Current Lessons from the Past: How the Fed Repeats Its History  
By: Allan H. Meltzer, Carnegie Mellon University and the Hoover Institution

From Wicksell (1906) quoted in Issing and Wieland (2013)

“Here, then, the rulers of society have an opportunity to show their wisdom or folly. Monetary history reveals the fact that folly has frequently been paramount: for it describes many fateful mistakes.”

My paper mentions a few examples of wisdom, but it is mainly about errors.
We all know about: The Great Depression  
The Great Inflation  
The Great Recession

My theme is mistakes caused by analytic errors, repeated  
Related to increased authority – discretion  
Started 1913-14 with very strict limits on action  
Crises, wars, international developments reduced restraints  
Treasury debt  
Gold standard
Political Board, Reserve Bank bankers

Meaning of “independence”—Martin

Fed is an economic, but also a political agency

Article 1, Sec.8
Depression and Employment Act

Optimal policy?

Strong and Reserve Banks won control in 1920s

1920-21 recession and Open Market Operations
Banks not Board

1933 and 1935 Acts  Centralized control

Martin in 1950s – more political control
Bills only—political solution
Heller and Tobin – Quadriad
Catalogue of major analytic errors

Great Depression—real bills doctrine (Philadelphia)
1960s Simple K model—coordination
Failure of coordination
Burns—price and wage control
Burns and Nixon
The Phillips curve trade-off—Friedman,
   Volcker, Greenspan, and Bernanke
Woodford and the credit crisis
   Friedman, Tobin, Brunner and Meltzer
Lender of last resort—Bagehot (1873) A RULE! For payments system, not banks

Preventing most failures: 4 steps
1) A clearly stated rule for LOLR
2) Protect the payments system not the failing banks
3) Prevent spread by lending at penalty rate
4) Require equity capital sufficient to absorb anticipated losses

PRUDENCE!

Bagehot gives evidence these rules work

NY banks 1929-32

2005-8 gives evidence that Dodd-Frank will fail

Two best periods in Fed’s 100 years
1923-28 gold exchange rule
1985-2002 or 2003 Taylor Rule

No comparable period for discretion 1950s Eisenhower
Why discretion worse results: 2 main reasons
   Short-term focus based on quarterly forecasts
   My Western pres. Address
   Permanent—Both Friedman and Modigliani
   My proposal Use Muth (1960)

Summary of Principal Errors that are repeated
   1) Wrong choice of model, neglect of money and credit, asset prices
   2) Failure to distinguish real and nominal events
   3) Excessive attention to monthly and quarterly data; neglect of permanent changes -- Greenspan on productivity
   4) Failure to announce and follow a rule: politicization

Some examples of proper, even praiseworthy actions

Back to main theme—errors, repeated mistakes
Example of QE 2 and 3
95% idle; what can another $1 trillion per year do
Why? Failure to distinguish real and nominal
Current economic sluggishness mainly real problems
   Investment
   Harvard MBA alums
   Bank and corporate balance sheets

Repeated failure to distinguish real from nominal
   Plosser (1979)
   1932 1970s interest rates, Phillips curve,

Failure to distinguish large relative price changes and inflation
   Price controls
   Oil shocks (SOMC)

Rules vs. discretion
   Kydland and Prescott
   Taylor rule

Neglect of credit and money
   Velocity Unstable?

What Congress Must Do to Increase Stability
Monetary Trends

Velocity
Nominal GDP/MZM, Nominal GDP/M2 (Ratio Scale)

Interest Rates
Percent

MZM Velocity and Interest Rate Spread
Ratio Scale

M2 Velocity and Interest Rate Spread
Ratio Scale