

ECONOMICS U\$A
21st Century Edition

Program #25

MONETARY POLICY: HOW WELL DOES IT WORK?

AIRSCRIPT

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Final Transcript

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DAVID SCHOUMACHER: In the late 1970s, Chairman Paul Volcker set the Fed on a course that would lead to the worst recession since the Great Depression. What could have been worth such a terrible price? On October 20, 1987, the heartbeat of the financial world nearly fluttered out. What could new Fed Chairman Alan Greenspan do to revive the patient? By 2008, the American economy was once again in deep trouble. The nation's banking system was near panic. Unemployment mounted and a great recession was upon us. What could monetary policy do to stem the tide?

During the last quarter of the 20th Century the Federal Reserve adopted long-term policy directions from Congress to halt inflation and ease unemployment, a dual and difficult mandate under the best of circumstances. But how well would the Fed do in an economic emergency? Monetary Policy: How Well Does It Work? With the help of Economic Analysts Nariman Behravesh and Richard Gill that's the question we'll investigate on this 21st Century edition of ECONOMICS U\$A. I'm David Schoumacher.

PART I

DAVID SCHOUMACHER: By the late 1970s, inflation had taken over again and there was a widespread feeling that the Fed had to exercise restraint on the economy. But how? Up until this period, most economists felt that the best way to cool inflation was to raise interest rates, keeping the price of money high. That would slow down business investment and spending and put inflation back in the box. But others felt that it was best to work on the money supply directly and to focus on the long run rather than the short run. In August 1979, Paul Volcker became the new Fed Chairman. What course would he take? The Fed was already facing enormous criticism, much of it coming from a group of economists called “Monetarists.” At the head of the Monetarist attack was economist Milton Friedman.

MILTON FRIEDMAN: “In my opinion, given that there is a Federal Reserve, the best way for it to operate would be to set targets for a single monetary aggregate, and stick to those targets, and keep to them as closely as possible. Those targets should be set so as to go from wherever you start to a rate of growth in the money supply which is consistent with zero inflation.”

DAVID SCHOUMACHER: On October 6, 1979, Paul Volcker announced that the Fed would no longer target interest rates, but would focus instead on targeting the money supply itself, restraining it until inflation was broken. In a speech before the National Press Club, he stressed his determination to stick to this long-term course.

PAUL VOLCKER: “Will the Fed stick with it? My short and simple answer to that question is “yes” and I don’t intend to qualify...I don’t intend to qualify that answer. But I do want to be clear... clear about what it is that we intend to stick with. It, in the sense of our October 6th actions, is restraint on the money supply... reducing its growth over time toward levels consistent with price stability.”

DAVID SCHOUMACHER: Fred Schultz was Vice-Chairman of the Fed Board under Volcker.

FRED SCHULTZ: "The major change was a difference in how monetary policy was going to be carried out. Before that, there had been an effort to try to have relatively slow interest rate changes. That clearly was not doing the job of controlling the economy in this kind of a very volatile, inflationary environment that had appeared in 1979. And so the change was to go to strict targeting on the money supply alone. The effect of that is... if you're not paying any attention to the price of money, which is what interest rates are, the effect of targeting entirely on the supply is that the price of money is going to change a good deal more."

DAVID SCHOUMACHER: By the end of the year, interest rates began to rise, and rise dramatically. By February the prime rate had reached a record 20 percent. Among the first to feel the squeeze were small businessmen.

BUSINESSMAN: "We understand what the objective of the national government is, what the objective of the Fed is, but we think that what can be a cure for the country's ills can be fatal to the small businessman."

DAVID SCHOUMACHER: The Carter administration reacted to the sky-high rates by imposing a limit on the amount of credit banks could offer. Suddenly, the buying spree ended and the Fed was pulled off course. They were forced to expand the money supply to rescue the plummeting economy. But in late 1980, the situation changed. The election of Ronald Reagan gave Volcker the opportunity to return to his long-term plan. As part of his economic program, Reagan encouraged and supported monetary restraint. But, in 1981, restraint began to take its toll. High interest rates caused a collapse in the building industry. The high cost of consumer loans put auto dealers out of business and autoworkers out of jobs. Still, Volcker held to his long-term course.

PAUL VOLCKER: "Consolidating and extending the heartening progress of inflation will require a continuing restraint on monetary growth, and we intend to maintain the necessary degree of restraint."

DAVID SCHOUMACHER: By 1982, the economy had fallen into the deepest recession since the Great Depression. Even the Reagan Administration was urging the Fed to relent. But Volcker and the Fed Board, determined to bring inflation down, held tight. Finally, in late 1982, the Fed saw inflation drop substantially, and eased the money supply.

RONALD REAGAN: "This last week, the Federal Reserve Bank decided to lower its discount rate to nine and one half percent, the first time this key interest rate has gone below two digits since 1979, and the fifth reduction in just four months. This demonstrates the Fed's confidence that inflation and market rates will continue coming down, and it's confidence that we can work together for a healthy, non-inflationary recovery."

DAVID SCHOUMACHER: Throughout the recovery that followed, inflation held at 4%. Though inflation had been substantially reduced, the Monetarists criticized the Fed for not adhering to a strict growth rate of the money supply.

MILTON FRIEDMAN: "In my opinion, the actions of the Federal Reserve have added to the uncertainty, have added to the instability of the economy rather than reduced it. And, let me emphasize, stable monetary growth is not a guarantee of stable economy. It's a guarantee that you will not have disturbing elements introduced by the operation of monetary policy. It's a way, as it were, to keep the Federal Reserve from doing mischief, and not a way to produce Nirvana."

FRED SCHULTZ: "The idea of "monetarism" is that there is a stable relationship between money and the gross national product. Well, we've seen that that's not the case. Furthermore, if you were to be very precise in your targeting and just stayed on that

target path day to day, interest rates would fluctuate enormously, and that wouldn't be good for the economy. So we took a pretty "Monetarist" approach in October of 1979 because it called for extreme measures. But, as you've seen, since then that position has been ameliorated. Now does that mean that money doesn't count? Of course not, money is very important, but I think this strict "Monetarist" approach is not workable over a long period of time, but it was necessary when we did it."

DAVID SCHOUUMACHER: Focusing on the money supply appears to have worked, but the cost was high. Chronic inflation, which had plagued the economy for more than a decade, was reduced and contained, but at the price of forcing the economy through two deep recessions. Why was the Fed willing to pay such a high price in its battle against inflation? We asked Economic Analyst Richard Gill.

(MUSIC PLAYS—COMMENT & ANALYSIS I)

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RICHARD GILL: Basically, they were willing to pay this high price because they saw no alternative. What happened in the late 1970s and early 1980s, in the field of monetary policy, can be read either (A) as a confession of failure or (B) an expression of hope. The failure side was an admission that monetary policy, whether focused on interest rates or the money supply, couldn't do much to avoid short-term difficulties in the economy. And the recession of the early 1980s was serious. People lost jobs. Basic industries faltered. And Volcker's policy was often cited as responsible. But the policy was also an expression of hope. It said, in effect, let's shift our attention to the longer run. We may be able to do something to wring inflationary pressures out of the economy over a period of years.

In terms of our equation of exchange, it was admitted that in the short-run V and Q might jump around all over the place, but that, in the long run, you could control prices (P) by keeping at least a somewhat firmer hand on the money supply throttle. Failure and hope, the latter justified by what did in fact happen to the rate of inflation. It did fall and, in

many ways, more sharply than anyone might have predicted. So then, has hope won out? Perhaps. Though we discovered in the 1980s that there are times when the short run has to take precedence over the long run. October 1987 gave us a dramatic case in point.

PART II

DAVID SCHOUMACHER: 1929. The plunging stock market causes a panic. The Federal Reserve clamps down on the money supply, stifling the economy. Banks starved for ready cash—liquidity—fail by the thousands. Businesses close. Soon 18 million Americans are unemployed, hopeless, and hungry.

This is Wall Street today. Buying and selling by computer, trusting Congress and the Federal Reserve to prevent a repetition of 1929. After many years of experimentation, Wall Street and the nation have learned that a long-term consistent monetary policy is good medicine to keep the economy healthy. But in 1987 the question remained unanswered: What could monetary policy do in an economic emergency?

RONALD REAGAN: “I have a statement for you. Paul Volcker has advised me of his decision not to accept a third term as a member and Chairman of the Federal Reserve Board. I accepted Mr. Volcker’s decision with great reluctance and regret. It is my intention to nominate Dr. Alan Greenspan to a four-year term as Chairman of the Federal Reserve.”

DAVID SCHOUMACHER: On his first day in office Chairman Greenspan revealed his wish list.

ALAN GREENSPAN: “A dollar which is always stable, interest rates which stay low, and employment which stays high.”

DAVID SCHOUMACHER: His first action as Chairman of the Board of Governors was to reaffirm Volcker’s tight money policy, a long-range strategy that most economists

believed was crucial to maintaining orderly economic growth. But if there was one sector of the economy that was far from orderly in 1987, it was the stock market.

Greenspan feared a collapse, but what could the Fed do? Securities Analyst Roger Kubarych:

ROGER KUBARYCH: “When Chairman Greenspan came into office in August, one of the first things he did was to launch a series of studies, call them war games if you like, that did include both the Board staff in Washington, members of the Board, and the New York Fed, on a number of possible scenarios for market disruption, financial market disruption.”

DAVID SCHOUUMACHER: On October 19, 1987, Greenspan got an unwelcome opportunity to test his plans. The market fell 508 points, more than five times greater than the 1929 drop that precipitated the Great Depression. Many investors faced total financial ruin.

ROGER KUBARYCH: “There was a clear picture of an impending problem of monumental proportion so... it was a fascination. It was like watching a car accident that was happening right on your block.”

DAVID SCHOUUMACHER: The business of buying and selling stocks is based on confidence. By Tuesday morning, October 20, confidence had fled. What were people afraid of? We asked Economic Forecaster Nariman Behravesh.

NARIMAN BEHRAVESH: “The specter of a 1929-style depression loomed very large for the markets and for the Federal Reserve. I think the kind of scenario that the Fed was most worried about was that people had borrowed a lot to finance purchasing stock as the stock market rose. As it crashed, a lot of those loans were called in. And the Fed was worried that there would be a lot of bankruptcies—personal bankruptcies, corporate bankruptcies. As those occurred a lot of people would be laid off. The unemployment

rate would rise, and you'd have a full-scale recession, and maybe even a depression, on your hands."

DAVID SCHOUMACHER: A bank run seemed imminent. Banks needed liquidity immediately. How would the nation's central banker respond?

ROGER KUBARYCH: "What the Fed did was two-fold. It supplied liquidity through ordinary open market operations and through the use of the discount window—very standard techniques of supplying liquidity. But under the guidance of Chairman Greenspan, they also sought to reduce the demand for liquidity. In other words to use what you might call 'tender persuasion' to convince people that they needn't go seeking liquidity, bidding for liquidity...it would be there."

DAVID SCHOUMACHER: In 1929, the Fed tightened the money supply. This time Greenspan did the opposite. The Fed's message was: "Whatever you need, we'll give you." Greenspan had said the magic words, but was anyone listening? On Tuesday morning, the market continued its dive—plunging 225 points. By noon the market was approaching complete meltdown. Buying was at a virtual standstill. Then, buy orders began trickling in like water upon parched land. The buying trend accelerated. And Wednesday morning the world awoke to headlines touting the largest rally in the big Board's history.

DAVID SCHOUMACHER: Monetary Policy works in mysterious ways, little understood outside the economic community. But on Tuesday, October 20, 1987, Alan Greenspan demonstrated both the power and the flexibility of the Federal Reserve. His willingness to turn his back on long-term tight money policies and pump cash into a desperate economy helped save the stock market and quite possibly the economy. We asked analyst Richard Gill what this emergency intervention has to do with the demands we place on monetary policy.

(MUSIC PLAYS—COMMENT & ANALYSIS II)

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RICHARD GILL: Well, perhaps the basic thing it shows is that, although it might be nice to focus on keeping things steady in the long run, there are times when human judgment and discretion are crucial. The fall in the stock market in October of 1987 was real. The dangers of a profound effect on the economy, equally real. Numerous commentators observed that the parallels to 1929 were ominous. Even the upturn in the market in late 1987 had had its parallel in the 1920's, only to be followed by a further collapse and the greatest depression of all times. But it didn't happen. And one reason was that theories of long-run steadiness gave way immediately to an appreciation of the crisis. Did we need more money? More liquidity?" "We would have it," the Fed told us quickly and unequivocally. "Forget general rules. Handle the crisis first"—which leaves us where? Perhaps better off in economic fact than in economic theory. Cruise control is great in automobiles on the open highway. But when the traffic gets hot and heavy there is, alas, no substitute for human judgment. Hopefully, good judgment.

PART III

ALAN GREENSPAN: "Clearly, sustained low inflation implies less uncertainty about the future, and lower risk premiums imply higher prices of stocks and other earning assets...But how do we know when irrational exuberance has unduly escalated asset values?"

DAVID SCHOUUMACHER: How do we know? Well if you're an average consumer, you probably don't. But if you're on the Federal Reserve Board, it's your job to know or at least make an informed decision on how to use the tools of monetary policy to control the economy. And since these tools were used so effectively in the last few decades of the 20th Century, you would assume they would work well in the new century. Well, think again.

DAVID SCHOUMACHER: After the 1987 market crash, the Federal Reserve temporarily pumped cash into the economy, quelling the fears of investors. E-business began to bloom. Stock prices shot up. “Irrational” or not, the Internet captured entrepreneurial imagination. Anything that was “dot com” seemed likely to succeed.

DONALD KOHN: “So in the latter part of the 1990s there was a big surge in productivity...So as the stock prices rose we raised interest rates in order to keep inflation under control, and then when stock prices fell we lowered interest rates in order to prevent unemployment from rising even more substantially than it did. Starting in 1999 the U.S. Federal Reserve increased interest rates six times and predictably the economy began to lose speed.”

DAVID SCHOUMACHER: When the Tech Bubble finally burst, Stocks assets plummeted and nearly half of the dot-com-business went belly up.

DONALD KOHN: “Monetary policy works with lags on the economy. What the Federal Reserve does today has effects on the U.S. economy and to some extent on the global economy over the next several years, so it’s always got to be a forward looking kind of process... that’s one of the vulnerabilities. One can never predict accurately what is going to happen.”

DAVID SCHOUMACHER: Despite the destruction of roughly 5 trillion dollars in paper wealth, not one financial institution of any size failed. Once again the Fed lowered interest rates easing the money supply.

DONALD KOHN: “The same issues came up in the context of the housing market, 2004, 5, 6, and 7. So should the Federal Reserve have tightened monetary policy by more than we did?”

DAVID SCHOUMACHER: In 2006, when Benjamin Bernanke took over as Chairman of the Fed, the housing market had already been heating up.

DONALD KOHN: "We were tightening in 2005, 2006, but should we have tightened more in order to take the steam out of the housing market and to prevent the subsequent disaster?"

DOUGLAS ELLIOT: "There is a lot of controversy about the role of the Federal Reserve, because there are two things it does. First it broadly controls the monetary policy in the United States, that is, effectively it determines whether it's easy to borrow money, and cheap, or hard, and expensive, and there are people who think that it kept money too easy and too cheap for too long, and this helped feed the bubble. I've been asked by, I think it was the Wall Street Journal. to give a grade to Ben Bernanke... I forget exactly what it was, but my point simply was, it was a lousy grade before the crisis, because I do think the Fed could have done more to deal with the beginnings of the crisis, the things that created it..."

DONALD KOHN: "My personal view is that we kept our eyes on the right thing, which is a macro economy. That's our legislative mandate in the Federal Reserve Act: maximum employment and stable prices. That's what we were trying to promote."

DAVID SCHOUUMACHER: When the housing bubble burst, the banking system was in turmoil. Unemployment rose to levels not seen for decades. The President, Congressional Leaders, politicians put everything aside in an attempt to deal with the crisis. What could the Fed do?

DONALD KOHN: "In December of 2008 the economy was hit with such a severe shock arising from the failure--Lehman Brothers, and the financial panic that followed--that the Federal Reserve reduced its interest rates essentially to zero."

DAVID SCHOUUMACHER: And still the economy didn't budge.

DONALD KOHN: “How does the Federal Reserve go about stimulating spending under these circumstances when that Federal Funds Rate is already at zero? The way the Federal Reserve chose to do that was to purchase intermediate and longer term securities, and hopefully drive down the interest rates. … having the same effects I talked about on the incentive to spend on houses, and cars, and capital equipment…but it was an unusual, unprecedented situation in which the usual instrument that the Federal Reserve uses to equilibrate and calibrate the economy, to keep it on an even keel, was no longer available, because it was already at zero.”

BENJAMIN BERNANKE: “We thought it was an important step, and it was at an important time when we were all worried about a double dip and we were worried about deflation.”

DAVID SCHOUUMACHER: Despite the injection of cash into the economy, growth remained low and unemployment high,

DONALD KOHN: “In terms of growth and unemployment over the long run, the long-run capacity of the economy to grow, and the unemployment rate consistent with sustained stable growth, are really determined outside the central bank.”

DAVID SCHOUUMACHER: But in 2011 monetary policy appeared to be stuck. Inflation seemed to be under control, but unemployment continued to hover at nine percent.

We asked Economic Analyst Nariman Behravesh if monetary policy was still alive?

(MUSIC PLAYS—COMMENT & ANALYSIS III)
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NARIMAN BEHRAVESH: Despite the sluggish recovery after the Great Recession, most economists give the Fed fairly high marks for its crisis management. It prevented the worst financial crisis since the 1930s from turning into another Great Depression. There is a much less charitable view of the Fed's role in the period before the financial crisis of 2008 and 2009. Many economists believe that, in 2003 and 2004, the Fed kept interest rates too low for too long, and in the process contributed to the housing bubble that was a root cause of the financial meltdown. Some have even called the Fed a "serial bubble blower"—referring to the tech bubble of the 1990s and housing bubble of the 2000s.

More thoughtful analysts worry that the response of central banks to asset bubbles has been dangerously asymmetrical: benign neglect when prices are rising, and dramatic action when they are falling. While some of this criticism is justified, hindsight is 20/20, and operationally targeting asset prices can be difficult. Here are a few points to ponder. First, the Fed and other central banks don't have a mandate to burst asset bubbles. Second, it is often very difficult to be sure that a rise in asset prices is symptomatic of a speculative bubble. Third, if a central bank over-reacts to a bubble, the cure may be worse than the disease. Nevertheless, given the boom-bust cycle of asset prices since the 1990s, central bankers will have to pay much more attention to them in the future than they have in the past.

DAVID SCHOUMACHER: Monetary policy was an effective factor in holding down inflation in the booming '90s. But the very low interest rates in the first decade of the 21st Century became a major cause of the credit binge, the housing bubble and the banking crisis. Once the crisis occurred, the Fed earned high marks for limiting the damage. But how well monetary policy will work in the future is hard to say. We'll just have to wait and see. For this 21st Century Edition of ECONOMICS U\$A, I'm David Schoumacher.

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