

**Current Lessons from the Past: How the Fed Repeats Its History**  
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From Wicksell (1906) quoted in Issing and Wieland (2013)

“Here, then, the rulers of society have an opportunity to show their wisdom or folly. Monetary history reveals the fact that folly has frequently been paramount: for it describes many fateful mistakes.”

My paper mentions a few examples of wisdom, but it is mainly about errors.

We all know about: The Great Depression  
The Great Inflation  
The Great Recession

My theme is mistakes caused by analytic errors, repeated  
Related to increased authority – discretion  
Started 1913-14 with very strict limits on action  
Crises, wars, international developments reduced restraints  
Treasury debt  
Gold standard

Political Board, Reserve Bank bankers

Meaning of “independence” —Martin

Fed is an economic, but also a political agency

Article 1, Sec.8

Depression and Employment Act

Optimal policy?

Strong and Reserve Banks won control in 1920s

1920-21 recession and Open Market Operations

Banks not Board

1933 and 1935 Acts Centralized control

Martin in 1950s – more political control

Bills only—political solution

Heller and Tobin – Quadriad

## Catalogue of major analytic errors

Great Depression—real bills doctrine (Philadelphia)

1960s Simple K model—coordination

Failure of coordination

Burns—price and wage control

Burns and Nixon

The Phillips curve trade-off—Friedman,  
Volcker, Greenspan, and Bernanke

Woodford and the credit crisis

Friedman, Tobin, Brunner and Meltzer

Lender of last resort—Bagehot (1873) A RULE! For payments system, not banks

WHY? WHY? Politics? NY Fed?

Preventing most failures: 4 steps

- 1) A clearly stated rule for LOLR
- 2) Protect the payments system not the failing banks
- 3) Prevent spread by lending at penalty rate
- 4) Require equity capital sufficient to absorb anticipated losses

PRUDENCE!

Bagehot gives evidence these rules work

NY banks 1929-32

2005-8 gives evidence that Dodd-Frank will fail

Two best periods in Fed's 100 years

1923-28 gold exchange rule

1985-2002 Or 2003 Taylor Rule

No comparable period for discretion 1950s Eisenhower

Why discretion worse results: 2 main reasons

Short-term focus based on quarterly forecasts

My Western pres. Address

Permanent—Both Friedman and Modigliani

My proposal Use Muth (1960)

Summary of Principal Errors that are repeated

- 1) Wrong choice of model, neglect of money and credit, asset prices
- 2) Failure to distinguish real and nominal events
- 3) Excessive attention to monthly and quarterly data; neglect of permanent changes -- Greenspan on productivity
- 4) Failure to announce and follow a rule: politicization

Some examples of proper, even praiseworthy actions

Back to main theme—errors, repeated mistakes

## Example of QE 2 and 3

95% idle; what can another \$ 1 trillion per year do

Why? Failure to distinguish real and nominal

Current economic sluggishness mainly real problems

Investment

Harvard MBA alums

Bank and corporate balance sheets

## Repeated failure to distinguish real from nominal

Plosser (1979)

1932 1970s interest rates, Phillips curve,

## Failure to distinguish large relative price changes and inflation

Price controls

Oil shocks (SOMC)

## Rules vs. discretion

Kydland and Prescott

Taylor rule

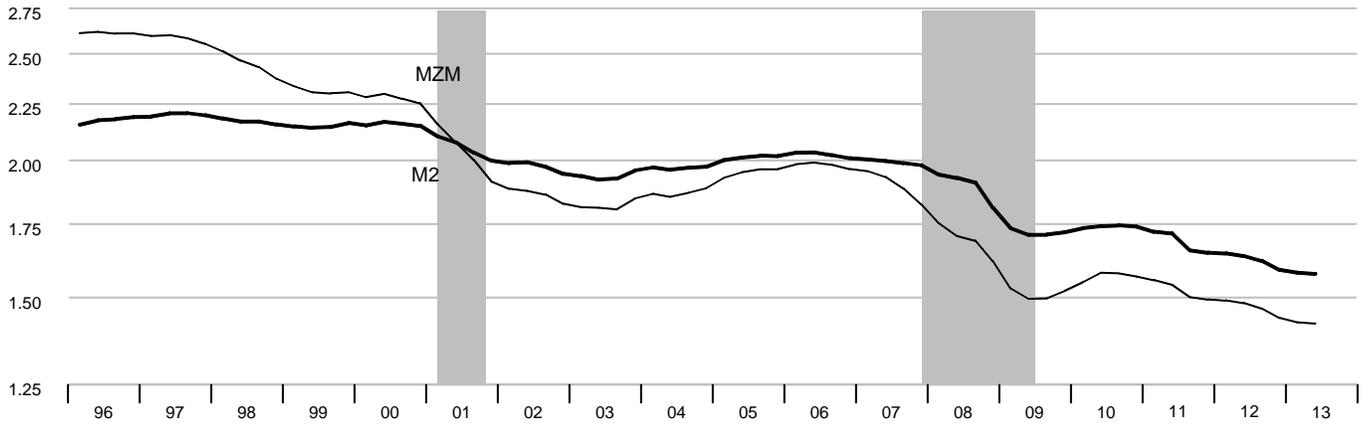
## Neglect of credit and money

Velocity Unstable?

## What Congress Must Do to Increase Stability

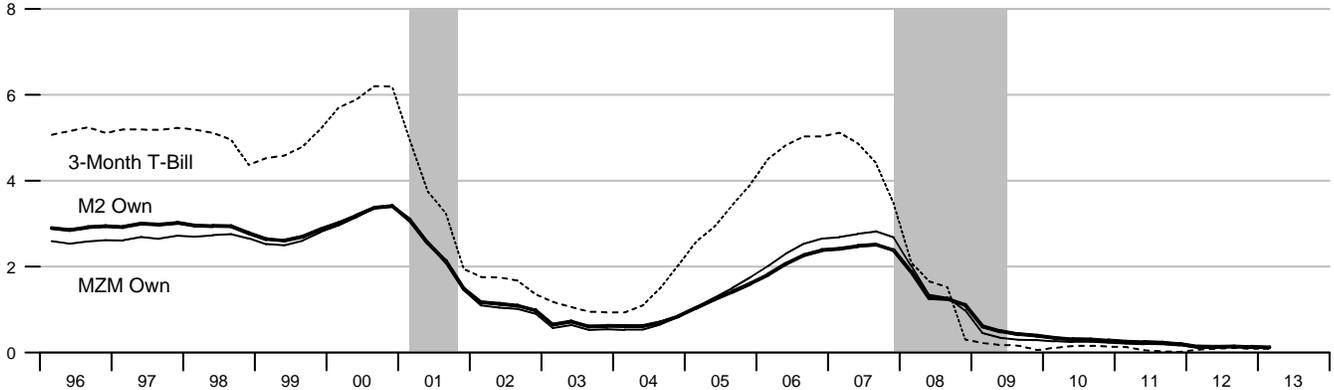
Velocity

Nominal GDP/MZM, Nominal GDP/M2 (Ratio Scale)



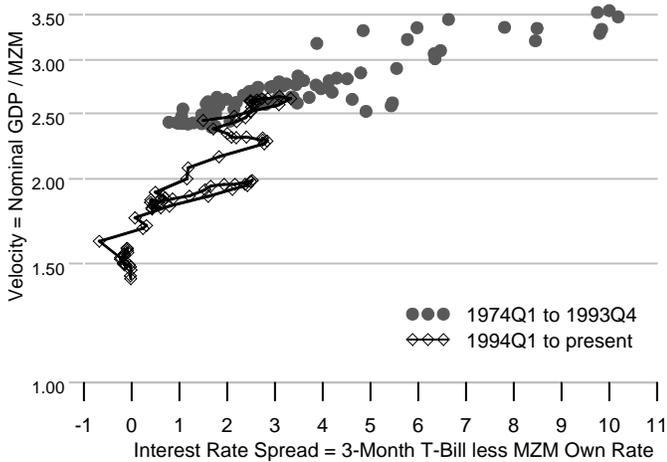
Interest Rates

Percent



MZM Velocity and Interest Rate Spread

Ratio Scale



M2 Velocity and Interest Rate Spread

Ratio Scale

