

## **That '70s Show**

By Allan H. Meltzer  
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Is the Federal Reserve an independent monetary authority or a handmaiden beholden to political and market players? Has it reverted to its mistaken behavior in the 1970s? Recent actions and public commitments, including Fed Chairman Ben Bernanke's testimony to Congress yesterday--where he warned of a steeper decline and suggested that more rate cuts lie ahead--leave little doubt on both counts.

An independent central bank is supposed to maintain the value of the currency and prevent inflation. In the 1970s and again now, Federal Reserve officials repeatedly promised themselves and each other that they would lower inflation. But as soon as the unemployment rate ticked up a bit, the promises were forgotten.

People soon recognized that avoiding possible recession overwhelmed any concern about inflation. Many concluded that inflation would increase over time and that the Fed would do little more than talk. Prices and wages fell very little in recessions. The result was inflation and stagnant growth: stagflation.

It's beginning to happen again. Unlike the response of wages and prices in the low inflation 1990s, expectations of rising inflation now delay or stop price and wage adjustment, inhibiting growth.

One lesson of the inflationary 1970s: A country that will not accept the possibility of a small recession will end up having a big one when the politicians at last respond to the public's complaints about inflation. Instead of paying the relatively small cost of a possible recession, the public pays the much larger cost of sustained inflation and a deeper recession. And enduring the deeper recession is the only way to convince the public that the Fed has at last decided to slow inflation.

Economic forecasts are not very accurate; still, the International Monetary Fund, the Congressional Budget Office and even the Federal Reserve do not forecast recession in 2008. The Fed thinks that the unemployment rate may rise to 5.3%, below the postwar average. In any event, it cannot do much to change economic activity or unemployment experienced in the next few months, and the Fed anticipates stronger growth in the second half of the year. Why the haste to cut interest rates drastically?

The freezing up of short-term financial markets called for more borrowing. The Fed's response was creative and correct. It recognized that its responsibility as lender of last resort required bold action to maintain the payments system; and it delivered.

But the rush to bring real short-term interest rates to negative values is an unseemly and dangerous response to pressures from Wall Street, Congress and the administration. The Federal

Reserve became "independent" in 1913 so that it could resist pressures of that kind. And in the postwar years, although it often failed to do so, it was expected to safeguard the purchasing power of our money and maintain economic growth.

For Wall Street, the pressure for lower interest rates is based on a hope that bond and mortgage yields will decline and their losses will be limited. Often long-term rates fall when the Fed lowers short-term rates--and since bond and mortgage prices rise when their rates fall, the losses of investors in these instruments will be reduced. For Congress and the administration, there is a need to show "concern" by doing something in an election year. These are not the concerns that should influence an independent central bank.

Surely Mr. Bernanke and his colleagues remember what happened in the 1970s. They console themselves with the belief that they will respond to any inflation that occurs by promptly raising interest rates. That repeats the commitments made repeatedly in the 1970s, which the Fed was unwilling to keep. The blunt fact is that there is rarely a popular time to raise interest rates. And with the growing streak of populism in the country, it will become more difficult.

The Fed's recent behavior is in sharp contrast to the European Central Bank. The ECB keeps its eye on both objectives, growth and low inflation. It doesn't shift back and forth from one to the other. The Fed should do the same. In the 1970s, because the Fed shifted from one goal to the other and back again, it achieved neither. Both inflation and unemployment rose on average, then fell together in the 1980s--after the Fed controlled inflation.

After 1985, Fed policy kept inflation and unemployment low. The result was 20 years of growth, and three of the longest peacetime expansions punctuated by short recessions.

We should not throw this policy away. Federal Reserve independence is a valuable right which should not be discarded. The Fed should insist on its obligation to prevent inflation and sustain growth, not sacrificing inflation to lower unemployment before the election.

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