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MONETARY POLICY IN THE NEW WORLD ORDER

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Summary

This paper presents a comprehensive progressive reform for the present structure of monetary policymaking.

The program has three points of departure. First, it recognizes that monetary policy cannot be responsible both for price stability and for economic growth. Second, it holds that such policy must now be made in a global context. And third, it argues that institutional reforms intended to make the Federal Reserve more accountable and more democratic should be designed to support the necessary transformation in the way that monetary policy is made.

The fact of global context makes impossible the conservative dream of a monetary policy aimed at price stability alone. It also complicates the populist vision of an easy fix with easy money. It makes necessary a comprehensive program, including low and stable interest rates as part of a strategy for growth, public investment, industrial competitiveness, and export development.

The elements of comprehensive progressive reform may be summarized as follows:

1. Lower interest rates. Chairman Alan Greenspan has delivered cut after cut in the discount rate, but long-term rates remain high. Why? In part because Greenspan and his Board cannot credibly pre-commit to low short-term rates next year. For political and economic reasons, the markets evidently do not trust the Federal Reserve to keep interest rates down. The solution to this problem probably requires a regime change, to establish a clear commitment to stable, low interest rates. As in 1979, a regime change would have to include a new Chairman.

2. A middle class tax cut offset by phased-in higher taxes on the rich. It makes good sense to convert the personal exemption for children to an $800 refundable child care credit (Downey-Gore). But the macroeconomic effects of this will be modest, and it would be disastrous to dissipate the peace dividend in tax cuts. Revenues should therefore be recovered beginning in 1994 with new tax brackets hitting the top 1 percent of income earners.

3. *A global growth policy.* The only way to sustain recovery over the medium term is with strong export demand. Begin with a competitive exchange rate. Send technical assistance, food, and other support to the Soviet Union and Eastern Europe. Use regulatory pressure to cancel Latin commercial bank debts. Move forward on trade agreements with Mexico and Latin America emphasizing labor rights and environmental standards in exchange for market access and financial help. Global growth is a good investment, and it is also the best industrial policy our advanced, high-wage industries can hope for.

4. *Military reductions.* The military should be cut in half. Obvious measures include getting rid of Seawolf, SDI, the rest of Stealth, nuclear testing, excess land-based missiles, and troops in Europe. Most of all, Congress should cut the force structure. We can save $150-odd billion per year in the long run, of which two-thirds might be directed to civilian investments as outlined below.

5. *Invest the peace dividend.* There is a vast agenda of productive measures affecting the supply side, into which this paper does not enter in detail. These include enacting an infrastructure program for states and localities, including immediate measures to forestall ongoing cuts in public capital expenditures. Developing comprehensive health insurance. Getting to work on school reform. Supporting universities and Pell Grants. Transfering advanced technology research and development from the military to a civilian agency and shifting the emphasis toward civilian needs. Expanding environmental and occupational protections, emphasizing new technologies. Such measures should be set up as permanent increases in public investment, NOT as temporary or counter-cyclical measures that might disappear in a year or two. And for this purpose Congress should break the budget agreement: $75 billion per year for all this initially is not too much, and the total rate of investment could rise to $100 billion per year as military spending declines, leaving $50 billion for net tax cuts or deficit reduction.

6. In *an environment of low interest rates, high public and* private capital formation *and export-led growth, there will be a much stronger need for regulatory and political measures to restrain both financial speculation and wage-price inflation.* American political leadership should face up to this reality, and begin now to design stabilization policies that work. Mercifully, the inflation danger is presently controlled by recession and low-wage import competition, and there will be time to develop alternatives to these instruments once a recovery is underway.

The End of the Volcker Era

Headlines since last September tell of a Federal Reserve gripped by anxiety and perhaps increasingly by desperation. The recovery has no strength, inflation is dormant, fiscal policy remains paralyzed, and there has been neither any alternative to lowering interest rates nor any excuse for not doing so. As a result, the Federal Reserve is again pushing on its string, and the discount rate is at its lowest point in twenty-seven years. Alan Greenspan, the prudent epigone, seems hell-bent on easy money.

It is also now twelve years since Paul Volcker launched a policy intended to make efforts of this sort unnecessary for all time. That “October Surprise,” perhaps even more than the other one, ruined the Democratic Party. It led immediately to Carter’s defeat, and after another deep but well-timed recession in 1981-82, to the strong, noninflationary recovery that Reagan rode to political triumph in 1984. But it did not achieve the longer term goals of steady noninflationary growth claimed for it, or we would not be facing the present recession. It is a good time to recognize this, and to draw the conclusion that the strategy of monetary policy must now be changed.

Volcker was never accused of a political motivation,’ not even by William Greider.[2] To the contrary, most observers took him at his word then and would still do so, crediting the broad purposes of the policy as he expressed them. These were to drive down the rate of inflation and in so doing to eliminate expectations of inflation from the system. With expectations tamed, the theory went, monetary policy would create conditions in which sustained growth without renewed inflation would become possible. Volcker set out, in a word, to cure the American economy of instability. If a recession and temporary high unemployment were necessary for this end (and Volcker never joined the enthusiasts who denied this), then defenders of the policy argued that the pain would be justified by the results over the long term.

As late as 1986 or 1987, one might have believed that the policy was a success. Inflation did fall, and did not return with recovery to as much as half of its former peak. U.S. economic performance was good both by comparison with our own recent history and in international perspective. True, Europe (for its own reasons) remained unusually stagnant, and, true, Latin America was in crisis, so that the comparisons were perhaps rigged in America's favor. But the United States had apparently reconciled real economic growth rates averaging about 4 percent per year with stable inflation of about the same amount. We had also reduced unemployment from 11 to 7 percent, creating thirteen million new jobs. Eventually the expansion became the longest on the postwar record, a fact that Administration and Federal Reserve supporters cited repeatedly from that point forward.

But could it continue? Had inflation truly been driven out of the system? Or were the gains merely temporary, provisional, an interim of stability at the price of chaos later on? This was the critical and a most difficult question. Still, two arguments could have been made against Volcker's chances even while the experiment was underway, and one of them was. As it happened, the argument that was made was not correct, while the argument that was correct was not widely made.

The Twin Deficit Scare

The budget deficit became the rallying cry for most of those who argued that the Reagan/Volcker policies were a road to perdition. There was something awesome about the sheer size of deficits three times larger, in dollar terms, than ever before. Investment bankers, Democratic politicians, foreign central bankers, and business journalists formed a Greek chorus on the irresponsibility of it all, and warned sternly of the need to cut "entitlements" -- a code word for Social Security -- or to raise taxes in order to avoid national financial ruin. This argument also had the property that it exempted the Federal Reserve itself from responsibility for any eventual debacle -- overlooking the fact that interest on the public debt, an item not insensitive to high interest rates, was the fastest growing element of expenditure, and the fact that tight monetary policy had a dramatic effect on private incomes and tax collections. For this reason, the budget argument drew sanction and respectability from Volcker himself, for whom it could serve as an escape valve if (when) things went wrong.

Curiously, the academic economics profession did not entirely join this chorus? Indeed, economists from widely divergent parts of the political spectrum -- from Robert

Barro on the right to Robert Eisner on the left[4] -- produced skeptical analyses of the accuracy and relevance of deficit worries. True, the dollar figure was quite enormous. But in relation to GNP the national debt was still smaller than it had been in 1960. The trade deficit was also enormous. But in an international financial perspective the American balance sheet continued to look respectable; we incurred vast losses in the early 1980s but still had a vast portfolio of foreign holdings to offset against them. And by all measures the deficit fell in importance as the decade wore on, while the national debt stabilized in relation to GNP. Many had cried wolf, but as the supply-sider Alan Reynolds recently observed, "there was only a Chihuahua at the door."[5]

Inflation, Imports, and the Business Cycle

A better argument could have been found in the pattern of the American business cycle itself. In each business expansion of the 1960s and 1970s the early years were the best years, It was always the case that in the immediate aftermath of a recession, investment picked up, productivity rebounded, a still-soft labor market held back money wage demands, and the combination of these conditions generated noninflationary growth -- for a time. But it was also always the case that these conditions did not last. Each recent business cycle expansion came to an end amid slowing productivity and rising infla tion.[6]

Thus one could have argued that Volcker's experiment was really no experiment at all, but only a harsh repeat of experiences initiated by William McChesney Martin in the mini-crunch of 1967, and developed to an art form by Arthur F. Burns, prime mover behind the recession of 1974. Certainly, in the wake of recessions there would be a simulacrum of stable growth without inflation, for a time. But no amount of favorable early-expansion performance could prove that instability had actually been conquered. Given time, instability, a slowdown in productivity and real output, and rising inflation would return, and all the rhetoric about "conquering inflation expectations" and achieving a "stable, noninflationary long-run growth path" would be proven hollow.

This argument was not widely made, and the reasons go beyond the fact that, unlike the "twin deficit" argument, this one drew no support (and protective cover) from the Federal Reserve. First, its truth was not completely evident at the time. There *had* been a change of circumstances, which worked to stall the rise in inflation and so prolong the growth phase relative to that in previous cycles. This was the fact that rising trade in manufactured goods was splitting apart the wage structure. As trade, especially with the

Third World, expanded after 1980, cost competition held down wage increases across a wide spectrum of industries--in particular labor and materials-intensive sectors from textiles to cars--and prevented wage increases in the most successful sectors from spreading to less successful ones and driving up prices.'

Unfortunately, and unlike the advertised "reduction in inflation expectations" which was given the credit, the phenomenon of low-wage imports was not costless. It cost many people their jobs. And it tended to substitute a large trade deficit for rising inflation as the primary symptom of macroeconomic instability. In the policy arena trade issues -- protectionism -- tended to crowd out discussion of inflation. But it nevertheless remained true that when policy moved to reduce the trade deficit, as it did successfully with dollar depreciation in 1988-89, a rising rate of inflation would follow.

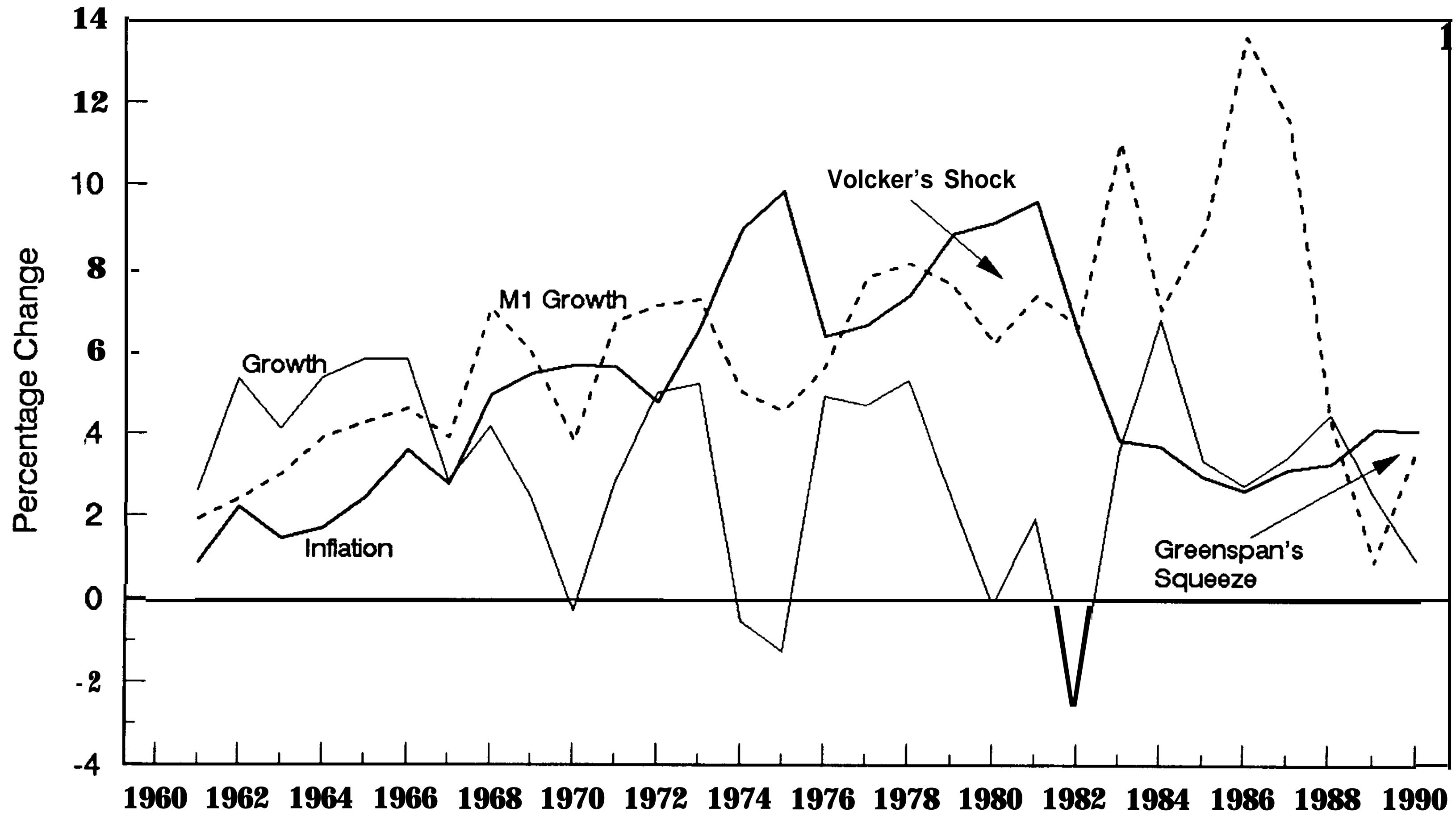
Second, for reasons of their own, opponents of the Reagan-Bush-Volcker policies did not generally find the history-will-repeat-itself argument appealing. Their psychology is understandable. It had been, after all, the failure of Democrats in the face of an end-of-cycle productivity/inflation crisis in 1979 that had brought Volcker to the Federal Reserve and Reagan to the Presidency in the first place. To call attention to the fact that nothing fundamental had really changed would only have called attention to the fact that the Democrats were still unprepared to cope with this type of crisis.

Paul Volcker seems to have suspected the truth of the matter, for he resigned in the summer of 1987, "the man," as I wrote then, "who got out in the nick of time."' And thus it was that Alan Greenspan, the man who wanted in the worst way to be a central banker, got his wish. The economy at the moment of his appointment was not yet in crisis, and so he could hardly have called for a state of emergency and the draconian measures on which central bankers build their legends. (Anyway, both politics and the Volcker myth would have blocked such a course.) But nor could Greenspan hope to sustain a noninflationary expansion through the whole of his term in office. Greenspan was fated to preside over a slow destabilization, and in such a way that he would himself be blamed for it by many people (including, not least, a scapegoat-hunting administration) when "it" happened. His only choice was between a recession before an inflation crisis, or after.

Greenspan's Choice

Figure 1 illustrates all of the above developments, and makes clear Greenspan's choice. This was to slow the economy, raising interest rates and constricting the growth of

Figure 1
Economic and Monetary Conditions,
1960-1990



Note: As a rule of thumb, MI growth less than the inflation rate indicates tight policy.

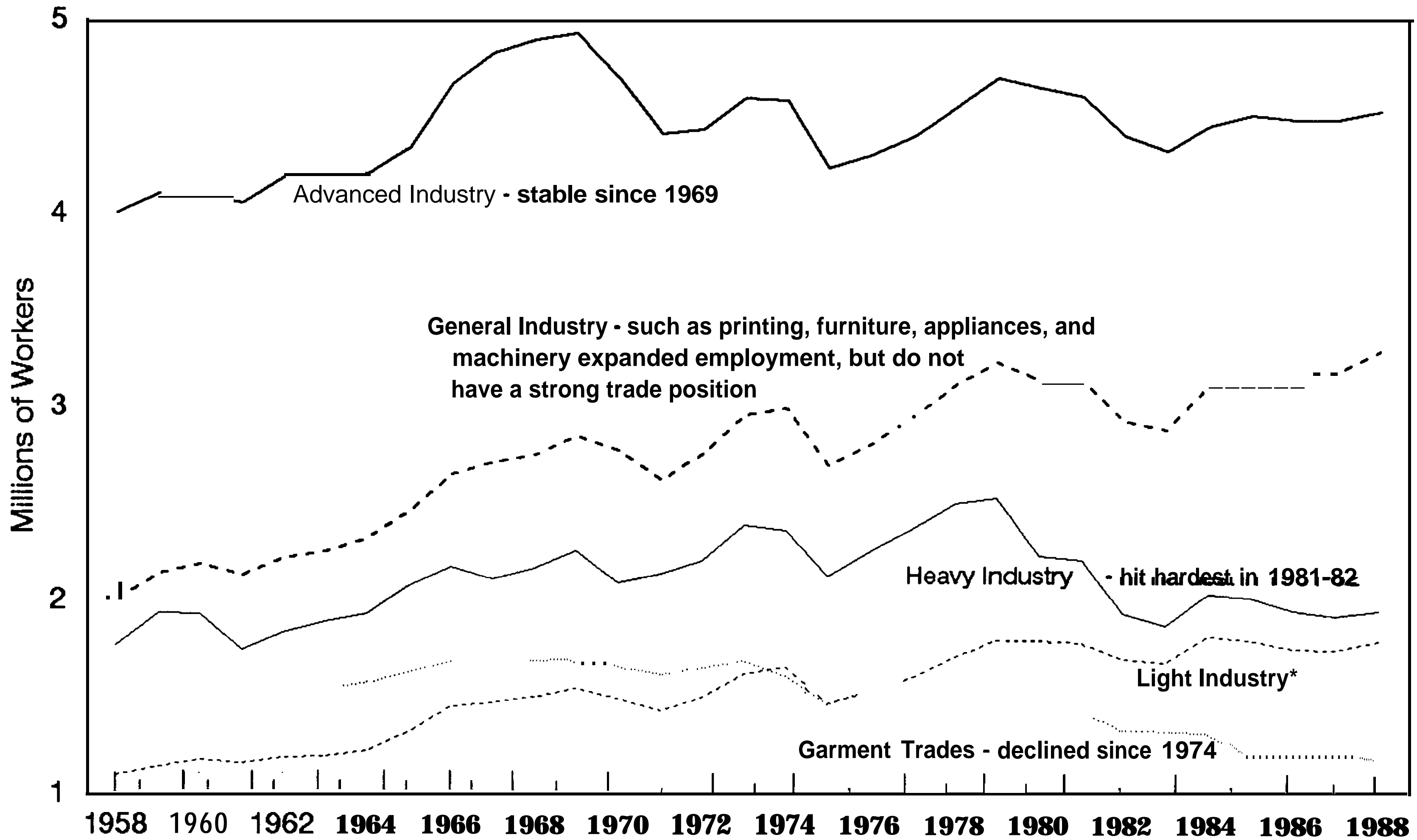
money, holding the rise of inflation in check. Step by step, from 1987 onward, the screws tightened and the growth rate fell. By 1989, real growth was less than the growth of population, and the economy was stagnant. By mid-1990 stagnation had turned into recession, and by late 1991 hopes for recovery, once quite strong, were actually fading. The inflation crisis would not happen; growth would be choked off before it could.

As for the present situation, three things seem clear. First, the Federal Reserve has seemed mainly interested in generating enough of a recovery by the summer of 1992, in which case economic conditions may yet not impede George Bush's re-election. Second, through most of 1991 not much of a boost to recovery seemed required, and so the pace of' falling short-term interest rates remained quite gradual, up to the Christmas cut in the discount rate. Third, markets have been convinced that short-term interest rates will rise again just as soon as recovery is underway and low short-term interest rates are no longer needed. For this reason, no one has been lending long money at low interest rates, and while long bond rates have declined somewhat, they seem to jump back upwards, as they did in early January, at the slightest hint of economic improvement.

More broadly, the recession of 1990-91 punctures the myth that sustained stable growth without inflation can be achieved by macroeconomic policy and *laissez-faire* alone. If the recession is not too deep, and if it ends soon, then the acceleration of inflation will probably resume from its recent base rate of 5 to 6 percent -- as happened following the previous turn-of-the-decade mild recessions in 1960, 1970, and 1980. If on the other hand the recession proves deep and prolonged, we may yet eventually see a noninflationary recovery for a time -- but not permanently and at the price of prolonged and serious suffering before we get there.

It is also clear that while this pattern of policy behavior occasionally produces good "years" of high growth rates and low inflation (as it did in 1972 and 1984 for obvious reasons), it is destructive to the financial and industrial stability of the country. It can be shown, in particular Figure 2, that each recession since 1970 has laid waste to a particular swath of industry, which did not recover thereafter. The 1974 recession fell hardest on apparel and textiles, and that of the 1980s on capital-intensive heavy industries, particularly automobiles and its satellites, including the engine, turbine, and heavy equipment sectors. While other industries expanded to fill the gaps, it is clear from the trade deficit that the most competitive industries did not expand enough. And in another deep recession, such as is surely being prepared for the mid-1990s, even the advanced

Figure 2
Recessions and Industry Employment, 1958-I 988



* Note: Import-competing light industry gained employment due to strong consumer product demand.

manufactures might fall victim as well. Moreover, there is something extraordinarily wasteful about a system of economic management that leaves large sectors in machine-building and construction idle for extended periods of time, and that routinely throws older workers onto the displaced-persons scrap-heap while they are still productive. Other advanced nations avoid both forms of waste, and for this reason alone their competitive strides in relation to us should not be surprising.

Strategies for Reform

And so, reform might indeed be useful. Suppose we could plan our economic policymaking system anew. Might we not prefer one that was less disruptive, that destroyed fewer lives and livelihoods, that maintained a higher average standard of living, that was not so readily abused by politicians?

The question is, How to Get There? I shall explore four basic possibilities that have been advanced by reformers of differing stripes. While not exhausting the possibilities for reform, these cover the main positions, and share the characteristic that all begin with major changes in the mandate and/or structure of the Federal Reserve.

1. Assign to the Federal Reserve the sole responsibility of stopping inflation, and create an institutional structure that will permit it to pursue this objective without political hindrance. (The zero inflation option.)

2. Assign to the Federal Reserve the responsibility for maintaining low interest rates, and recreate the mechanisms that would insulate the pursuit of this objective from pressures in the financial markets. (The low interest rate option.)

3. Preserve the Federal Reserve's existing policy mandate, but bring Federal Reserve decision-making into even better coordination with that of the Administration, so that the political interdependence of the two is explicit and unmistakable. (The *accountability* option.)

4. Recreate a new system of economic signals and, where necessary, incomes policies or controls, so as to make possible the reconciliation of stable growth and low inflation, while at the same time supporting trade balance through rapid growth of world markets for American goods. (The comprehensive option.)

In my view, the first option, though it recognizes part of the actual problem, would lead in practice to economic disaster. The second and third are both desirable on many grounds, but the second is not sustainable on its own, and the third, while it would surely

improve our politics, cannot be relied on to produce improved economic performance on its own. My case for the fourth option is therefore quite simple: it might work, though it is surely the most difficult politically of them all.

Zero Inflation?

The idea that the Central Bank should have a clear mandate to fight inflation and inflation alone passes these days for a "new intellectualism" at the Federal Reserve Board, among certain journalists, and in one obscure corner of Capitol Hill. It is in fact the political expression of some by-now old and quite familiar academic ideas, lofted under the banner of the "New Classical Economics" in the mid-1970s. These have been picked up by Federal Reserve Governor Wayne Angell, and expressed in a proposed statute by Representative Steve Neal (D-NC), a Congressman who seems never to have escaped the thrall of my old friend from the congressional staff, the late proselytizing monetarist Robert Weintraub. The zero-inflation option also has the *pro forma* endorsement of Chairman Greenspan, whose enthusiasm for it, however, appears from press reports to be thoroughly under control.

Presently, of course, the Federal Reserve operates under the legal mandate of the Employment Act of 1946, as amended and supposedly strengthened by the Humphrey-Hawkins Full Employment and Balanced Growth Act of 1978. It is therefore legally part of a structure of policymaking that is aimed at a variety of goals, of which full employment is the central one, and reasonable price stability a second. In practice, moreover, the Federal Reserve responds to a range of goals, including some non-statutory ones such as the stability of the dollar exchange rate, and changes its primary focus according to the pressures of circumstance. A zero-inflation standard would eliminate all pressures of circumstance, including (its one merit) the pressure of regressive politicians seeking reelection.

Advocates of a zero-inflation standard would, if serious, have to change both the legal and the political environment in which the Federal Reserve operates. In principle, the legal changes could be done with the stroke of a pen. The willingness to do so presupposes, however, that Congress would be willing to abandon an official employment objective, or that Congress would assign achievement of that objective to some other institutional entity -- such as, for example, the President himself.

A formal repeal of the full employment policy objective seems unlikely, not least because conservatives are smart enough to know that they need not go that far. They could happily settle for a "compromise," according to which the Federal Reserve would receive its unambiguous anti-inflation mandate, while the goal of full employment would become the purview of the Executive Branch. Since the Executive would also be constrained by Gramm-Rudman-like laws aimed at a balanced budget, both fiscal and monetary policy would then be immobilized. "Full employment policy" would devolve in practice to a Labor Department concerned mainly with "making labor markets work better." The practical result would be that any existing unemployment rate would be redefined as within a fraction of the "Natural Rate," and apart from minor expenditures on labor exchanges the government would be quit of the matter.

Progressives take note: this is not as far-fetched as it seems. It is the logical implication of accepting, as many conservatives do, the New Classical vision of labor markets and inflation policy. And in practice it might not lead to a terribly high measured unemployment rate. As our economy becomes less and less industrial, it is easier and easier to find jobs -- just as it was easy sixty years ago to find a "job" back on the farm. The problem lies in the increasingly bad quality and low pay and unproductive character of the available work. If we have a nonindustrial problem of underemployment, the "full employment" criterion might in the end prove to be one that conservative policymakers turn to their advantage?

How would a zero-inflation world turn out in practice? Getting there would be half the fun. Since the 1981-82 recession -- viewed in long perspective -- accomplished only half the job, we would need to have another, reasonably soon. This would, with luck, eliminate the remaining market power of workers, by hitting hard (through a sharp appreciation in the dollar) at the remaining sectors where American industrial workers continue to enjoy a competitive advantage on world markets, such as aerospace, communications, food processing, chemicals, pharmaceuticals, and advanced industrial equipment. Labor markets would be made "competitive" by the simple device of crippling the industries that presently are "competitive" -- in the other sense -- on world markets. Meanwhile construction and other cyclical workers would lie idle, and those in open competition now with Third World products would see their relative wages fall.

With zero inflation once achieved, the downphase of the recession could end. The Federal Reserve would then settle down to its job of maintaining zero inflation. To

prevent a revival of asset prices that might lead product prices in interest-sensitive sectors upward, interest rates would have to be kept high. Over time, of course, zero inflation would have to mean lower nominal interest rates. But not at once. And therefore, as soon as inflation fell from its present underlying rate of 5 to 6 percent to 0, real interest rates on existing loans would rise by a comparable amount. Businesses who have gotten used since 1979 to paying 6 percent in real terms would find themselves paying 12 percent. Could they do so? Of course not." There would be business bankruptcies and home foreclosures on a considerable scale, going at the very least well beyond the records already being set this year. We would end the political business cycle, in a word, on the same terms that it ended in 1930: there would be no cycle because there would be no upswing. Well, enough. .. let us pass on to the second alternative.

A Low Interest Rate Policy

> The first necessity is that bank credit should be cheap and abundant ...
> (Keynes, 1930)

Political progressives from Epstein to Greider take the position that the best monetary policy is an easy policy, and that the only good interest rate is a low one. Certain elements in Congress, too, are strongly attracted to this view, and it has a useful way of surfacing in legislative proposals when credit crunches get bad. As Epstein and others have demonstrated (and as any reasonable Fed-watcher in recent months would have to accept), the Federal Reserve does effectively control the course of short-term interest rates." Thus, their policy position cannot be dismissed as unrealistic. The issue, therefore, is what would be the economic and political consequences of a policy of relentlessly lower short-term interest rates?

> But this is only the first stage. In the early phase of recovery there is not much loan-expenditure which can be safely financed by short-term bank credit. .. The second stage, therefore, must be reached, at which the long-term rate of interest is low for reasonably sound borrowers. .. (Keynes, 1930)

The economic consequences of this policy would depend on the response of long-term interest rates to a drop in short rates. It is always unlikely that those who plan physical investments will borrow short on a large scale, since a fall in short rates does not by itself restore the expectation of profits, and even when that expectation is restored there is always the risk that short rates could rise before the projects become profitable.

The reaction of long-term rates, in turn, would depend heavily on the credibility of the drop in short rates. If long lenders believe that short rates are going to stay down, so that a series of short-term borrowings can plausibly substitute for a single long bond issue, then the liquidity premium on short issues will decline, the current yield structure in the bond market will collapse, and long bond prices will soar. The Treasury could help directly, by stopping at once the issue of long-maturity bonds, as recommended by Professor James Tobin and others.[12]

Once there was a credible expectation of profits, the result would be a capital investment boom.

A capital investment boom would be in most respects a very good thing. The nation needs houses, roads, ports, airports, and an accelerated renewal of its industrial capital stock. We have in recent years substantially downsized our construction sector; apartment construction particularly is down by nearly half. Industries that produce construction equipment, farm equipment, and machinery of all kinds took a vicious beating in the early 1980s, and a good capital boom (though it would have to rely heavily on imports at first) might over time help to restore these sectors.

A low interest rate policy would also have some progressive distributive effects. Holders of real capital assets and land would gain at the expense of holders of money and the more liquid short-term debts (including some of the elderly, much noticed in the press these days). Broadly speaking, given the concentration of middle-class assets in home ownership, this would tend to benefit the younger middle classes, who would gain more in their house values than they would lose (if they would lose at all) on their pension funds. The middle classes would also benefit mightily from a reduction in interest on their floating-rate consumer and mortgage debts. While there might be some losers among the rich, it seems likely that portfolio diversification would save most rich people from large net effects (and the new rich created by growth could quickly fill the social role of any losers among the old rich). The really big losers would seem to be foreigners with relatively liquid claims valued in dollars, and those few institutional entities such as bond trading firms (why does the name Salomon Brothers come to mind?) that specialize in speculative movements in bond markets.[13]

The biggest and most systematic distributive effect would be on the government itself, in its role as the sole issuer of the national debt. Low interest rates and a capital investment boom would have two main effects on government: they would cut

expenditures and raise revenue. Every macroeconomic model verifies this dirty little secret -- that lower interest rates would powerfully rectify the financial problems of the government.

Undeniably, there are also risks. A credit boom has inherently unstable properties. Those who fear that the low-rate environment will not last may borrow in advance of their own needs, in the hope of capitalizing on a subsequent rise in interest rates. These speculative movements in credit demand, which may be very large and will grow larger if expectations of a rate rise grow, can put an immense strain on a low-rate policy. For this reason, a sustained low-interest policy presupposes safeguards on the flows of credit, so as to assure against speculative moves against the policy itself. Even quick examination of sustained low-interest policies in other countries, such as Japan and France from the 1950s through the end of the 1970s, reveals that such quantity-safeguards, whether in the form of "window guidance" or more rigorous regulation such as the *encadrement* de credit, were almost always in effect. Without such regulation, the ability of a low-interest policy to withstand speculation is doubtful.

Finally, there is the question of inflation. Inflation will not be a problem at first, because of excess capacity and the generally cowed character of the labor markets. Later on, it may become one. It is likely that the move toward sustained low interest rates would trigger dollar devaluation, raising import prices in advanced product lines (those imported from advanced countries against whose currencies the dollar would fall) and strengthening the bargaining hand of the strongest elements of American labor. While the breakdown of wage solidarity has cut the risks of inflation below what they were in the 1960s and 1970s, the risks are not gone, and there is every reason to suppose that a low-interest policy would at least modestly accelerate the rise in the general rate of inflation that had already been underway for three or four years before the recession.

Conservatives are aware of all this, which explains in part their opposition to a low-interest-rate policy. To the extent that American politics and particularly those of the Republican Party are now dominated by a *rentier* class, enriched under Reagan and Bush and jealous of the sources of its wealth (of which clipping coupons is a major part and speculating on asset prices not a small one), getting to a stable, low-short-rate policy will not be easy.

Indeed, perhaps it is not reasonable to expect that a Bushite Board and Chairman can ever credibly embrace such a goal. The very failure of the Greenspan Board to drive

down long-term interest rates -- when they would surely have loved to do so -- must reflect their *inability to precommit to a sustained policy of low short-term rates. The* markets expect that short-term rates will go back up shortly after recovery begins, and in any event as soon as it appears well-established. Inflation fighting is expected to return after the election -- whether or not there is by that time any serious problem of inflation. For this reason, long rates stay high, and recovery based on credit expansion cannot occur. We are in, perhaps, a huge Catch-22: when low interest rates are desired, the markets do not trust a Republican Federal Reserve![14]

Thus we come to a first conclusion. Achieving the goal of lower long-term rates requires not just a fall in short rates but a credible policy of stable and low short rates on a sustained basis. This a right-wing, anti-growth, rentier-dominated, stagnationist Board, allied with a do-nothing Administration, cannot deliver. Just as conservatives once argued for a "credible precommitment" to low and steady money growth, progressives must now argue for a credible precommitment to low interest rates. For this, evidently, we would need a new Federal Reserve Board and a new Chairman.

A second conclusion also follows. To sustain a low interest rate policy over time, the government must be prepared to meet by other means the main contingencies that might cause it to be abandoned. Chief among these is inflation. While some inflation can frankly be tolerated, and while some occurs as the result of external shocks that cannot always be avoided, other causes can and must be managed. Three, in particular, are (a) inflation that stems from rising unit costs due to declining productivity growth, (b) wage-push inflation, and (c) the spillover from asset market speculation into new goods prices. To deal with these would require measures of credit regulation and a wage-price policy -- a return, in short, to the old politics of inflation control.

Taking these conclusions together, we may conclude that the low interest option does not represent an easy alternative to large-scale structural reform. It is, at best, merely one form that such reform might take. I shall argue later that so long as radical reform is on the agenda, a low-interest-rate policy, though necessary, is best subsumed into an even more comprehensive and ambitious program.

Democracy and Accountability

For those who shrink from the reckless presumption involved in telling a central bank what to do, an attractive alternative lies in proposals for changing the structure of the

Federal Reserve. There are two separate ideas here. One is to democratize the process of monetary policymaking, and make it more responsive to the will of the people as expressed by their elected President or by representatives in Congress. This is exactly the opposite of elements in the preceding two programs that rely on giving the Federal Reserve an unrevisable mandate. The other idea is simply to make monetary policymaking more transparent, and is based on the general (and completely correct) presumption that secret policies are not to be trusted. As a broad rule, "democratizing" proposals would generally make the Federal Reserve more subservient to the Executive Branch; "accountability" proposals would generally make it more responsive to Congress.

Small "d" democrats can easily find flaws in the Federal Reserve's structure. The composition of its principal decision-making body, the Federal Open Market Committee (FOMC), is flagrantly unconstitutional, since the five regional Federal Reserve Bank Presidents who rotate on and off this Committee are not "officers of the United States" under the appointments clause of the Constitution.[15] To take another example, the spending powers of the Federal Reserve are uniquely insulated from congressional oversight. The Federal Reserve "earns" its budget as interest on the portfolio of national debt that it holds, subtracts what it needs for its own purposes, and returns the remainder as "surplus" to the Treasury.[16] Or again, the Federal Open Market Committee and the Board of Governors are uniquely exempt from normal federal sunlight and record-keeping requirements. When Chairman Bums discontinued the taking of detailed minutes of the Federal Open Market Committee meetings in the mid-1970s (in the face of a Freedom of Information Act suit that would have forced disclosure of those minutes before the five-year time lapse that was then the practice), he was able to get away with it. Fixing these defects would on many grounds be a good thing.

However, the question must be: what difference would it make for policy? William Greider and Bernard Nossiter, to name two journalists active at various times in this debate, have championed the subordination of the Federal Reserve to the Treasury Department. The administrative structure of these proposals varies, from simply placing Treasury representatives on the Federal Reserve Board (the Treasury Secretary once sat there *ex officio*), to moving the whole institution into-the Executive Branch (where it would be headed, presumably, by the Undersecretary for Monetary Affairs). Their argument is quite baldly that an "integrated" central bank (to use Epstein's nice phrase) would tend to

pursue an easier policy, accepting higher inflation on average and achieving a lower rate of unemployment.

This argument has to be pursued on a number of levels. Suppose we accept, as we can most easily, that the Federal Reserve could manipulate the trade-off between inflation and unemployment. Suppose we further agree that it would be desirable for it to do so. Then we have to ask whether it would in fact do so more readily under strict Treasury supervision than at present. In other words, is there a divergence of interest between the Federal Reserve Board, or Federal Open Market Committee, and the Administration? Is there presently a failure of coordination between fiscal and monetary policy (as Epstein argues), whose correction would result in a different policy mix and economic outcome?

At best the answer is not clear. Epstein offers some cross-section evidence that integrated central banks operate in higher growth economies," but this correlation need not be causal. The high growth economies enjoy many political institutions that are oriented toward the achievement of high growth, of which a dependent central bank is only one. It is not clear that changing this one feature of U.S. government would also change, for example, the political power of those who react against high rates of inflation.

For Republican administrations, as well as for Democrats of the late-Carter stripe, there is arguably no fundamental conflict between Federal Reserve policy and administration desires. In this case, the nominal independence of the Federal Reserve is mainly a political convenience. It enables the President to pretend to insulate himself to some extent from the fallout of tight policies, and to pretend to favor an easier monetary policy than in fact he does.

Putting the Federal Reserve under the Treasury would deal with this case, and force the Administration to invent another bogey (the role now played by the Bundesbank in, say, France or Britain might serve as a model). But it is doubtful that the independence of the Federal Reserve has ever fooled the voters very much; they remain resolutely willing to punish an incumbent administration for high unemployment (1970, 1974, 1980, 1982), and to reward it for high growth (1972, 1984). Republican Presidents know this (Democrats have been known to forget), and therefore do not allow the Federal Reserve to escape from partisan control. So long as Republicans and conservative Democrats are in power, making partisan control explicit would not change policy very much.

Perhaps the safest conclusion is therefore that proposed institutional changes would matter sometimes, but not at others. Under a progressive Democratic administration,

committed to high growth and structural reform, subordination of a hostile Federal Reserve Board would be essential. But whether this is achieved by changing the legislative status of the institution or by "court-packing" seems less important. Indeed, perhaps court-packing would be the preferable way to go, since it would help insulate a progressive monetary policy from immediate dismantlement by a subsequent administration.

Proposals to increase Federal Reserve accountability work on a slightly different argument, namely that there are sometimes strong reasons why Federal Reserve (and administration) interests differ from those of Congress. One intuitive point emerges immediately from the discussion just concluded. Congress, compared to the Executive, is a very stable institution." Congressmen make careers of their jobs; they face their constituents every weekend and their voters every two years. They therefore don't like recessions, and especially not off-year recessions patently geared to producing re-election booms two years further on. There are no "off-year" elections to the Congress.

Increasing Federal Reserve exposure to the Congress thus has the practical effect of turning up the volume of congressional criticism of the Federal Reserve during recession years, and this is generally a stabilizing influence on policy. "Turning up the volume" can be achieved in practice in a number of ways. It was the purpose of a series of actions beginning with H.Con. Res 133 in 1975 and continuing through the Federal Reserve Act amendments in the Humphrey-Hawkins Act in 1978, which established a regular schedule of congressional oversight hearings into the conduct of monetary policy. In that case, and not by accident, Congress framed the Federal Reserve's reporting requirements in ways that were intended explicitly to encourage more stable demand policy, by specifying that monetary targets be given on an annual basis, and by tracking over time the growth of money in relation to past targets. The design of such oversight is flawed and the implementation weak, but the intent does reflect a true congressional desire for a stability which actual Federal Reserve policy has not displayed.

A second avenue open to Congress is to change, or to propose to change, the law. Several 1982 legislative initiatives, beginning with bills that would have made lower interest rates a statutory requirement and ending with a simple statement in the Budget Resolution that monetary and fiscal policies should be coordinated, expressed in different ways the frustration of Congress with Federal Reserve policy. Earlier, legislation to curtail the Federal Reserve's institutional independence was a favorite tactic of a great advocate of lower interest rates: Congressman Wright Patman. In recent years, proposals by

Representatives Lee Hamilton (D-IN) and Byron Dorgan (D-ND), which would place the Federal Reserve's expenditures under the budget, have had a similar intent. These proposals stand little chance of passage in ordinary times, but their repeated introduction by senior members of Congress does serve to warn the Federal Reserve that there may be limits to how far destabilizing policies can be pushed.

The difficulty with congressional oversight of monetary policy is that it is an issue with very little political mileage in it for Congressmen, and at least some political risks. The Federal Reserve under G. William Miller and Paul Volcker became more open and responsive to congressional questions about policy than it had been under Arthur Burns, but someone still has to care enough to ask the questions. Henry Reuss, as Chairman of the Banking Committee until 1981, did so, but there has not been a similarly active Banking Chairman since then, and congressional monetary policy oversight in the House has drifted under the ambit of a subcommittee. In the Senate, oversight suffered from the departure of Senator Proxmire. Lesser Members lack the reputations that can make their colleagues or the press pay attention to sustained criticism of monetary policy, and are perhaps subject to the pressure of subtle disapproval from their home banks if they stick out too far on this issue.

The overall message is therefore somewhat discouraging. Democracy and accountability are surely fine things, but it seems doubtful if either one is worth fifty basis points on the federal funds rate. If I had to choose two points from this agenda on which to focus, they would be designed as first steps that might raise the practical usefulness of later democracy/accountability reforms later on.

On democracy, the more potent issue is perhaps not whether the Federal Reserve System can be brought "under" the control of the Treasury or the Congress, but whether it can be detached and insulated "from" the structural influences of the large commercial banks. These influences are now built into the system; in a general climate of tougher financial regulation, a reform package could do worse than to take them out. Congress could pass the Hamilton-Sarbanes proposal to remove the five banker-appointed regional Federal Reserve Bank Presidents from their voting role on the Open Market Committee. The membership system, and the nominal ownership of the Federal Reserve Banks by their commercial bank members, could be ended." To achieve true regionalism without private bank ownership, the Boards of Directors of the regional Federal Reserve Banks, which now include local bankers by statute, could be reconstituted as state government

appointments." The budget of the whole system should be brought into the federal budget, of course. These actions would abolish the visible symbols of private affiliation that the system now has. They might make life easier for a future administration that wanted an easier policy, whether or not the policy decisions of the Federal Reserve were brought directly under Executive Branch control.

On the side of accountability, the single most useful reform might be to require the immediate public announcement of all Federal Open Market Committee directives. The practical effect of these directives is almost always completely transparent to the markets, and their concealment has only one purpose, which is to blunt their impact as news and therefore their vulnerability to criticism from the public and Congress. The present practice of releasing an old directive only after a new one has replaced it kills the news interest of the Open Market Committee's decisions, and makes it all but impossible for Congress to make current monetary policy a subject of current political debate. Milton Friedman long ago suggested that the proper procedure would be to make and implement the Open Market decision on Friday, releasing the directive itself to the papers on Monday morning. This seems like an eminently sensible suggestion still, and it might prove to be a reform with unexpectedly far-reaching effects.

A Comprehensive Progressive Reform

I shall now argue that the right way to a progressive reform of American economic policymaking in general, and of Federal Reserve policymaking in particular, lies in comprehensive structural reform and the reassignment of instruments and goals. Such reform is compatible with much of the low-interest-rate and democracy/accountability programs. It would force a radical reconsideration of the Federal Reserve's responsibility for the control of inflation. And it turns on a systematic integration of international and domes tic policy considerations.

The first priority must be to restore growth and profitability by whatever means, recognizing that economic recovery is simply not likely to occur on its own. From the 1950s through the 1980s, recessions were invariably perceived to be self-liquidating within a short time. Either the economy itself -- in particular investment and consumers' durable purchases -- would bounce back once short-term interest rates fell, or else the government would reliably cut taxes and enact jobs programs to provide the necessary upward kick. However, these mechanisms are now blocked. After a decade of leverage and disinflation,

private debt burdens remain prohibitively high. Neither households nor businesses wish to borrow if they can avoid it; nor would a shell-shocked banking system lend to them if they did. Moreover, after a decade of high public deficits, the expectation that government will kick in with an emergency program is no longer there. Only in the past few weeks, thanks to Senator Bentsen, has the ice surrounding the question of a tax cut finally been broken.

A tax cut is the quintessential quick fix. It will boost profitability, trigger new consumption expenditure, and provide households with new cash flow to service debts. But we are no longer living in 1964, or even in 1981. Even a truly middle class tax cut, such as converting the personal exemption for children to a refundable credit, can be no more than a quick fix. For, as soon as the engines of demand growth start rolling, so will the engines of import demand, and the trade deficit -- quiescent in a domestic recession -- will again soar to the top of the news. And an increased part of the new investment and job creation in a demand-driven expansion will be located across our borders, especially in Mexico in anticipation of the free trade agreement. Therefore, as a proportion of GNP in a demand-driven expansion the trade deficit will be larger than ever before. If we wish to prevent this outcome and its consequences, then a middle-class tax cut in 1992 must be substantially recouped, beginning in 1993 or 1994, by raising taxes on the rich.[21]

Over the medium term, there can be only one principal source of net demand growth for the American economy, and that is and must be export demand. The experience of the late 1980s showed conclusively that the U.S. retains competitiveness in large export markets in the advanced world -- at the right exchange rate we can sell aircraft and communications equipment and chemicals and computers eyeball to eyeball with anyone. But this same experience also showed that our areas of competitive strength are no longer large enough, in relation to our economy, to support our living standards at full employment. To make them large enough once again, both on the demand side and on the supply side, is the primary task that medium-term economic policy must face.

On the demand side, the requirements are the following: first, strong growth in the world economy outside the United States; second, a competitively-priced exchange rate; third, renewed growth in Latin America and other debt-afflicted regions, as part of a combination of economic reform and debt cancellation -- both long overdue; and fourth, a major participation by the United States in the reconstruction and rehabilitation of Eastern Europe and the former Soviet Union. The instruments of diplomacy and political and

financial power must be turned to these objectives, notwithstanding the contrary ideological positions of other parties, such as the Bundesbank. It is not more difficult than, say, introducing democracy to Russia or reconciling Palestinians and Israelis in the Middle East.

On the supply side, government must attend to its long-neglected obligations. The country needs an infrastructure program, and its schools and universities need money as well as reform and good intentions.[22] There are large unmet human needs with long-term economic implications, for national health care and for child care and housing. Further, the social function served up to now by the military's support of science, engineering, materials research, and product development especially in aerospace, electronics, and communications, needs to be taken over and sustained by the civilian sector. These programs, moreover, must be viewed not as counter-cyclical or temporary measures, but as steady and permanent commitments, as prospective public investments on which private investors, domestic and foreign, can bank.[23]

Macroeconomic conditions and deficits do not prevent the assumption of new public responsibilities, but they do impose the constraint that such programs not be a disproportionate source of new demand. Thus, beyond the early days of a recovery program, steady new public spending must be paid for. Still, an ambitious set of military force reductions alone might free up $150 billion or more per year in the long run, while sustained lower interest rates could crowd in additional tens of billions. From these sources funds that presently support public and private consumption can be turned to productive use, without making the financial difficulties of the government any worse.

Once these conditions for macroeconomic growth and stability are defined, the role of monetary policy virtually follows. The Federal Reserve must, in the first instance, support private investment and export demand through a credible policy of lower short-and-long-term interest rates -- with credibility achieved by new faces on the Board if (as I have argued) the old ones are irreparably compromised. And the financial system clearly needs a new discipline even now; in a low interest rate environment it will need one even more. The Federal Reserve must promote financial stability and recapitalization through its regulatory powers in two ways: by discouraging households from unsound borrowing as their incomes expand on the one hand, and by discouraging banks from high rolling on the other. And it must no longer assume for itself the anti-inflation role to which, since 1951, it has been accustomed, and which since 1981 has led to disastrous consequences on

the trade front. In other words, like the CIA and the Pentagon, the Federal Reserve in the New World Order ought to accustom itself to being a much less important and much less adventurous place.

What of inflation? The dangers of inflation are no doubt less than they were twenty years ago, because of the breakdown of wage solidarity and the rise of competition from low-wage manufactured imports. Nevertheless the danger has not been expunged. And if a global growth strategy succeeds, the risks of inflation will unavoidably worsen, from several directions. There may be a new commodity or asset boom, as in the 1970s. There may be a credit-based profits boom, driving up prices and wages in the sectors producing capital goods. Or, though least likely, there could be a resurgence of the power of labor, beginning in the most advanced sectors, to extract wage increases that the whole economy cannot afford.

That will leave the management and control of inflation back in the hands of the political authorities -- an unwelcome but unavoidable assignment. Here, since the record of past political authorities in coping with inflation in the United States is not good, a measure of imagination and new policy design may be required. I believe that the essence of this matter is probably the coordination of the timing of wage settlements, and a concomitant enhancement of the social and economic role and responsibilities of labor." Mercifully, there is time at the moment for a fuller discussion of these issues, for two reasons. First, given the increasing pressure of foreign competition in the industrial sector, widespread wage inflation is simply not likely in the near term. And second, if the policymakers don't come up with a successful means of price stabilization with incomes policy support in the short term, the consequences, namely a bit of inflation with economic recovery in the next few years, are probably a lot less damaging than the alternatives of zero growth and debt deflation.

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Endnotes

1. Unlike Arthur Burns, Volcker's predecessor once removed, a blatantly political animal who engineered Nixon's reelection boom in 1972. It is true that Volcker was one of the few high Carter appointees to be reappointed by Reagan and Bush. Ambassador Mike Mansfield in Japan and National Security Council staffer Donald Gregg are other cases, and of course no one has suggested that the Mansfield appointment had a political motive.

2. Greider's Secrets of the *Temple* does however describe Volcker as "The Choice of Wall Street" and notes that Carter was warned (by Bert Lance, and too late) that the nomination would "mortgage" the 1980 election (p. 47).

3. With prominent exceptions, especially, Benjamin Friedman, Larry Summers, and others who believed in the functional equivalence of lower budget deficits and increased "national savings," and therefore that the budget deficits meant a lower rate of investment in the capital stock. Against this view, Robert Eisner pointed out that deficits raised corporate profits, and hence the willingness of private companies to make new investments; Eisner also made the empirical point that the correlation between deficits and private investment spending was positive rather than negative.

4. Robert Barro, *The Behavior of US Deficits,* National Bureau of Economic Research Working Paper # 1309, March 1984; Robert Eisner, How *Real is the Federal Deficit?* The Free Press of MacMillan, 1987.

5. Alan Reynolds, "Who's On Next?" *National Review,* August 1991.

6. It was once fashionable to believe that "random shocks" on the "supply-side" were responsible for recessions, at least in 1974 and 1979, and perhaps generally. This viewpoint is now in disfavor. The evidence shows that the shocks are themselves responses to developing conditions, and rarely strong enough to bring on a recession without help from policy.

7. For a summary of this argument, see my "A New Picture of the American Economy" in *The American Prospect,* Fall 1991.

8. I wrote on that occasion:

> Volcker. .. understands the relentless doom that awaited his reputation. For. .. the impetus provided to growth is fading away [and] there are signs that a rise in inflation is underway. .. Against all this, Paul Volcker stood in recent months increasingly alone at the tiller, and a little forlorn, issuing warnings to Congress that were less and less oblique as time passed, raising interest rates to shore up the dollar and then lowering them again to avert recession, and otherwise presenting a profile of well-justified worry. But for how long could he evade the fact that the channel between inflation and recession is blocked off entirely just up ahead?

"The Case for Shock Treatment," *Challenge,* July-August 1987.

9. For this reason, I entitled a chapter of my 1989 book *Balancing Acts,* 'The Obsolescence of Full Employment."

10. There is a way to rewrite all nominal contracts simultaneously, which is to exchange the existing currency for a new one, along the lines attempted by Brazil and Argentina in the mid-1980s. Thus the dollar could be replaced by a new currency (say, the U.S. cruzeiro), and all interest contracts in dollars translated into U.S. cruzeiros at the new nominal rates. However advocates of a zero inflation standard have not yet been seen to embrace this course of action.

11. One legitimate question on this point concerns the constraints on monetary policy imposed by the rest of the world. For a while in the summer and early fall of 1987, in the power vacuum left by Volcker's departure, it seemed as though U.S. interest rates were henceforward to be set in Frankfurt. That came to an end with the stock crash of October 1987, and after that the potential independence of U.S. interest rates from those set in Europe and Asia was clearly demonstrated. Of course, a lower interest rate policy for the U.S. does usually mean a falling dollar, and occasionally since 1987 monetary policy has appeared to feel itself constrained to keep the dollar from falling too fast. This constraint, now on and now off, today seems to be about the limit of U.S. monetary policy interaction with the rest of the world.

12. Going further, the Federal Reserve could place tender offers for existing long bonds, with a view to bidding up the price and retiring those with the highest yields. "Operation Twist" in the 1960s was an historical example of such operations, also recommended in the 1930s by Keynes.

13. The repeal of the 1951 Treasury-Federal Reserve Accord, which is what Epstein particularly has in mind, would effectively peg the price of government bonds and put the government desks of the bond traders out of business.

14. Thinking back to 1979 may help defuse the paradox here. At that time, higher interest rates were widely desired, and for that purpose the markets would not trust a Democratic Federal Reserve. Long-term interest rates refused to rise in real terms until Volcker replaced Miller and precommitted to sustained high short term interest rates, which he did by changing the policy regime.

15. Only a tangle of juridical arguments over legal standing prevented a lawsuit on this matter from being tried on its merits in the 1980s. The suit, Reuss v. Bolles et al. in its original incarnation, would have devolved the FOMC's functions back onto the Presidentially-appointed Federal Reserve Board.

16. With the demise of Marxism this is one of the few remaining instances where the concept of "surplus" is still used.

17. Gerald Epstein, "An Argument for a Democratic Monetary Policy," June, 1991, mimeo.

18. Full details of my argument to this effect can be found in my article, "The exchange of favors in the market for commitments," in David Colander and A.W. Coats, eds., *The Spread of* Economic *Ideas*. Cambridge: Cambridge University Press, 1989.

19. The membership system was rendered largely irrelevant to the application of reserve requirements and regulatory authority by congressional action anyway in 1980.

20. That is, state governors could make appointments to the boards of the Federal Reserve Banks for their regions.

21. If only one half of the tax breaks given since 1978 to the richest one percent of Americans were now removed, say by imposing new brackets on the income tax at very high income levels -- the public as a whole would have new revenues of about $40 billion every year.

22. These needs are present even if the linkage between these specific actions and measured productivity is, as I have argued in the present issue of The *American Prospect,* questionable.

23. A good analogy here is Taiwan's recently announced $300 billion public improvements program. This program, which amounts to the virtual reconstruction of the entire island, is sure to act by its very existence as a magnet for an entirely new class of high wage industrial and service industries.

24. This issue is the main theme of my 1989 book *Balancing Acts.* Since that time, work on wage coordination in different countries by David Soskice, reported in the *Oxford Review of Economic Policy,* 1990, has powerfully confirmed that countries with centralized bargaining structures enjoy lower inflation for given levels of unemployment.