

# HOW THE FED CROWDED OUT REAGAN'S ECONOMIC POLICY

*Paul Craig Roberts*

## The Split between Fed Power and Accountability

There is a fundamental problem with the Fed's policymaking function. Under the U.S. Constitution, government is not supposed to convey power without accountability. But as a former president of the St. Louis Fed acknowledges, accountability does not seem to be the case with the Federal Reserve (Roos 1986). Perhaps this mattered less in the past when there was a gold standard and fixed exchange rates. Today, however, the advent of fiat money and flexible exchange rates has removed practically all constraints on the Fed. The result is enormous discretionary power that allows the Fed to act in self-protective ways that can crowd out the policies of an elected government.

### *The Self-Protective Fed*

The Fed's rogue monetary policy during 1981–82 is a good example of an unaccountable central bank acting in self-protective ways and crowding out the policies of an elected government. To a large extent, the Fed's policy, which resulted in an unexpected and severe recession and in an unexpected collapse in the inflation rate, frustrated the Reagan administration's efforts to shift the emphasis of economic policy toward greater private sector incentives and growth. The recession forced President Reagan on the defensive early in his administration, causing him to lose control of the budget while simultaneously confronting him with the largest budget deficits in our history.

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The truth starkly contrasts with the widespread belief that a courageous Fed followed a conscious gameplan and conquered inflation despite an excessively stimulatory fiscal policy. In late 1980 and early 1981 when the new administration was putting together its economic policy, there was an almost universal consensus that not very much could be done about inflation—and certainly not very quickly. The administration intended to emphasize economic growth, but it was confronted with the “Phillips curve,” which argued against the prospect of real economic growth and a declining rate of inflation. At the time, forecasting models such as DRI had a “core rate of inflation” of 10 percent, which was believed to mean that 10 percent inflation was a floor even with restrictive monetary and fiscal policies.

Given the constraints of conventional thinking, a proposal from the Reagan administration to abruptly reduce inflation would have had no credibility. Moreover, many monetarists were opposed, at least in principle, to attempting an overnight cure of inflation. From their point of view, using recession to bring down inflation was pointless, because the resulting unemployment puts tremendous political pressures on the system to reflate. Monetarists wanted to break this roller coaster cycle.

In 1981 the administration’s supply-side fiscal policy was a reduction in the tax burden on labor and capital. This was a disinflationary policy, because it lowered the cost of production. However, the policy was widely misinterpreted by irresponsible economists, journalists, and politicians as a Keynesian demand stimulus coming at a time of a 12.5 percent inflation rate, a \$50 billion budget deficit inherited from the Carter administration, 10 percent “core inflation,” and a Phillips curve environment. All of this was following a decade of rising inflation expectations. The Fed was convinced, largely by conservative Republican economists, that inflation was going to explode and that the Fed would be blamed. The Fed responded in a self-protective way and simply turned off the money, reasoning that an administration with monetarists in office could not blame the Fed for inflation if there was no growth in the money supply. The Fed was as surprised as everyone else by the unexpected collapse in inflation and by the severe debt and liquidity problems that followed in train.

When President Reagan was inaugurated the prime rate was at a peak of 21.5 percent. Perhaps these high interest rates were Reagan’s legacy from Volcker’s attempt to reelect President Carter by providing rapid growth in money whether measured by M1 or the St. Louis base, from July through November of 1980. The conventional wisdom was that a staunch conservative like Reagan could not be elected

President, and the outpouring of money by the Fed may have caused markets to expect a continuation of the upward ratcheting of inflation. Whatever their cause, the high rates of interest, or the uncertainty that they reflected, had a negative impact on the economy.

*Ignoring Reagan's Stable Money Objective*

The Reagan administration intended to deal with the situation by providing moderate, stable, and predictable money growth that would first stabilize the inflation rate and then gradually bring it down. Once markets saw that money growth and inflation were under control, interest rates would fall faster than the inflation rate due to changed expectations. The February 18, 1981 report that announced Reagan's economic program states: "The economic scenario assumes that the growth rates of money and credit are steadily reduced from the 1980 levels to one-half those levels by 1986."

The Reagan administration also intended to contribute to lower real interest rates with tax policies that would increase private sector saving and with expenditure policies that would reduce the growth rate of federal spending. From 1975 through 1980, inflation interacting with the progressive income tax and depreciation allowances had reduced private sector saving by \$350–\$450 billion, depending on how it is measured. During this same period federal spending had grown faster than GNP, resulting in a cumulative federal deficit of \$368 billion.

Unfortunately for Reagan's economic policy and for millions of people in the economy, the Federal Reserve did not provide the moderate, stable, and predictable growth of money that the central bank agreed to provide. First, the Fed allowed M1 to increase sharply from February through April 1981, which had bad psychological effects and was taken as confirmation in many quarters that the administration intended to monetize deficits. Then the Fed slammed on the brakes and held M1 growth at about zero for six months. Before the Fed revised the data, the figures showed less money in the economy in October 1981 than in the previous April. This is a very sharp slowdown, especially coming off the previous acceleration. All in all, in 1981 alone the Fed produced 75 percent of the total reduction in money growth that we intended to spread over a six-year period.

In 1982 the Fed repeated the pattern, allowing rapid money growth in December 1981 and January 1982 and then bringing it down to a very low rate for six months. The monetary base (St. Louis, 3-month growth rates) began decelerating in December 1980 and continued until November 1981. Velocity of money did not rise in 1981 to

compensate for the decline in money growth, and in 1982 velocity fell. Unless the well-documented findings of monetarists are completely dismissed, monetary policy would seem to be a principal cause of the recession.

## Fiscal Policy and Inflation Hysteria

Turning to fiscal policy, Keynesian measures show that it was also tight in 1981. According to the Congressional Budget Office (1982), the high employment budget showed a \$7 billion surplus for 1981.

Fiscal policy was depressing GNP and tax collections from a supply-side perspective as well. The delay and phase-in of the tax cuts encouraged people to shift income earning activities to the future, where tax rates were lower, and to shift tax deductions and credits to 1981 where their value was highest. The result was to worsen the economy and the deficit in 1981.

This argument is not a supply-side rationale offered after the fact of the recession. It was made prior to the election of Ronald Reagan in response to Martin Feldstein's proposal to delay any tax cuts in order to balance the budget. He argued in the summer of 1980 that the way to avoid large budget deficits as a consequence of cutting marginal rates was to enact in the present a schedule of future tax cuts. People would begin working and investing more in anticipation of the lower tax rates, he claimed, and the growth in the tax base would generate the revenues to pay for the subsequent tax cuts.

I argued in the *Wall Street Journal* (1980) that the results would be the opposite of what Feldstein imagined. Supply-side fiscal policy works by increasing the after-tax return to labor and capital. When marginal tax rates fall, both leisure and current consumption become more expensive in terms of forgone income, causing people to shift into work out of leisure and into investment out of current consumption. However, if people know that the prices of leisure and current consumption are going to rise at a future date, they could rationally decide to enjoy both while they are still cheap, just as consumers purchase commodities in anticipation of future price increases.

My argument was theoretical, but it was validated by the practical advice that accounting firms and tax lawyers gave their clients. For example, on public television the very day the 1981 tax reduction bill was signed, MacNeil and Lehrer interviewed tax accountants who explained how to take maximum advantage of the tax cut by postponing income and bringing deductions forward to the 1981 tax year. On August 25 Sylvia Porter's column began: "Millions of you, in corporations ranging from salespersons to physicians to lawyers

can shift portions of your income from 1981 to 1982. Start arranging to do so now, and you will be able to cut your federal income taxes substantially." On October 26, 1981 *Business Week* wrote about the "flood of advice on postponing income and accelerating deductions."

How were economists (and some Reagan policymakers) responding in 1981 to a recessionary monetary and fiscal policy? Almost universally they were predicting inflation. Among many, Walter Heller was convinced that the proposed tax cuts would inject too much inflationary purchasing power into the economy. He asked in the *Wall Street Journal* on February 10, 1981: "How can the economy absorb that big an expansionary punch without aggravating our already intolerable inflation?" A few days later *Washington Post* columnist Hobart Rowen, who stays tuned in to the Brookings Institution, declared that the tax cut was "so big that traditional Republicans and many Democrats regard it as dangerously inflationary." So did Mr. Rowen: "Even if Congress were to pass budget cuts that matched the tax cuts dollar for dollar, there is nothing in the fiscal program—in the view of those not addicted to supply-side theory—that works against inflation. The nation would still be face to face with OPEC, Reagan's oil deregulation orders, high farm prices, and escalating wages. And the Federal Reserve would be following a restrictive credit policy maintaining high interest rates, themselves a collateral cause of inflation."

Over the succeeding months the inflation hysteria grew. On May 11, Senate Finance Committee Chairman Bob Dole told the *New York Times* that he personally continued to fear that the tax cut would be inflationary. At a July meeting of the Board of Governors of the Federal Reserve System with its economic consultants, Alan Greenspan expected that a restrictive monetary policy would be overwhelmed by the tax cuts, and inflation would explode. Monetary policy was "the junior partner," Greenspan said, and could "do nothing other than a weak rear-guard action." There can be little doubt that Volcker was encouraged to overreact by clamping down on money growth so that he would not be left holding the bag for an inflationary administration.

Almost every week during 1981 brought a new hand-wringing from Herbert Stein, who was certain that wild-eyed supply-siders were going to send the economy up in the smoke of inflation. So was the *New York Times*, which on July 29 editorialized again that "the Great Tax Cut of 1981 . . . promises more inflation."

An old-fashioned Keynesian belief in the predominance of fiscal policy had combined with a natural envy of the influence that a handful of supply-side economists had on national economic policy

to whip up an inflation hysteria even while the economy was plummeting into recession. The inflation hysteria that was so assiduously cultivated by economists and the media was a principal cause of the recession. In such an atmosphere not even the Treasury secretary could succeed in calling attention to the recessionary monetary policy. My additional argument that fiscal policy itself was recessionary had an even smaller audience.

Secretary Regan's warning in the first week of August 1981 that the Fed was leading the economy into recession had no effect. By October the situation was desperate. Regan again called for the Fed to honor its own targets and to loosen the extraordinarily tight monetary reins. On October 19 *Time* described the Treasury secretary as a "wanderer from the true faith," and gleefully told how CEA Chairman Weidenbaum had called Regan and asked him, "What's going on here? We've got to be talking with one voice."

What was going on was the economy was sinking into the black hole of recession, and the "one voice" was pretending that the problem was inflationary deficits caused by the tax cuts. Weidenbaum, *Time* reported, "was opposed to the Fed pumping more money into the economy now"—a strange point of view considering that the M1 numbers showed that the Fed had been *pumping money out* of the economy for the past six months and was far below its target. OMB Director David Stockman rushed off to a breakfast meeting with reporters the day after Regan's warning where, *Time* reported, he "contradicted Regan by arguing that the Fed should keep the brakes on the money supply."

## The Fed's Crowding Out of Reaganomics

Former Treasury Secretary William E. Simon has said that as soon as a President is elected he is captured by the past. Ronald Reagan was no exception. Ostensibly the President was bringing about a big change in economic policy. Change itself is unsettling even if people are convinced that it is needed. Even very positive changes disrupt many relationships, cause uncertainty, and depreciate human capital. Big change can succeed only if the government shows confidence. But the President brought on board too many people who did not share his faith in his policies and who were not prepared to assume the risks of implementing them. As a result, internally the administration lacked confidence, and it was reflected publicly in many decisions, such as the one to delay the tax rate reductions in order to balance the budget. The Fed perceived this lack of confidence and moved to take control over economic policy.

The dead hand of the past overwhelmed many of the hopeful changes that Reagan intended for the economy. From the beginning the emphasis was shifted from hope to gloom, and from economic growth to balancing the budget with austerity. Republican economists like Alan Greenspan, Herbert Stein, and Arthur Burns were very negative about the President's economic program. They believed that if nothing was done to stimulate the economy, inflation might be gradually squeezed out as long as the budget was balanced. Greenspan did not lack allies in the administration and the Senate Budget Committee.

Before the new administration was a month old we were engulfed in such a gloomy atmosphere that a dreary forecast was labeled a "rosy scenario." Despite the restructuring of the tax code envisioned to improve saving and investment incentives, the real GNP growth projections in the February 1981 forecast were lower than the economy achieved in 1976, 1977, and 1978. They were significantly lower than the original forecasts of the Carter and Ford administrations. Yet the hyperbole flew fast and loose. In an editorial on March 9, 1981, the *Washington Post* charged that President Reagan's "scenario lies far beyond the limits of any past experience in this country or any other industrial democracy."

The inflation outlook was also gloomy due to the influence that core inflation had on Weidenbaum and Greenspan. According to the DRI model at the time, core inflation was 10 percent, which meant that monetary policy could do little. The conflict between the lower nominal GNP path based on the monetarists' assumptions about the growth rate of money and the higher inflation rate projections demanded by the core inflationists was resolved when David Stockman arbitrarily raised the nominal GNP path in order to project a balanced budget. This created the famous "velocity problem" (the projected GNP being too high for the projected money supply to support without a dramatic increase in velocity of circulation) and led to a chorus of criticism from Keynesian economists, who had never previously put any store in monetarist ruminations about velocity.

Had the traditional economists been blamed for insisting on core inflation and a balanced budget, much less damage would have been done to the credibility of the President's economic program. Instead the rumor was spread that the supply-siders were playing with the numbers in order to project real growth and lower inflation, an impossibility according to the Phillips curve. The effect was to spread the insidious belief that the President's program was unrealistic and based on nothing but an extremist ideology. Some administration

sources themselves fed this notion as part of their fight for power. All of these things undermined the confidence that is necessary for change to succeed and allowed the Fed to become the arbiter of economic policy.

The supply-side economists in the Treasury were prepared to accept deficits as the price of restructuring the tax code and bringing down inflation. We believed the deficits would be kept within reason by controlling the growth of government spending and that spending restraint and economic growth would eventually balance the budget. We were opposed to making a balanced budget the issue or goal of the economic program. We knew that if a balanced budget became the issue, traditional Republican economists would shift the focus of policy to austerity, which would worsen the performance of the economy and enlarge the constituencies for federal spending programs. Even if we could succeed in holding on to the President's program internally, we knew that once a balanced budget was the goal, the President would be at the mercy of the Congress and the Fed. The former could destroy him by spending and the latter with tight money.

In retrospect the Treasury was right. Once Stockman succeeded in making the deficit the issue, the old Republican strategy of trying to fix the budget prior to fixing the economy prevailed. First the tax cuts were delayed in the name of a balanced budget—while the Fed closed down the economy with tight money. The recession produced deficits, and the Republicans responded by raising taxes in the middle of a recession, repealing most of the incentives for business investment contained in the 1981 tax reduction. This was followed by more tax increases. Continued agitation for further tax increases has hovered over the Reagan presidency like a black cloud. Policy-makers and economists were soon making more grandiose predictions about the economic benefits of raising taxes than Art Laffer and Jude Wanniski had made for lowering taxes.

On the monetary policy front, so far, "stop-go" has prevailed over the Reagan administration's request for moderate, stable, and predictable growth in the money supply. Successful investing continues to depend on skill at guessing the Fed's behavior.

One might say that it is more important that inflation is down than how it came down, a point that might have some merit. But the confused and unexpected—indeed, accidental—way in which inflation was brought down imposed substantial economic and political costs that have been shifted to President Reagan and the new fiscal policy. Moreover, the implications of these costs are not yet fully known. The large budget deficits may yet lead to incentive-destroy-

ing tax increases or to a weakened national defense. Policymakers might respond inappropriately to the dollar's sharp recovery from the historic low to which it was driven by a decade of rising inflation. The political costs of the sudden erosion in the asset values underlying farm debt, for example, are yet to come in. The world debt crisis is not yet over, and the implications of the enlarged role of the International Monetary Fund in the international financial system are not yet clearly visible.

### Making the Fed More Accountable

Disagreement among economists, disunity in administrations, and political competition all work to enhance the Fed's discretionary power. The policy situation can be improved, and the Fed's integrity enhanced, with some small changes that will help to make the Fed more accountable. The Treasury secretary could be reinstated as a member of the open market committee. That would allow the administration to have knowledge of what the Fed was doing, and it would provide occasions for the Fed to listen to what the administration was saying. The terms of the members of the Fed's Board of Governors could be reduced from 14 to 7 years to increase turnover and the infusion of fresh ideas. It might also be helpful if some things were done to reduce the secrecy with which the Fed conducts its operations. For example, policy changes might be announced immediately.

None of these suggestions will provide a panacea. Conventional wisdom will always be flawed and this, together with the general political competition between parties, within parties, and among economists themselves, will always create a fertile environment for the discretionary exercise of power. As long as governments are making policy, there will be inescapable dangers.

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