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Comment Allan H. Meltzer

Professors Bordo and Eichengreen offer a welcome addition to the large literature on the Great Inflation. They do not dispute the findings in many earlier studies. They add to our understanding by considering some international and balance of payments responses. Many of my comments supplement their story, but I do not accept their conclusion that the Martin Federal Reserve raised interest rates for balance-of-payments reasons or that the public expected them to act that way.

One main theme is correct. The Kennedy and Johnson administrations put very different weight on the balance-of-payments deficit. President Kennedy had great concern about the gold outflow. He feared it, he said, as second only to an atomic attack. At one point, he threatened to pull US troops out of Europe, if the French and Germans continued to demand gold. DeGaulle did not believe him. President Kennedy's attention soon shifted to the Cuban missile crisis, so he did not pursue his threat. I cite this episode to reinforce Bordo and Eichengreen's evidence that international economic issues were a major concern in the early 1960s.

Concern is one thing. Policy and actions are different matters. I served briefly in the Kennedy Treasury Department in 1961 to 1962 and recall the discussions. The Treasury's first problem was to gain control of the policy response. Secretary Douglas Dillon was a Republican with close ties to Wall Street. His under secretary was Robert Roosa, who came to the Treasury from the New York Federal Reserve Bank. That background is important because New York was the strong supporter of a fixed exchange rate. Most of them wanted a dollar-based system tied to gold.

The Treasury's main rival for influence found a home in the Council of Economic Advisers, where James Tobin was a member and Robert Solow was on the staff. Paul Samuelson was not part of the administration but

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served as an influential voice at the White House because of his relationship to the president.

The Treasury gained the upper hand after a compromise. Policy aimed at lowering long-term rates to expand output and raising short-term rates to slow the capital and gold outflow. This was an effort to “twist the yield curve” by lowering long-term and raising short-term rates. The policy called on the Treasury to finance the deficit by selling mainly Treasury bills, and it called on the Federal Reserve to buy long-term bonds.

In the 1950s and the 1960 election, the Democrats opposed the Federal Reserve’s “bills only” policy. They claimed that the policy raised long-term interest rates and reduced economic growth. This was an error, part of a persistent failure to distinguish real and nominal interest rates. Chairman Martin at the Board agreed to cooperate with the new administration, but he would not resign, as some in the administration wished. He gave up “bills only” and agreed to buy long-term debt.

In my opinion at the time, there was not much chance that policy could twist the yield curve. The main proponent, Jim Tobin, believed the Federal Reserve failed to buy enough long-term debt, and he complained that the Treasury sold long-term debt. He kept track of weekly Federal Reserve purchases. When they slowed, he urged Walter Heller, chairman of the council, to ask the president to call a meeting of economic policymakers known as the Quadriad. He believed that Chairman Martin increased the rate of purchase before such meetings.

Once the economy recovered, policy changed. Tobin left the council and Roosa, at the Treasury, developed new techniques. He strengthened the London Gold Pool. Ten other countries agreed to buy and sell gold to sustain the \$35 per ounce price. As part of the agreement, the United States agreed to purchase any gold that other countries bought, so the agreement gave only short-term support to the dollar. Roosa prevailed on the Federal Reserve to engage in “swap” agreements, under which the Federal Reserve purchased dollars by borrowing foreign currency. Also, because the Treasury lacked the resources to share equally in those transactions, the Federal Reserve loaned money to the Treasury. Such loans are illegal, so they were described as “warehousing.” This, too, was a short-term palliative. Pushed by independent governors like James Robertson, Martin and others admitted as much. They did not offer a long-term program.

Roosa was creative and inventive, but he never considered parity changes as a solution. He believed the long-term solution was exchange rate stability. His policies responded to pressures and sought to rely on the US economy to produce a favorable long-term result.

In the 1920s the Federal Reserve, especially Benjamin Strong at the New York Bank, conducted international economic policy. Carter Glass blamed Strong for the Great Depression because he did not follow the real bills doctrine. Glass was influential. As a congressman in 1913, he had taken a

leading role in the creation of the Federal Reserve. In 1933, as a senator he insisted on removing New York's role in international policy. The Treasury became the principal actor. Chairman Martin recognized that the Federal Reserve had a secondary role.

Inflation remained low in the early 1960s, lower than in major trading partners. There were a few months of falling prices in 1961. Relatively low inflation and a fixed exchange rate revalued the real exchange rate. By 1965, the balance-of-payments problem seemed on the way to solution.

Bordo and Eichengreen cite the minutes as evidence that the Federal Reserve took an active role in balance-of-payments problems. I agree that the minutes or transcripts contain the statements they cite. They do not note, however, that most of the statements were made by Alfred Hayes, president of the New York Bank. And they fail to note that Hayes's views were rarely the majority view. The Federal Reserve did not raise interest rates for balance-of-payments reasons, with few exceptions.

Chairman Martin did not have a balance of payments policy. He disliked economics. He was a market man with friends in the New York banks from his years as head of the stock exchange. His policy preference was to manage free reserves or "color, tone and feel." Connection to international or domestic economic outcomes was, at best, accidental. His aim was to regulate a short-term interest rate but never to acknowledge it out of concern for populists in Congress who usually wanted lower interest rates. As we know, free reserves and interest rates are not closely related. Martin banned forecasts until the mid-1960s. He did not ask the staff to analyze the relation between Federal Reserve actions and economic outcomes.

Why, then, did inflation remain low enough before 1965 to appreciate the real exchange rate? When I studied the period, I found Martin saying several times that the Federal Reserve was independent within government. Martin explained that he meant that the Federal Reserve could raise interest rates enough to stop a boom caused by strong private spending. But Congress passed the budget and the president signed it. The Federal Reserve, he believed, had to facilitate budgetary finance. That was his big mistake. In the 1950s and early 1960s, budget deficits remained low except during recessions. Monetary policy did not face the problem that came to the fore in the Johnson administration.

By 1965, Kennedy, Dillon, and Roosa were gone. President Johnson was a strong populist. He hated increases in interest rates. Many economists at the time favored coordination of fiscal and monetary policy. Council chair Gardner Ackley opposed Federal Reserve independence. Given Martin's beliefs about independence and President Johnson's concerns, the Federal Reserve helped to finance the enlarged budget deficit that financed the Vietnam War and the Great Society programs.

The Fed followed a policy called "even keel" of maintaining interest rates unchanged during Treasury funding. Reserve growth often rose at such

times. The FOMC would not act to remove the excess. Average growth of monetary base and money (M_1) rose and inflation followed.

Coordination worked one way only. The Fed supported government borrowing. The administration would not agree to Martin's urging that it should ask for a tax increase. Many in Congress would not support a tax surcharge unless the president agreed to reduce spending, especially spending for the Great Society. Martin warned President Johnson about inflation several times. After one such warning in May 1965, Martin gave a commencement address at Columbia University warning about inflation and raising concerns about the return of the Great Depression. That got headlines, but it did not get a tax surcharge.

At its September 1965 meeting, many on the FOMC were ready to raise the funds rate. Martin opposed because the administration opposed and because most of the votes could come from the bank presidents, not the Board. The FOMC waited until December when on a four to three vote the Board raised the discount rate. Why did Martin change his mind? He explained at the time that for him the issue had become independence. Others voiced concern about inflation and the balance of payments.

Martin was called to Johnson's ranch and castigated, but he did not lower the discount rate. In the months between December 1965 and June 1966, total reserves rose at a 6.3 percent annual rate, four times the rate from the previous June to November. Sherman Maisel, a Board member at the time, recognized that policy had become more expansive. The reason, he said, was that the Federal Reserve used a money market strategy. Borrowing increased, so free reserves fell from \$8 million in December to -\$255 million the following March.

The money market strategy misled the FOMC on several occasions. It is not the whole story. In the late 1940s, Congress approved the Employment Act and the Bretton Woods Enabling Act. The only way to reconcile these guides was to maintain low inflation. Otherwise they were in conflict.

The vague language of the Employment Act called for maximum employment and purchasing power. In practice, that came to mean a 4 percent unemployment rate. The council and the Johnson administration believed that a bit of inflation was a small price to pay for a lower unemployment rate. They supported their predilection by appealing to a negatively sloped Phillips curve. President Nixon's council accepted that the long-run Phillips curve was vertical, but the president was not willing to accept higher unemployment to lower inflation.

The important policy change in 1964 or 1965 was an increased willingness by the administration and Congress to accept higher inflation to get lower unemployment. This combined with the Federal Reserve's commitment to policy coordination (and its frequent analytic errors) produced higher inflation.

In my reading of the minutes and the history, balance of payments was a secondary or tertiary consideration for most of the FOMC members. They

regarded the balance as a Treasury responsibility. They saw their role as, at most, supportive of Treasury policy. Bordo and Eichengreen agree with that in part at least.

Academic economists shared, even sponsored, many of these views about inflation. Polling data suggests that until 1979, the public rarely gave much weight to inflation when asked about its concerns.

During the Kennedy and Johnson administrations, international payments called for two types of action. They put restrictions on mainly private spending whenever there was an apparent crisis. These included the Interest Equalization Tax, limits on foreign lending by banks and on foreign investment by corporations, requirements to ship in US flag carriers, and several other controls. The other policy action was a series of meetings to get agreement on Special Drawing Rights.

In 1969, Paul Volcker became Treasury under secretary for Monetary Affairs. In his first six weeks in office, he prepared a memo for the secretary and later the president. For the first time, his memo discussed exchange rate adjustment. Volcker proposed that this administration give two years to discussing exchange rate adjustment with other countries. After that time would run out, the gold stock would decline, and the United States would have to act unilaterally. His judgment was correct. A bit more than two years after he wrote, President Nixon closed the gold window.

The end of fixed exchange rates in 1973 did not eliminate either inflation or the balance-of-payments deficit. Until 1976, the government's estimate of the equilibrium unemployment rate remained at 4 percent. As Orphanides has ably shown, the Phillips curve continued to underestimate the inflation rate much of the time.

Inflation ended after the public told the pollsters that inflation was the most important problem they saw. Probably they mixed the increased relative price of oil with inflation.

President Carter appointed Paul Volcker. In his interview Volcker told the president he would work to reduce inflation. President Carter replied, "Good, that's what I want." Volcker changed the weights on inflation and unemployment in the Fed's objective function and restored independence. Concern for independence and credibility lasted until recently, and so did low inflation.

Discussion

Anna Schwartz had issues with two parts of the chapter. The chapter does not mention the Gold Standard Act of 1934. It appointed the secretary of the Treasury as the manager of the foreign exchange value of the dollar. The secretary needed the approval of the president for any actions he wanted to