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Keep Political Hands Off the Fed

by Robert J. Barro

Treasury Secretary Nicholas Brady has been complaining that the money supply is not growing fast enough to spur the economy. He thinks that matters would improve if a proposal like Rep. Lee Hamilton's were adopted to make the Federal Reserve less independent of the government. The Treasury secretary must believe that the government's policies have been so successful in other areas – taxes, spending, regulation – that it would be useful to extend this expertise to monetary policy.

Mr. Brady's complaint is especially odd because the Federal Reserve has been a source of sound policies for an administration whose ideas about the economy seem mainly to be confused. The hallmark of an effective monetary policy is price stability. The Fed has to avoid the kind of high and erratic inflation and interest rates that characterized the pre-Volcker/Carter administration, but it also cannot allow the sort of deflation that occurred during the Great Depression of the 1930s.

From this perspective, the recent results on inflation and interest rates – and, hence, on monetary policy – have been excellent. The inflation rate (based on the GDP deflator) was about 4% in 1989, rose only slightly despite the disturbances from the Gulf War in late 1990 and early 1991, and has since fallen to a fairly narrow band around 3%. The credibility of monetary policy can be gauged by the behavior of long-term nominal interest rates. Although long-term rates remain well above short-term rates, the yields of U.S. Treasury securities with a 10-year maturity have declined from 8 1/2% in 1989 to 6 1/2% today. Thus, the financial markets anticipate that low inflation will persist for a long time.

The behavior of monetary aggregates is, as usual, more difficult to interpret. The magnitude that the Fed controls directly, the monetary base, grew at 9% per year since the beginning of 1992 and has recently been expanding at a 7% to 8% rate. The conventional measure of the money stock, M1, has risen at a 12% annual rate since the start of the year, but only at an 8% rate over the last three months. The broader aggregate, M2 – the target of Mr. Brady's attack – increased in 1992 at only a 0.5% annual rate and has declined since March.

The recent fall in M2 reflects a sharp decrease in time deposits held at depository institutions. This behavior is symptomatic of the slow growth in the economy, especially of the reduced volume of commercial loans. The operative term here is symptomatic. The sharp decline in the real demand for M2 because of the sluggish economy means that the nominal quantity of M2 had to fall if the Federal Reserve maintained its policy of price stability. The only way to have achieved a rise in nominal M2 would have been to increase the monetary base at an even faster rate than 7% to 8% per year. Such an expansionary monetary policy would have caused a run-up in inflation and nominal interest rates. Moreover, there is no indication that it would have helped the real economy, even in the short run.

Mr. Brady is probably correct that the Federal Reserve would have carried out a more aggressive monetary policy if it were more dependent on the government. Studies of the major developed countries during the post-World War II period show that a less independent central bank tends to deliver higher and more variable inflation. (For a summary of the evidence, see a forthcoming article by Alberto

Alesina and Lawrence Summers in the Journal of Money, Credit, and Banking, from which the accompanying chart is drawn.) (See accompanying illustration -- WSJ Aug. 26, 1992.) For example, between 1955 and 1988, Switzerland and Germany had the most independent central banks and had average inflation rates of 3.2% and 3.0%, respectively, whereas New Zealand, Spain and Italy had the least independent central banks and had average inflation rates of 7.6%, 8.5%, and 7.3%.

These results make sense because a less independent central bank is more subject to political pressures to inflate the economy in response to a recession. This kind of inflation tends to stimulate the economy (if it does at all) only when it exceeds the inflation that the economy has gotten used to -- that is, expected inflation. The politically dependent central bank therefore tries to set inflation systematically above expected inflation, an objective that violates Abraham Lincoln's famous dictum about the possibilities for fooling people and that leads on average to a high rate of inflation.

The higher and more variable inflation associated with government-dependent central banks might be worthwhile if it led to better real outcomes. But the degree of bank independence turns out to be unrelated to the average growth rate of real GNP and the average unemployment rate. There is, in fact, some evidence that a more independent central bank and a consequent lower average rate of inflation lead in the long run to a higher level of output. Thus, the kind of "reform" that Mr. Brady and Mr. Hamilton have in mind would be predicted to cause higher and more variable inflation and a loss of real output in the long run.

The U.S. is lucky to have a chairman of the Federal Reserve, Alan Greenspan, who has a good understanding of the economy and is able to maintain a sound monetary policy despite political pressure from a beleaguered administration.

One has to wonder why we cannot have a Treasury secretary with the same level of economic expertise. The standard set by the first Treasury secretary, Alexander Hamilton, may be too much to expect, but why must we have a secretary who thinks, as he himself put it, that the way to assess the economy's performance is not to look at data but to ask a few average citizens how things are going?

Some countries that have undergone successful economic reforms in recent years have found that a capable finance minister with a background in economics and a staff of skilled economists can make a big difference. An example is Sergio De Castro, a Chicago Ph.D. in economics, who led a team that implemented an array of free-market reforms in Chile from 1975 to 1982. The current relative prosperity in Chile derives from the structural changes that Mr. De Castro put into place over a decade ago.

Similarly, Mexico's successful privatizations owe a great deal to the finance minister, Pedro Aspe, a Ph.D. from M.I.T. In Argentina, the stabilization and the beginnings of free-market policies are the ideas of the finance minister, Domingo Cavallo, an economics Ph.D. from Harvard.

Basically, the leading U.S. universities have been doing a great job of producing economists who successfully run other economies. The U.S. government could also benefit from this resource – for example, by choosing an economist, rather than a lawyer or a banker, as the next secretary of the Treasury. But then again, some economists are better than others.

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The Freer the Bank, the Lower the Inflation

Average inflation rate vs. relative independence of major central banks; 0.5 represents the greatest government control.