

On Economic History and Humility

BY JOHN A. WEINBERG

Economists have been arguing about the ability of monetary policy to affect real economic activity when the Fed has already pushed short-term interest rates close to zero, a condition known as the “zero lower bound.” This debate remains important as the recovery from the Great Recession continues to yield disappointing results in terms of economic activity and, especially, employment — results that have persisted despite a lengthy period of accommodative monetary policy.

For many Fed leaders, including Federal Reserve Board Governors and presidents of Federal Reserve Banks, this state of affairs underscores the limits of our knowledge about the effects of unconventional monetary policy; moreover, it counsels in favor of a degree of humility when considering the course of future policy. For example, Chairman Bernanke, while supporting continued action by the Fed to attempt to stimulate the economy through monetary policy, noted in his December press conference that “we are now in the world of unconventional policy that has both uncertain costs and uncertain efficacy or uncertain benefits.”

I find this point of view persuasive — but it has generated controversy. Some observers, such as Christina and David Romer of the University of California, Berkeley, have pointed to past instances in which the Fed’s monetary policy was, in their view, the product of too much humility. By this, they mean that policy was not sufficiently aggressive in one direction or another, and Fed leaders justified their restraint on the basis of doubts about the likely costs and benefits of more ambitious moves. The first of these episodes is the early Great Depression period of 1929–1933, when the Fed rejected monetary expansion and, in fact, allowed the money stock to fall by 26 percent. The second is the inflationary 1970s (prior to the chairmanship of Paul Volcker), when Fed leaders believed that the rising price levels of the time could not be tamed through contractionary policy.

These critics of the Fed draw a line from the early Depression and the 1970s to Fed policy of the past several years and to the cautionary public statements of Fed policymakers during that period. They have cited, for example, Chairman Bernanke’s statement in October that “monetary policy is not a panacea,” and the statements of Reserve Bank presidents at various times, including Richmond Fed President Jeffrey Lacker, that further accelerating monetary expansion would increase the risk of inflation.

Comparisons across historical episodes can be instructive, and are in fact essential if policymaking is to improve over time. But in this regard, the differences between

episodes are at least as important as the similarities. A key difference between the earlier episodes and our more recent experience is in the behavior of prices. In both of the earlier periods, the doubts expressed by some policymakers and other observers about the Fed’s ability to have an effect included doubts about its ability to affect the path of the price level — to stem the deflation of the early 1930s or the inflation of the 1970s.

In the early stages of the Great Depression, many saw the gold standard as taking the control of the price level entirely out of the hands of the Fed’s monetary policy. In the 1970s, inflation was seen as being driven by an array of non-monetary forces, and many thought that monetary action to

bring down inflation would have unacceptably high costs in terms of economic activity and employment. By contrast, the consensus today is that monetary policy most certainly can increase or decrease nominal price levels. Indeed, the Fed has since taken pains to maintain credibility regarding inflation,

recognizing that only monetary policy can affect the general level of prices over time.

The question now, rather, is the extent to which the central bank can affect real activity — particularly employment — without putting its hard-won credibility for price stability at risk. Many observers favor continued monetary expansion on a large scale, on the belief that economic slack will restrain any incipient inflationary pressures. Others argue that, in view of the magnitude of the monetary and fiscal policy tools that have already been employed, it is not clear that the Fed can remedy the situation, while avoiding other hazards to the economy, by increasing what it has already been doing. Given that people on both sides of the issue are necessarily reaching their conclusions on the basis of limited information about the use of unconventional tools, it is appropriate that all of us do so with an awareness of the limitations of what we know. But such prudence does not reflect doubts about the ability of monetary policy to affect inflation.

Far from believing that monetary policy doesn’t matter, as critics have suggested, Chairman Bernanke and others involved with monetary policymaking have acted both with boldness and with circumspection precisely because they are mindful of the power of monetary policy — power that has led to both good and bad results in history. Responsible leaders owe the public nothing less. **EF**

Disappointing results in terms of economic activity underscore the limits of our knowledge about the effects of unconventional monetary policy.

John A. Weinberg is senior vice president and director of research at the Federal Reserve Bank of Richmond.