REFLECTIONS ON **ALLAN H. MELTZER'S** CONTRIBUTIONS TO MONETARY ECONOMICS AND PUBLIC POLICY

EDITED BY DAVID BECKWORTH

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About Allan H. Meltzer

Allan Meltzer (1928–2017) was one of the greatest monetary economists of his generation. During his career, he authored many books and papers that help shape the modern consensus on monetary policy and the art of central banking. His work also contributed to a wider debate on the role of public policy in a capitalist system.

Meltzer's academic work on monetary policy demonstrated how central banks can sway the business cycle and why it is important to discipline this influence over economic activity. His efforts continue to inform policy making today, including his landmark books *A History of the Federal Reserve*, volumes 1 and 2 (University of Chicago Press, 2002 and 2010), and the still-ongoing and influential Carnegie-Rochester Conference Series on Public Policy that he founded along with Karl Brunner. His book *Why Capitalism?* (Oxford University Press, 2012) gives an impassioned defense of the market economy in a time when many have blamed capitalism for economic disaster, inequality, and other social ills.

Meltzer joined the faculty at Carnegie Mellon Graduate School of Industrial Administration, later named the Tepper School, in 1957 and would go on to hold a professorship in political economy there until his death. He was also a distinguished visiting fellow at the Hoover Institution as well as a visiting professor at numerous universities, including Harvard University and the University of Chicago.

Meltzer also threw his hat into the policy world by serving as a consultant for several congressional committees, the president's Council of Economic Advisers, the US Treasury Department, the Board of Governors of the Federal Reserve System, foreign governments, and various central banks. He was also a member of the President's Economic Policy Advisory Board from 1988 to 1990.

From 1986 to 2002, he was an honorary adviser to the Institute for Monetary and Economic Studies of the Bank of Japan. In 1999–2000, he served as chair of the International Financial Institution Advisory Commission, known as the Meltzer Commission, which proposed major reforms of the International Monetary Fund and the development banks.

Over the course of his career, Meltzer won many awards, including the 2003 Irving Kristol Award from the American Enterprise Institute and the 2009 Distinguished Teaching Award from the International Mensa Foundation. In 2011, he won the Bradley Award, the Harry Truman Medal for Public Policy, and the Truman Medal for Economic Policy.

Meltzer received his BA in economics from Duke University and his MA and PhD in economics from UCLA under the direction of Karl Brunner. He is survived by his wife of sixty-six years, Marilyn, as well as by three children and eight grandchildren.

Allan Meltzer had a long and productive career and the world is a better place because of it.

Introduction

DAVID BECKWORTH

Allan Meltzer was one of the leading monetary economists of the twentieth century, authoring more than a dozen books and 300 papers during his distinguished career. His work changed the fields of economics, central banking, and public policy.

Meltzer's academic work was seminal in both the theoretical and practical applications of monetary economics. He carefully showed how central banks affect broad economic activity and how that influence could, and sometimes did, end in economic disaster. His work on monetary policy, including his magisterial two-volume *A History of the Federal Reserve* and the public policy conference series he founded with Karl Brunner, is still important and relevant today.

Meltzer participated in the policy world by serving as a consultant for several congressional committees, the president's Council of Economic Advisers, the US Treasury Department, the Board of Governors of the Federal Reserve System, foreign governments, and various central banks. He also served as chair of the International Financial Institution Advisory Commission, known as the Meltzer Commission, which proposed major reforms of the International Monetary Fund and development banks in the late 1990s.

Meltzer passed away in May 2017. To commemorate his career, a conference was held on January 4, 2018, in Philadelphia, Pennsylvania. The conference, titled Meltzer's Contributions to Monetary Economics and Public Policy, was organized by the Program on Monetary Policy at the Mercatus Center at George Mason University and by the Institute for Humane Studies.

Participants at the conference spoke of three areas in which Meltzer made important contributions: the history of the Federal Reserve, the monetary transmission mechanism, and public policy more generally. Their presentations make up most of the chapters in this book. Owing to the extemporaneous nature of conference proceedings, some of the chapters in this volume have been transcribed.

Chapter 1 starts the book with an essay by John Taylor. He takes a broad look at Meltzer's career and notes that it was characterized by a desire to be holistic. This is why Meltzer spent many years developing a theory of the monetary policy transmission mechanism only to follow that with many more years working on the history and political economy of the Federal Reserve. These various endeavors complemented each other and provided a well-rounded understanding of US monetary policy. Taylor also notes that one of the inescapable lessons Meltzer drew from this work was the need for rules. That is why Meltzer became a long-time advocate for monetary policy rules.

Chapter 2 begins the section of the book that takes a closer look at Meltzer's contribution to the history of the Federal Reserve. Authoring this chapter is Michael Bordo, who reviews the broad themes in Meltzer's *History of the Federal Reserve, 1913–1986* (*HFR*). He notes that, unlike Milton Friedman and Anna Schwartz's *A Monetary History of the United States, 1867–1960*, *HFR* is not a monetary history per se but more of a biography of the institution, its leaders, and their decision-making process. A key argument of *HFR* is that had the Fed followed the quantity-theory-based classical monetary theory—as espoused by Henry Thornton, Walter Bagehot, and Irving Fisher—the Fed could have easily avoided its biggest failures: the Great Contraction of 1929–1933 and the Great Inflation of 1965–1982. Conversely, its biggest successes, the Volcker Disinflation of 1979–1982 and the Great Moderation of 1985–2001, occurred because the Fed did follow classical monetary theory.

Robert Hetzel, however, pushes back in chapter 3 against Meltzer's claims in *HFR* and elsewhere that Fed officials were capable of following the "self-evident" quantity theoretic truths from classical monetary theory and, thereby, could have avoided the Great Depression. Hetzel notes that these claims trivialize the role played by Meltzer and the other monetarists in the monetarist counterrevolution. Their efforts over many years are what led to the modern understanding of monetary policy and the role of a central bank. To believe Fed officials in the 1930s could have acted differently is to assume they had access to the body of knowledge Meltzer and the other monetarists spent a lifetime establishing.

In chapter 4, George Selgin closes out the historical portion of the book by looking at one of the fascinating stories in *HFR* and using it to shed light on current development. Specifically, he looks at the Fed's raising reserve requirements between 1936 and 1937 and compares it to the Fed introducing interest on excess reserves (IOER) at a rate higher than comparable short-term interest rates starting in late 2008. In both cases, concerns about excess reserves stoking inflation were a motivating factor, and in both cases the policy actions served to sterilize the excess reserves by increasing banks' demand for reserves. Arguably, in both cases, these actions contributed to a subsequent downturn and slow recovery. Some history lessons get repeated.

Chapter 5 starts the portion of the book that looks at Meltzer's contributions to the monetary transmission mechanism. Peter Ireland, the author of this chapter, begins by observing that Meltzer worked closely with Karl Brunner over several decades to create what became known as the Brunner-Meltzer model. This model is similar in some ways to modern macroeconomic models but differs in other ways. One key difference is that the Brunner-Meltzer model sees monetary policy working through a wide spectrum of assets prices and yields rather than through just the expected path of the short-term interest rate target. As Ireland notes, this understanding implies that the effective lower bound on short-term interest rates should not be a binding constraint on monetary policy, for other asset yields can be affected through open market operations. The Brunner-Meltzer model, therefore, can be used to justify some form of quantitative easing. More generally, as Ireland shows, the model can be used to motivate the use of monetary aggregates in modern monetary policy.

Edward Nelson notes in chapter 6 that Meltzer saw the monetary base as central to understanding the monetary transmission mechanism. Meltzer believed the growth of the monetary base helped shape the growth of broader monetary aggregates and nominal income more generally. He also believed the real monetary base could be used as a summary indicator, or index of changes, across the many asset prices that mattered for aggregate demand. Nelson explores the implications of these beliefs and resolves some seeming paradoxes they create. For example, he shows how Meltzer's focus on the liability side of the Fed's balance sheet can be reconciled with monetary policy working through changes in the mix on its asset side. Nelson shows how this understanding makes sense in light of the Fed's large-scale asset purchases and interest rate targets.

In chapter 7, Joshua Hendrickson considers what the Brunner-Meltzer model implies for US monetary policy in light of the Fed's floor system. As noted, in late 2008 the Fed introduced IOER at a level higher than comparable short-term interest rates as it vastly expanded its balance sheet. These actions turned the Fed's operating system from a corridor system to a floor system. In this new operating system, the Fed uses an administered interest rate, the IOER, to set monetary policy. Hendrickson notes, however, that the Brunner-Meltzer model implies that monetary policy works through many asset prices and yields, not just a single target interest rate like the IOER. Moreover, the floor system has intentionally divorced money from monetary policy—by raising demand for bank reserves to the perfectly elastic portion of the demand curve—and so real money balances are no longer informative about the stance of monetary policy. The Fed, therefore, may find managing monetary policy more challenging in the floor system.

In chapter 8, St. Louis Federal Reserve president James Bullard reviews Meltzer's work on the Federal Reserve's search for a nominal anchor coming out of the Great Inflation of the 1970s and early 1980s. Bullard notes that much progress has been made with the Fed's adoption of an inflation target, first de facto in the mid-1990s and then explicitly in 2012. Bullard goes on to consider whether this progress has meant the Fed is conducting something close to optimal monetary policy. He does so by looking at the disappearing Phillips curve and deviations from the price-level growth path.

Chapter 9 starts the section that looks at Meltzer's contribution to public policy thought. The author of this chapter, Gerald O'Driscoll, shares his experience working with Meltzer on the International Financial Institution Advisory Commission, known as the Meltzer Commission, which sought to reform the International Monetary Fund and development banks in light of the emerging market crises of the mid-to-late 1990s. Meltzer was the chair of the commission, and O'Driscoll was his chief-of-staff. Meltzer had six months to navigate a commission divided among Republicans and Democrats and was able to produce a bipartisan report.

In chapter 10, Robert Lucas reflects on his time working with Meltzer at Carnegie Mellon University and recalls a debate Meltzer had with Noam Chomsky. Lucas also points to the seminal work Meltzer did on theoretical money demands models, starting with his influential 1963 *Journal of Political Economy* article. Lucas notes that Meltzer's work complemented that of Friedman and Schwartz, who focused more on pure monetary history. Lucas also shows that Meltzer's early money demand work still holds up if updated to the present.

Chapter 11 closes this section with Charles Plosser recognizing the many public policy contributions made by Meltzer. They include his co-creating the Shadow Open Market Committee and the Carnegie-Rochester Conference Series on Public Policy in the 1970s. These programs continue to this day and have made many important contributions to monetary policy, including John Taylor's 1993 Carnegie-Rochester Conference paper that coined his now-famous Taylor rule. Plosser suggests that Meltzer's biggest public policy contribution was his enduring support for monetary policy rules. Plosser agrees with Meltzer's assessment that the Fed's biggest policy failures occurred in periods of excessive discretion, the Great Depression and the Great Inflation. Conversely, in periods of more rule-like behavior, such as the Great Moderation, the Fed performed the best.

The final chapter of this book is a transcript of a live interview Meltzer did for the podcast *Macro Musings*. The interview took place in November 2016, just six months before he died. It is Meltzer in his own words, one last time before he passed. I was the host of the show and was impressed with his sharp-witted insights during our conversation. We talked about how he got into economics, the monetarist counterrevolution, his work with Brunner, his reinterpretation of Keynes's work, the role of money in monetary policy analysis, and his thoughts on the Great Recession, quantitative easing, and inflation targets.