Personal Reflections on Allan Meltzer and Monetary Policy

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It is my great pleasure to have the opportunity this morning to say a few words about the influence of Allan Meltzer's research on monetary policy, and the influence that Allan has had on me personally. I met Allan at a Carnegie-Rochester policy conference at the start of my career shortly after Paul Volcker announced the Fed's intention to take responsibility for the high inflation and bring it down. The Volcker Fed took responsibility for bringing inflation down by emphasizing that the Fed would reduce the growth of the money supply. Allan's influence on the Fed and on my research was born with that Fed commitment to monetary control.

In effect, the Fed put into practice the core monetarist idea developed by Allan, Karl Brunner, and Milton Friedman, among others--that inflation can and should be controlled with monetary policy. This core monetarist idea seems so obvious today that it is impossible to appreciate how controversial it was before the Fed demonstrated its value in practice.[2] Likewise, it is difficult to appreciate how hard Allan and the other leading monetarists worked to develop and promote the idea. I am old enough to remember. Allan and his monetarist colleagues deserve much of the credit for putting monetary policy on the right track.

Allan and Karl regularly invited Fed economists to their Carnegie-Rochester policy conferences to find out what the Fed was doing. In exchange for an "inside" understanding of the Fed, we acquired a first-hand appreciation of the academic approach to policy analysis and met some of the most skilled macroeconomists in the world.

The topics and papers that Allan and Karl chose for their conferences were always interesting and provocative. But the quality of the general discussions following the presentations made the conferences really special. Allan and Karl took the lead in this and set the example. I remember very well Allan's style and substance. Allan made powerful points about policy using a blend of economic theory, institutional knowledge, knowledge of economic history and data, and an understanding of political economy. He made his points with passion and conviction. I could tell that economic policy really mattered for Allan. This wasn't cool dispassionate debate that I had seen in graduate school. In Allan, Karl, and other participants at the Carnegie-Rochester conferences I found a model for my own professional development.

My path and Allan's crossed time and again over the years in both the physical and the research dimensions. Whenever possible, I sought Allan as a companion for a conference meal. I would talk with him about the latest Fed policy issues and get his take

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[2] See Goodfriend (1997).

on them. Our conversations ranged widely. Although I never had Allan as a teacher in a classroom, he became one of my mentors by conversation and example.

Our research paths first crossed with regard to the role of borrowed reserve targeting in the Fed's "new monetary control procedures" at the heart of the so-called "monetarist experiment" in the early 1980s. I wrote a paper modeling bank borrowing at the Fed discount window as a dynamic decision problem under rational expectations, pointing out that borrowed reserve targeting amounts to noisy federal funds rate targeting.[3] That research made clear that the new monetary control procedures did not follow monetarist recommendations for controlling money growth. The implication is that while monetarist ideas were tried and proven strategically in the fight against inflation, monetarist ideas were never tried tactically. In other words, there was no monetarist experiment in an operational sense.

Around that time I learned of Allan and Karl's path-breaking 1964 congressional study *The Federal Reserve's Attachment to the Free Reserves Concept*.[4] Since free reserves are excess reserves minus borrowed reserves, borrowed reserve targeting is closely related to free reserve targeting. In their study Allan and Karl showed that free reserve targeting was noisy interest rate targeting. They pointed out that using the interest rate as the policy instrument compromised monetary control. In effect, their work predated my findings about borrowed reserve targeting by 20 years!

In the mid-1980s Allan and Alex Cukierman published their famous *Econometrica* paper "A Theory of Ambiguity, Credibility, and Inflation Under Discretion and Asymmetric Information."[5] I published a paper about secrecy and central banking at about the same time.[6] Our research paths intersected in two senses in this case. We explored the theoretical rationale for secrecy; and we sought to understand the political-economy motive for secrecy in monetary policy. Research on the optimal degree of transparency in monetary policy has proliferated in recent years and the paper by Cukierman and Meltzer has become a classic reference in the literature.

Central bankers naturally prefer to facilitate the functioning of the market economy with as little direct interference in private decision-making as possible. Until the 1990s the presumption was that operating behind the scenes with deliberate ambiguity or secrecy was the best way to do so.

More recently central bankers have come to appreciate the value of transparency in monetary policy. The foundation for that shift was laid by the above-mentioned research on secrecy and ambiguity. The shift was also facilitated by a two-fold recognition: that efficient monetary policy requires a credible commitment to low inflation, and that transparency rather than secrecy is the best way to secure the credibility of that commitment.

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[3] Goodfriend (1983).
[4] Brunner and Meltzer (1964).
[5] Cukierman and Meltzer (1986).
[6] Goodfriend (1986).

In keeping with that trend and in line with monetarist thinking, Allan has expressed a preference for some form of inflation target as the primary objective for monetary policy.[7] Allan must be pleased that the Fed has in recent years put a particularly high priority on low inflation. However, the US has not adopted explicit inflation targeting procedures and the transparency to go with them, as Allan would like. Our paths crossed once more when, in a recent paper, I made the case that the US should adopt inflation targeting more formally.[8]

As a final example, the ideas about monetary policy transmission worked out long ago by monetarists Allan, Karl, and Milton provide inspiration and guidance for thinking about overcoming the zero bound on interest rate policy. See Allan's review and exposition of the monetarist transmission mechanism in his well-known 1995 *Journal of Economic Perspectives* paper.[9]

The relevance of monetarist thinking for the zero bound problem is this. The monetarist transmission mechanism emphasizes that the public responds to an injection of monetary liquidity by using that liquidity to purchase a variety of other assets. Portfolio rebalancing causes asset prices to rise. The rise in asset prices, in turn, stimulates production and employment and ultimately causes the price level to rise. Since the monetarist transmission mechanism does not depend exclusively on the interest rate channel, it continues to operate at the zero bound.

Monetarist reasoning suggests that monetary policy has the power to act against deflation at the zero bound in Japan, or elsewhere, if the central bank expands the monetary base aggressively by buying assets other than short-term securities, or by financing government transfers. At some level the monetarist view of the transmission mechanism must by correct. Otherwise, by simply printing money the government could acquire an enormous quantity of real goods or assets at essentially zero cost without causing inflation.

In a paper on overcoming the zero bound on interest rate policy I concluded that the risk of deflation stems as much from institutional policy paralysis as it does from a failure to understand that deflation can be fought decisively at the zero bound with monetary policy along monetarist lines.[10] By focusing on institutions and political economy in understanding the deflation threat, I drew on another lesson from Allan's research: in order to understand and improve institutions and policies, one must understand how they are shaped by the underlying political economy. Allan put this lesson into practice on numerous occasions, most recently as leader in the production of the *Report of the International Financial Institution Advisory Commission* for the US Congress, which reconsidered the role of the International Monetary Fund and the World Bank.[11]

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[7] See McCallum (1998), pp. 258-9.
[8] Goodfriend (2003).
[9] Meltzer (1995).
[10] Goodfriend (2000).
[11] Meltzer (2002).

With short-term nominal interest rates already zero in Japan and near zero in the US and elsewhere, the problem of how to deal with a deflation threat at the zero bound is one of the most pressing monetary policy issues of the day. In my opinion, the solution will involve integrating the monetarist and the political economy perspectives on monetary policy pioneered by Allan along the lines sketched in my zero bound paper. Of course, Allan has been making much the same point for a few years already![12]

[12] See, for instance, Meltzer (2001).

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