The Monetary Policy of the Federal Reserve: A History

Posted Tue, 2008-12-02 20:00 by backend

Author: Hetzel, Robert L.

Reviewer: Richardson, Gary

Published by EH.NET (December 2008)

Robert L. Hetzel, *The Monetary Policy of the Federal Reserve: A History*. Cambridge: Cambridge University Press, 2008. xvi + 390 pp. $50 (cloth), ISBN: 978-0-521-88132-6.

Reviewed for EH.NET by Gary Richardson, Department of Economics, University of California — Irvine.

The Monetary Policy of the Federal Reserve: A History by Robert Hetzel studies the evolution of monetary policy from the beginning of the Federal Reserve until the end of the Greenspan Era. The title claims the book is a history, and it is that, but it is much more. As a history, Hetzel's book details the conduct of monetary policy over nearly ninety years, and sets that conduct in the context of the intellectual and political environment of the time. As an economic synthesis, Hetzel's book views the evolution of monetary policies as a series of experiments useful for understanding fundamental issues concerning money, prices, and macroeconomic policy. The past serves as a laboratory for understanding the present. The emergence of modern monetary policy and prospects for our nation's financial future are understood by studying the learning-curve of the leaders of the Federal Reserve, the painful process of replacing the gold standard with a fiat money standard, and the recurrent monetary instability during the decades following the Second World War.

Enough for the sales pitch. Let me get to the details.

The book contains 26 chapters and an appendix listing the data that the FOMC saw during the "stop-go" period from 1963 to 1982. Chapter 3, "From Gold to Fiat Money," examines policy from the founding of the Federal Reserve System in 1913 through the end of the Great Depression. Chapters 4 and 9 examine the creation of the postwar monetary system (note that one of my few suggestions to the author would have been to place most of the material in Chapter 9 in the fourth chapter). Chapters 10 through 14 discuss the Great Inflation of the 1970s, Volcker's disinflation at the tail end of the 1970s and beginning of the next decade, and monetary policies during the early 1980s. Chapters 15 through 25 focus on monetary policies during the Greenspan Era. The distribution of time across chapters reveals the focus of the book, which is largely on postwar monetary policy and particularly on recent decades. As a student of the Great Depression, I desired more analysis of earlier decades, but I realize that the author's research and experience make his insights on the later decades more valuable, and believe that his decisions about emphasis and pacing reflect carefully considered judgments about his marginal product. In other words, he made sensible choices about where he should devote his time and attention.

A strength of the book is its integrative chapters, including Chapters 1, 2, 23, and 26. These shed light on broad policy issues that cut across time and elaborate on his insight that monetary policy during the twentieth century consisted of a series of policy experiments whose outcomes we are just beginning to understand.

Chapter 1 examines the evolution of the monetary standard. It points out the importance of this issue. Monetary instability coincided with social upheaval and political disorder throughout the twentieth century. An example is the rise of Nazism in Germany after the hyperinflation of the 1920s and during the depression of the 1930s. The success of society in the twenty-first century may depend on whether societies learn the lessons from the twentieth century. "One of the 'grand' monetary experiments of the last century was the replacement of the gold standard with a fiat money standard."

Initially, central banks did not understand their new powers and responsibilities, and failed to provide a nominal anchor for prices. Keynesian economists tried to exploit expectations of price stability and fine tune the economy. Their stop-go aggregate demand management led to gradually increasing inflation during the 1950s and 1960s and the spectacular monetary failures of the 1970s. Eventually, central banks realized the importance of nominal anchoring, and adopted policies that promoted price stability. This period coincided with Paul Volcker and Alan Greenspan's reigns over the Federal Reserve. From this experience, the author concludes that "The central bank cannot predictably manipulate real variables — real money or unemployment. It can control trend inflation, but it must do so through consistent (rule-like) behavior that creates the expectation of unchanging trend inflation."

Chapter 2 continues the overview of the monetary experiments of the twentieth century and the author's conclusions. The chapter discusses disagreements over the nature of monetary policy and the political advantages of policy ambiguity relative to the confusion that ambiguity causes about the appropriate role for monetary policy.

Chapter 26 summarizes "a century of monetary experiments." The chapter emphasizes three key lessons. (1) Inflation and deflation are monetary phenomenon. In a world with fiat money, the behavior of the central bank determines the level and rate of change of prices. (2) To stabilize inflation, central banks must maintain a consistent and credible policy designed to fight inflation. (3) The government must allow the price system to operate and relative prices to allocate resources among competing opportunities.

Overall, I find Hetzel's book cogent and comprehensive. Hetzel participated in many of the monetary experiments that he describes. His seminal innovation is the Treasury Inflation Protected Securities (TIPS) program. Returns on half of these securities are fixed in nominal terms. Returns on the other half are indexed to the price level. The difference in the prices of these securities provides a market measure of expected inflation, providing the Federal Reserve with the information it needs to establish a nominal anchor for the price level. The importance of this innovation and the quality of Hetzel's book insure that it will be widely read for many years to come.

Gary Richardson is an Associate Professor of Economics at the University of California in Irvine who studies the causes and consequences of the banking panics of the Great Depression.

Geographic Area:
North America
Subject:
Financial Markets, Financial Institutions, and Monetary History
Time period:
20th Century: WWII and post-WWII