Evolution of the Research Function at Reserve Banks after the 1951 Accord

Ned Prescott (FRB Cleveland)*

Panel on the Evolution of Federal Reserve's Mission and Governance
Monetary and Financial History Workshop
May 24, 2022

* The views expressed in this presentation are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or the Federal Reserve System.

Overview

- Evolution of Reserve Bank research since the 1950s

- Emphasize two institutional developments
  - Internal reforms to FOMC instituted by Chairman Martin in 1950s
  - Increased professionalization of economics starting in 1960s

- Highlight how Reserve Bank research led to monetary policy reforms
  - Brings in some history of thought

- Talk taken from my paper with Michael Bordo
  - "Federal Reserve Structure, Economic Ideas and Monetary Policy." FRB Cleveland WP 19-13.

Reserve Bank Governance

- Complicated with various checks and balances, changes over time
- Private and public governance features
- Precise details not important for this talk
- Main point – structure allows a Reserve Bank some ability to develop and support its own views on monetary and banking policy

Fed as a Bureau of Treasury: 1936-1951

- Treasury dominates Fed under Roosevelt

- WW 2 starts
  - Fed’s focus is to help Treasury finance war effort
  - Fed pegs long-term Treasury rate
  - Continues after war ends

Reserve Bank Research in 1940s

- Not much going on
- Mainly collecting regional statistics
- Quality economic analysis limited
- Best economists at the Board

Source: T.W. Schultz (1943) review of research at the Reserve Banks.

Fed-Treasury Accord of 1951

- Fed (also Congress and financial press) fear inflation. Truman and Treasury want peg to continue. Conflict leads to Fed-Treasury Accord.

- William McChesney Martin from Treasury becomes Chairman

- As Chairman, Martin takes Fed side
  - Fed gets monetary policy independence
  - Note: had support in Congress (Sen. Douglas) and financial press

- Martin then begins several internal reforms with long-term consequences

Martin's Review of Operating Procedures

- Starts a review of FOMC operating procedures in 1952
- Debate with two facets:
  - Appropriateness of different monetary policy procedures
    - Martin and Board staff want bills only
      - Believes markets can price the yield curve
    - Sproul (NY) wants to target entire yield curve of Treasuries and believes the desk needs to intervene across the yield curve
  - Whether Board or NY would control monetary policy
    - Existing arrangement – FOMC delegates to a small executive committee. Full FOMC only meets 4 times a year. NY most knowledgeable about money markets, so result is that NY (Sproul) dominates.
  - See Hetzel and Leach (2001)

Martin’s Reforms in 1955

- Martin wins battle for control
- Executive Committee abolished
- Full FOMC now meets seven times a year
- Bills only put into place (with some exceptions)
- Alan Sproul resigns in 1956 and replaced by Hayes who was a banker with little Federal Reserve experience
    - *The Economist* (June 2, 1956) views this move as the Board asserting supremacy over NY

Long-Term Effects of Martin’s Reforms

- Changes role of non-NY banks

- Reserve Bank presidents and staff now go regularly to FOMC meetings
  - Now exposed to monetary policy questions
  - Need to say something sensible

- Changes non-NY Reserve bank incentives in terms of research, interest in monetary policy ideas, interactions with academia

Business Week Article (1956)

FINANCE

CURRENCY An 800-lb. cartload of $400,000 in new $1 bills arrives from the U. S. Treasury for storage in Cleveland's main vault.

POLICY Merle Hostetler, research director, arms Pres. Fulton and Chmn. Virden with facts and figures on business situation.

LOANS Harry Burmester, president of Cleveland's Union Bank of Commerce, talks loans with Pres. Fulton.

The Bankers' Bank in Cleveland: A Leader's Role

Behind the classic facade of the Cleveland Federal Reserve Bank (above, right) are the services and decisions that affect the economic life of 15-million persons in a center of the nation's heavy industry.

Only a handful of people who were not employed by the Federal Reserve Bank of Cleveland entered its spacious marble quarters last week. The visitors included a few businessmen, some bankers, a number of bank messengers, a group of high school students on a tour. But despite this relative isolation from the general public, the Cleveland Fed, like its 11 counterparts across the country, was a beehive of activity that involved the entire community.

These activities are rarely witnessed by the public, because the Cleveland Fed plays a largely inconspicuous and almost invisible role. This is true of all 12 district Federal Reserve Banks. Yet they play a vital role. Together, they have a decisive influence on the amount of credit available to the nation and the amount of cash in the public's pockets.

• **12 Central Banks**—This arises out of their special position as central banks. Unlike many other nations, which have only one central bank, the U. S. has a decentralized system of 12 central banks.

Each is a private corporation that is completely independent in the area it serves. Coordinated by the Federal Reserve Board in Washington they form one collective central bank with

Change in Presidents’ Job

- From the article

“[Federal Reserve Bank of Cleveland President] Fulton disclaims any desire to be known as a leader in the System. But he is a prime example of the type of policymaker now being developed.

Until the 1951 accord, most Fed bank presidents, with the exception of Alan Sproul in New York, spent most of their time overseeing technical operations and ironing out regional banking problems. Although Fulton was trained as a practical banker rather than a student of monetary policy, he had managed to learn the ropes of central banking. … His own experience has taught him that there is a pressing need to develop personnel who can grapple with the complicated problems of monetary policy.”

Changes in non-NY Reserve Banks Leadership

- Professional economists assume a more important role in running the banks
  - By 1961 – 6 of 12 Presidents professional economists

- Whittlesey (1963)

“The most striking, though not necessarily the most significant, manifestation of the rise of economists has been their appointment to topmost administrative positions. By 1961, the presidents of six of the twelve Federal Reserve banks were professional economists, all but one of them holders of the Ph.D. degree. Trained economists were also conspicuous at the vice-presidential level. As far as the Federal Reserve is concerned, a background in economics now seems to provide better credentials than experience in law or banking for the responsibilities of a central banker.”

Early and mid 1960s: More professionalization

- Martin's main concerns are low inflation and managing balance of payments
  - Governors' backgrounds in banking and business
  - Martin distrusts economic theory, forecasts not allowed at FOMC meetings
  - Martin and Board staff rely on indicators from money market conditions and free reserves
- Big macroeconomic intellectual development at time is Keynesianism
  - Emphasizes importance of coordinating fiscal and monetary policy
  - Exploiting the Phillips curve
- Keynesian ideas enter the System through a few means
  - First, hiring new economists
  - Board starts developing a large-scale econometric model in 1966 (the MPS) of the Laurence Klein variety
    - Academics (Modigliani and Ando) lead this project
  - Walter Heller (chair of CEA under Presidents Kennedy and Johnson) pushes for Governors who are economists of the "liberal expansionary influence"
    - George Mitchell in 1961, Sherman Maisel in 1965, Andrew Brimmer in 1966

St. Louis Fed innovates

- In 1958, President D.C. Johns appoints Homer Jones as research director
  - Johns felt that he was being ignored by Board (Melzer 1989)
  - Jones taught Milton Friedman at Rutgers
- St. Louis becomes the center of monetarism in the System
  - In early 1960s, criticizes Martin/Board's reliance on money market conditions/free reserves as key indicators of economy
  - Later, when Keynesian ideas take over, criticizes the Board for its inflationary policies
  - Close ties to Friedman, Meltzer, Brunner
- View continues under successive presidents (Darryl Francis and Lawrence Roos) and research directors (Jerry Jordan)

St. Louis Fed Influence on FOMC

- In short run, not so much.
  - President Francis uses monetarist arguments at FOMC in 1970s. FOMC doesn't go along.
    - Hafer and Wheelock (2001)

- In longer run
  - SL influences intellectual debate. Publicizes monetary aggregates, monetarist ideas.
  - Humphrey Hawkins 1978. Fed to present M aggregates targets
  - Volcker uses it, possibly as cover for raising rates, and reduces inflation.

- Example of the value of a Reserve Bank
  - Independence and continuity allow long-term support of a dissenting idea
  - More than being able to process the idea
  - By being insiders they can link it to operating procedures of the Fed and support ideas over time within the System
  - Monetarist ideas became valuable during the Volcker disinflation

The 1970s: Great Inflation and Ideas

- Leading ideas: Phillips curve, cost-push ideas of inflation
  - Burns, Samuelson, Solow

- Resolved by Volcker (October 1979) using Cold Turkey approach

- Showed importance of expectations, which links to Minneapolis Fed

- Intellectually, monetarism fades later
  - Money demand equations are not stable. Velocity changes.
  - Replaced by rational expectations, GE models and associated ideas like credibility
  - Though most modern models are consistent with Friedman (1968) view of long-run neutrality of money

Internal Competition in Ideas Does not Always Go Over Well
Board in 1970s Does Not Like Public Dissent

- Martin tolerated dissent, resisted pressure to clamp down on St. Louis
  - Business Week (1967)
- Chairman Burns doesn't like dissent
  - Under Burns, Board requires RBs to send RB publications to Board for approval (previously, sent as a courtesy)
  - In late 1970s, Board even controlling internal communications about measures of money supply (Business Week (1979))
  - Philadelphia Fed Research Department revolts in 1978
    - Key policy advisor (Kaminow) leaves. Others leave soon after.
- However, lots of political pressure on Fed in 1970s

Political Pressure on Fed

- Tension between Board and some Reserve Banks
  - Not only due to Burns’ personality

- Board under Congressional pressure particularly when raising rates
  - 1960s – Wright Patman
  - 1970s – Henry Reuss, William Proxmire
  - 1980s-90s – Henry Gonzalez
  - Numerous attempts to limit Fed latitude on monetary policy
    - Fed does not have constitutional protections like the courts
    - Only takes one law to eliminate independence

- Differences in views weaken Board when dealing with Congress and the public
  - All government agencies and even corporations face this problem
  - Fed unusual in that its structure lets it partially commit to tolerating publicly dissenting views

Minneapolis Fed: The Next Innovator

- Minneapolis Fed key in developing modern macroeconomics
- Connection starts in late 1960s
  - Walter Heller (again!). Returns to U of MN after CEA.
    - Gets President Galushka together with John Kareken (U of MN)
- Kareken, Wallace, Muench, Sargent try to build an econometric model in which to derive optimal policy rules
  - All four at U of MN, Kareken also at bank (going to FOMC meetings). All Keynesians at time.
  - Read draft of Lucas (1972); abandon project and start working on rational expectations
- Minneapolis dept. research model really starts mid-70s under President Willis
  - Department becomes orientated around long-term research
  - Sargent and Wallace attract the good young researchers
  - Sims at U of MN
  - Prescott comes to U of MN in 1981
- Little immediate effect on FOMC policy
  - Presidents MacLaury and Willis do raise these issues
- But ideas and their macro methods have important long-term implications

Key Monetary Policy Ideas Tied to Minneapolis

- Phillips Curve relationships can be hard to exploit
- Expectations key
- Time inconsistency of optimal plans
  - Kydland and Prescott (1977), Barro and Gordon (1983)
  - Rules versus discretion
  - Institutional design important for commitment (note: implication for Fed structure)
- Methodology
  - Econometric methods (Sargent, Sims, Litterman)
    - Note: these methods attack Keynesian econometric models
  - Dynamic general equilibrium models for macro
    - Developed at Carnegie, Chicago, Minnesota, Rochester
- Role of long-term government budget constraint on inflation
  - Sargent and Wallace

Mpls Fed Influence on FOMC

- In 1970s, very little

- Longer term, different

Great Moderation: Ideas

- Monetary policy ideas that come out of rational expectations
  - Credibility - Independent central banks valuable
    - Rogoff (1985) “tough central banker”
      - Provides a role for Reserve Banks because presidents tend to prefer tighter policy (Belden (1991))
    - Alesina and Summers (1993) – empirical evidence supports independence
    - Reserve Banks source of independence for System
      - Several steps removed from political process
      - Helps improve commitment (reduces time consistency problem)
  - Taylor rules
  - New Keynesian model

Ideas out of Rational Expectations coming from Reserve Banks that become FOMC policy

- Transparency
  - FOMC decisions used to be secret
  - Idea that transparency can help with credibility
    - Associated with Richmond Fed, Goodfriend (1986)
  - FOMC now much more open
    - Minutes released, transcripts after five years, minor negative effects
- Inflation targeting
  - Cleveland Fed under President Hoskins (1987-1991)
    - Hoskins actually pushed for the related idea of price level targeting
  - FOMC starts inflation targeting in 2012

Analogies for Banking Policy

- Supreme Court decision in 1960 that antitrust applies to bank merger
  - Research develops on bank performance and structure
- Bank failures starting in 1970s
  - Research develops on deposit insurance reform
    - Chicago Fed and George Kaufmann in 1980s
  - Research on too big to fail
    - Minneapolis Fed takes a stand on
- Lender of Last Resort function expanded in 1970s
  - Richmond Fed takes positions
- Monetary Control Act of 1980 – Fed needs to price bank services
  - Research develops on payments (mix of IO and monetary economics)

Now

- All Reserve Banks do academic research

- Board staff always did academic research
  - Seem to do more than in the past. Also, a broader set of topics.
  - Would be interesting to compare with history of FDIC, OCC, SEC

Summary

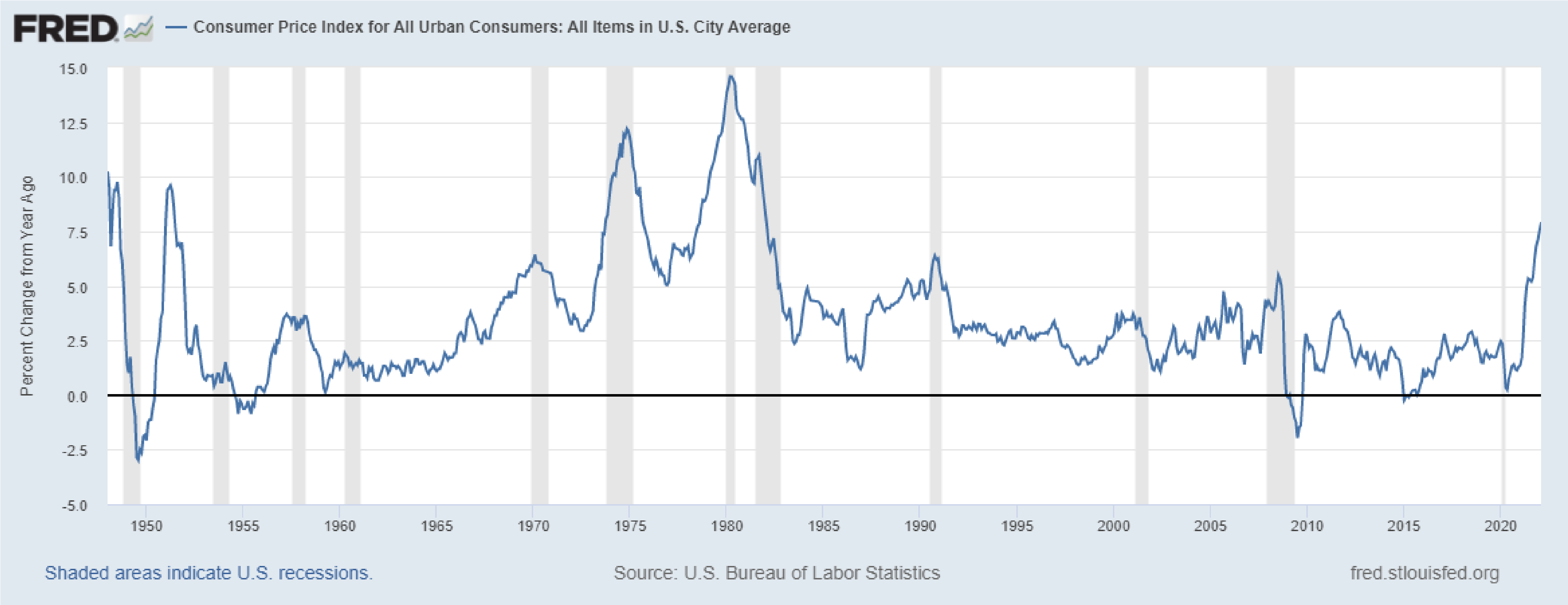
- Federal Reserve decentralized structure valuable as part of a system for central bank to process ideas
  - Evolved accidently after Martin’s post-Accord reforms to FOMC
  - Professionalization of leadership via economics a factor, but not enough alone
  - Reserve Banks semi-independent corporate structure makes this possible
  - Consistent with Fed’s founders’ belief in decentralization and checks and balances

Extra Slides

Cleveland Fed History

- W. Braddock Hickman appointed president in 1963. First, Ph.D. economist in role.
  - Fulton (his predecessor) background in banking
- First VP an economist – Donald Thompson (fellow in Am. Stat. Assoc.)
- Research director an economist – Merle Hostetler

U.S. Inflation



Phillips Curve isn’t stable

From Mpls Fed Annual Report (1977)

Figure 3.
Generalized Employment-Inflation Upswing
for U.S. since mid-sixties
(Plotted points are semiannual averages)