken it as his mission to defend the institution as it is, independently of any question. It became a sacrosanct institution to Arthur Burns, and he prevailed in the Reagan councils" (ibid.).

Official resistance to establishing a commission to explore alternative monetary regimes persists to this day, as attested by the fact that Congress failed to enact the Centennial Monetary Commission Act of 2013 (H.R. 1176), introduced by Rep. Kevin Brady (R-TX).[8]

Without a transparent and credible rule to guide monetary policy, there is much uncertainty about the Fed's next move in setting interest rates, as witnessed by the unexpected turnaround after last December's rate hike. Initially, Fed Chairman Jerome Powell led markets to believe there would be two rate hikes in 2019, but quickly changed his mind when the stock market tanked in December 2018. He then called for "patience" in setting the policy rate and in shrinking the Fed's massive balance sheet (Schneider and Spicer 2019).

A rule-guided monetary policy would help depoliticize the Fed, shift resources to more productive uses than "Fed watching," and reduce regime uncertainty by concentrating on long-run stability of nominal income and the price level rather than trying to fine-tune the economy or cater to Wall Street. Moreover, a "hard" rather than "soft" rule (i.e., one fudgeable by the Fed) would end the "ambiguous and chaotic" state of monetary law that Clark Warburton referred to when noting that "Monetary law in the United States . . . does not contain a suitable principle for the exercise of the monetary power held by the Federal Reserve System, and has caused confusion in the development of Federal Reserve policy" (Warburton 1966: 316).

The Federal Reserve Act of 1913 sought to provide "an elastic currency" and to have reserve banks set discount rates "with a view of accommodating commerce and business." Those were vague guidelines, however. The Fed failed to provide a quantity of money sufficient to maintain monetary equilibrium in the early 1930s, as Friedman and Schwarz (1963) and Warburton (1966) have shown. Weintraub (1978: 341–42) sums up the situation nicely:

> In the crucible of reality, the [1913] Act was found wanting. It contained no meaningful operational standard for the conduct of monetary policy. Aside from the constraints imposed by the gold standard and the gold backing requirement on Federal Reserve

[8]See www.govtrack.us/congress/bills/113/hr1176/text.

> notes and deposits, the Federal Reserve was free to do as it wanted, when it wanted, for whatever reasons it might have.[9]

The myopic nature of monetary policy stems from the lack of a rules-based monetary regime that would give credence to Section 2A of the Federal Reserve Act. As we have seen, the Fed never really adhered to a money supply target regime, and the link between money, income, and prices was severed by financial innovation beginning in the 1990s (see Labonte and Makinen 2008).[10] Thus, in July 1991, at a congressional hearing, Fed Chairman Alan Greenspan noted:

> The historical relationships between money and income, and between money and the price level, have largely broken down, depriving the aggregates of much of their usefulness as guides to policy. At least for the time being, M2 has been downgraded as a reliable indicator of financial conditions in the economy, and no single variable has yet been identified to take its place [Federal Reserve Bank of New York 2008: 2].

Since the 2008 financial crisis, the Fed's balance sheet has exploded, and, with the payment of interest on excess reserves (IOER) since October 2008, the increased demand for reserves has mitigated the monetary transmission mechanism whereby an increase in base money leads to a multiple increase in money and credit, and boosts nominal income (see Selgin 2018).

By separating its balance sheet from administering interest rates under the so-called floor system, the Fed has been able to avoid runaway inflation even as it suppresses interest rates—and it is more

[9]Humphrey and Timberlake (2019) argue that the Fed's adherence to the Real Bills Doctrine led it to misdiagnose the causes of the Great Contraction. The idea that limiting the discount window to commercial paper would bring about an optimal quantity of money was proven to be a poor guide to stable money and prices.

[10]Meltzer (2013: 410) has questioned the breakdown in the money-nominal income linkage: "The Federal Reserve rejects use of any monetary aggregate by claiming that monetary velocity is unstable. This conclusion comes from tests based on quarterly data. This is another example of the dominant role of myopia. . . . For the United States, annual data on monetary base velocity and a bond rate for nearly 80 years show reasonable stability." Using a Divisia (weighted) measure of the broad money supply (M4) also shows that money matters in shaping the path of income and prices (see Hanke 2018).

open to political manipulation. Indeed, the floor system allows for more administrative and congressional abuse of the Fed's balance sheet (Selgin 2017). As former Philadelphia Fed President Charles Plosser (2018: 15) argues, "A large balance sheet untethered to the conduct of monetary policy creates the opportunity and incentive for political actors to exploit the Fed's balance sheet to conduct off budget fiscal policy and credit allocation." Nevertheless, the Fed's new operating system need not expose the Fed to any greater tendency to set its rate targets according to presidential whims.

The Fed has sought to use "forward guidance" to steer monetary policy, but as seen from Chairman Powell's "pivot" after the FOMC increased rates last December, there is little certainty about the future course of monetary policy. Forecasting the macroeconomy and interest rates is notoriously difficult. Demands on forecasts could be significantly reduced by moving to a rule-based monetary regime. There are many rules to choose from, including ones based on convertibility of the dollar into some commodity or basket of commodities, a constant money growth rule, an inflation or price level rule, a nominal GDP rule designed to keep total spending on a steady path, a Taylor rule, and so on.[11]

Conclusion

As the Fed reviews its strategy and communications this year, it should not forget two important points: (1) independence is necessary for the Fed to do its stabilization job well, free of presidential meddling; and (2) specific monetary rules are an absolutely necessary condition to assure achievement of such independence. Moreover, the Fed needs to be open to a rational discussion of alternative monetary rules in attempting to improve the monetary regime. The problem is not too little inflation but too much discretion.

There needs to be a better understanding of why rules matter in reducing myopic monetary policy and in insulating the Fed from presidential power and day-to-day politics. Ultimately, the Fed must be bound by a constitution that protects the value of money and safeguards individual freedom under a rule of law. The current monetary regime is far from that ideal.

[11]On alternative monetary rules, see Dorn (2017) and Salter (2017). For a summary of the literature on the case for rules versus discretion, see Dorn (2018).

Creating a monetary commission to evaluate the Fed's performance and consider alternatives to the current discretionary fiat money regime would be a step in the direction of securing sound money.

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