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The Federal Reserve's abandonment of its 1923 objectives of monetary policy☆

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ABSTRACT

The "Guides to Credit Policy" in the Federal Reserve's Annual Report of 1923 specified that interest rates should be set so as to balance the benefits of meeting the credit needs of business with the dangers of speculative credit. This paper uses FOMC transcripts to study when these two objectives of monetary policy (meeting business needs and preventing speculative credit) ceased to be reiterated, so that they were effectively abandoned. It is demonstrated that this occurred in the mid-1960s, at roughly the same time that the Fed first abandoned its fight against inflation for fear of causing a recession. The 1923 Report also expressed a preference for using credit aggregates rather than monetary aggregates to judge the stance of monetary policy. Monetary aggregates appeared in Federal Reserve pronouncements before the mid 1960s while credit conditions continued to be discussed at FOMC meetings well past this date. The paper seeks to reconcile these dating differences.

The financial crisis of 2007–2008 has led several observers to declare that the pursuit of financial stability ought to become a central objective of the Federal Reserve. This would, to some extent, represent a return to a past practice that was subsequently abandoned. The Federal Reserve's 1923 Annual Report officially announced that a key goal of monetary policy was the avoidance of speculative lending. At a 1980 FOMC meeting, on the other hand, Federal Reserve Bank of Cleveland President Willis Winn's expression of concern with "speculative activity and … credit" used in commodity markets was interrupted by Chairman Volcker who said "What do you mean? We should not permit speculative loans?" Duly chastised, Winn replied "No, it is not that." The main purpose of this paper is to elucidate when the monetary policy ideas of the 1923 Report were dropped and thereby shed some light on why this occurred.

The schema enshrined in the 1923 Annual Report is not well-understood at present. One factor that may contribute to this lack of understanding is that several economists sought to discredit the 1923 approach by associating it with the "real bills doctrine" and demonstrating that a simplified version of this "doctrine" could lead to an exploding price level.[1] Attachment to the "real bills doctrine" was also blamed for the depth of the Great Depression, where prices declined.[2]

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[1] See, for example, Currie (1934) and Humphreys (1982).

[2] Meltzer (2009, p. 1217) states that "mistaken beliefs or incorrect theory – mainly the real bills doctrine [was] a decisive cause of the failure to take action to limit, prevent, and end the Great Depression". In another example, Humphreys (2001, p. 311) discussion of the Great Depression concludes with "The Fed's failure to act shows that its adherence to the real bills doctrine had deleterious consequences". Also, Timberlake (2005, p. 217) says "The reason Fed policy was so disastrous was... [that] Fed managers were operating on a real bills basis". An earlier criticism of the Fed for being attached to the real bills doctrine can be found in Friedman and Schwartz (1963, p. 169).

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The 1923 Report approach is similar to more recent approaches in that interest rates were supposed to respond to two variables. The Report says, in particular, "rates should be neither so low as to invite the use of credit for speculative purposes nor so high as to discourage its use for meeting legitimate productive needs of the business community."[3] The Fed thus had two often opposing objectives, meeting legitimate credit needs and avoiding speculative credit.

The desire to lower rates when businesses did not borrow enough to satisfy their legitimate productive needs seems somewhat similar to the more modern desire to lower rates when output is below potential. By contrast, the desire to raise rates when credit was used for "speculation" seems somewhat different than the desire to raise interest rates when inflation threatens. As I detail below, the 1923 Report noted this distinction and chose its anti-speculative goal purposefully.

The two 1923 objectives were reiterated numerous times at FOMC discussions, and each one was associated with particular words and phrases. My approach to finding when these objectives ceased to be important for interest rate determination is to investigate the frequency with which these phrases appear in FOMC discussions. When the frequency with which phrases associated with one of these two objectives becomes insignificant, I determine that it has been abandoned.

This methodology can seem somewhat lax in the sense that it is logically possible for someone to continue to use a phrase past the point at which the ideas in the phrase are no longer taken seriously by the bulk of FOMC members. This concern is allayed to some extent by two considerations. First, the phrases I investigate sometimes appear in sentences that make it clear that the person using them expects others to agree with him. Second, the exchange between Winn and Volcker detailed above shows that it was dangerous to advance goals at FOMC meetings that the Committee did not consider valid. More generally, the FOMC transcripts suggest that its members sought to make statements that others would find reasonable. I provide an example of this below.

In its use of the available FOMC discussions to analyze the role of ideas, this paper follows Romer and Romer (1989) and Chappell et al. (1997).[4] It is closest to Meade and Thornton (2012) in that I search for occurrences of specific combinations of words and discuss the contexts in which these combinations of words appear.[5]

The main finding of the paper is that phrases related to "business needs" as well as phrases related to "speculative lending" continued in substantial use in the early 1960s and became rare around 1966. Using more subjective methods, the existing literature contains contradictory assertions regarding the longevity of the 1923 objectives of policy. Testifying in 1964, Abba Lerner and Milton Friedman complained that the Fed continued to be more concerned with the quality of the assets held by banks (so that it continued to be averse to "speculative" loans) than with the evolution of the money supply. Indeed, Abba Lerner and Milton Friedman suggested that this emphasis was a necessary consequence of the Fed's organization, so that it could be expected to remain present unless the Fed was thoroughly reorganized.[6]

In contrast to this view, which regards a 1923 objective as dominant in 1964, Meltzer (2009) suggests that the 1923 Fed's ideas had lost force considerably earlier. Meltzer (2009, p. 281) recognizes that the "Board's 1923 Annual Report" was among the "only comprehensive efforts to develop a policy framework." Writing about 1960, however, Meltzer (2009, p. 281) states "Important as [these efforts] were at the time they were written, they had faded along with the real bills doctrine."[7]

At this point, it might be wondered whether dating the loss in policy importance of the 1923 objectives should be of interest to anyone beyond students of policy history. Four further reasons for caring about this date suggest themselves. The first is that it may shed light on the relevance of the hypotheses that have already been proposed to explain changes in the behavior of central banks. If these existing hypotheses do not provide a satisfactory explanation, this date might have the second benefit of suggesting a new hypothesis concerning what leads policy to change. Third, the 2007–2008 financial crisis has led some to suggest that monetary policy should be tightened when there is an increased risk of a renewed crisis. Echoing some ideas of the 1923 Report, Borio (2014) recommends that central banks should raise rates when credit aggregates rise substantially relative to GDP. What this study can contribute to this debate is an understanding of what could

[3] Federal Reserve 1923 Annual Report, p. 10.

[4] The time coverage is longer, however, with the result that my series includes texts whose formats differ slightly from one another. Before June 1967, they were published as "Historical Minutes", then as "Memoranda of Discussion" until March 1976 and finally as "Transcripts" starting in April 1976. The "Memoranda of Discussion" differ from the "Historical Minutes" in that the latter include a summary that was separated into the "Minutes of Actions" when the "Memoranda of Discussion" started to appear. Otherwise, the format of the "Historical Minutes" and the "Memoranda of Discussion" appears identical. "Historical Minutes" are available since 1936. There is a substantial change in July 1955, however. At this point, Intermeeting Executive Committee meetings were abolished and full FOMC meetings became more frequent. As a result, much of the detailed analysis in this paper focuses on the post-1955 period.

[5] Meade and Thornton (2012) are interested in appearances of words relating to the Phillips curve and end up focusing on the appearances of related expressions such as the "output gap".

[6] Friedman (1962) goes somewhat further and states that some of the 1923 objectives followed almost by necessity from the Fed's independence. This was because "an independent central bank will almost inevitably give undue emphasis to the point of view of bankers."

[7] Mehrling, (2002, p. 216) expresses a similar view. After discussing the intellectual currents that shaped the Fed at its inception, the article concludes with "The Fed was ultimately not able to develop its own traditions, much less to establish them firmly, before worldwide depression swept them all away." Meltzer (2009 p. 467) is the only passage in the book suggesting that "remnants of the real bills doctrine were not dead." This passage refers to a set of legislative proposals that, according to Meltzer (2009, p. 466) the Board did not expect to pass but which the Board nonetheless wished to propose in 1963 to signal its desires. This legislative proposal refers to the "maintenance of sound credit conditions, and the accommodation of commerce, industry, and agriculture."