I. Introduction

This book contains proceedings from a conference held at the Federal Reserve Bank of St. Louis on October 19-20, 1989. The volume includes solid efforts by several economists and policymakers to evaluate monetary policy issues that remain with us after 75 years of Federal Reserve policymaking.

Previously published evaluations of the Federal Reserve’s historical performance have been decidedly mixed. Not surprisingly, then, a reader of this book will discover some wide intellectual gulfs separating the views of several of the contributors. The differing approaches and conclusions of the authors reflect evolving divergences in methodologies and outlooks that characterize the profession of monetary economics but simultaneously nudge it onto future avenues of research.

One objective of this review article is to evaluate future research directions in monetary economics that this volume illuminates. Because some unevenness occurs across the contributions in the extent to which a balanced review of the implications of past research contributions is provided, another objective is to provide a few guideposts to the relevant literature that are lacking in some of the contributions.

The book is organized around five papers by Allan Meltzer; Alex Cukierman; Edmund Phelps; William Barnett, Melvin Hinich, and Piyu Yue; and Charles Plosser. At least one comment is published following each paper. The five contributions each focus on separate themes, and this review is organized around those themes.

II. The Fed at Seventy Five

The dominant paper in this book, in substance, scope, and length, is that of Meltzer, which surveys and evaluates the performance of the Federal Reserve System between its 50th and 75th years. In his critical review, Meltzer contends that the policy process is too activist, that it relies too much on theoretically and empirically unreliable Federal Reserve staff forecasts, that it has been procyclical, and that it actually has produced higher underlying rates of price inflation with no apparent gain in real stability.

These are familiar themes of Meltzer’s — no reader will be shocked by its contents. Nevertheless, Meltzer’s paper in this volume is particularly lucid and well supported.

Also of interest are the commentaries of K. Alec Chrystal and Jeffrey Miron. Chrystal’s approach is to evaluate the Federal Reserve’s performance by comparing it to that of other central banks. Unfortunately, his judgment ends up being based on a simple ranking of ex post inflation rate experiences of various nations rather than an examination of whether different procedures formulated on an ex ante basis were more or less desirable. It would be interesting to see more serious work along these lines that makes valid comparisons across central bank policy regimes.

Miron’s commentary provides a concise review of conclusions he has reached alone [1986, 1989] and with coauthors [1987] concerning changes in the seasonality of interest rates following the founding of the Federal Reserve. He argues that an outcome of Federal Reserve policy was less stability of aggregate output. This argument,
which largely supports Meltzer’s interpretation, indicates that the Federal Reserve has chosen to stabilize interest rates rather than output.

There are other explanations [Toma and Holland, 1990] concerning the abrupt smoothing of the seasonality in nominal interest rates following the founding of the Federal Reserve. Nonetheless, this remains an important research agenda. In his commentary in this book and in his separate work with Mankiw [1990], Miron has made an interesting start on explaining some of the observations. It is unclear, however, that focusing on the seasonality issue alone will take the profession much farther. The reason for the change in the seasonality of interest rates relates to a policy of day-to-day interest rate smoothing, at least as much as it reflects a Federal Reserve concern with seasonality *per se*. What is missing and needs attention in the literature is a combined theory of day-to-day and seasonal smoothing of interest rates.

III. Why Does the Fed Smooth Interest Rates?

Miron’s commentary provides a relevant backdrop for Alex Cukierman’s effort to answer a nagging question: Is there a positive theory of why the Federal Reserve might desire to stabilize nominal interest rates? Certainly, the work of Poole [1970] demonstrates that some interest rate smoothing generally is optimal if the Federal Reserve’s ultimate goal is to stabilize nominal income. Subsequent literature has extended this conclusion to cases in which the Federal Reserve seeks to stabilize other macroeconomic variables such as real income and prices. Even Barro [1990] has concluded that interest rate smoothing may be a legitimate policy approach. Nevertheless, Cukierman’s goal is to show that the Federal Reserve may desire interest rate smoothing as a goal rather than as a means to an end.

Via an approach that is similar in many respects to the earlier work of Wood [1975] and Startz [1983], Cukierman constructs a monopolistic competition model of bank behavior. In this respect, his approach differs from other efforts, such as those of Aftalion and White [1977] and VanHoose [1983, 1988].

Cukierman goes a significant step beyond past work by placing his banking paradigm in a setting that fully specifies central bank preferences. The central bank faces a trade-off involving inflation and bank profitability, which is taken as a proxy for financial stability. As Michelle Garfinkel points out in her perceptive comments, this approach shares some features with that of Cosimano and Van Huyck [1989]. She questions Cukierman’s use of profits as a proxy for financial stability, but Cukierman’s approach is similar to that used by Peltzman [1976] in a more general context.

Cukierman finds that there are a variety of conditions that could generate an inherent concern for the variability of interest rates as an apparent goal of policy. Furthermore, he reaches the interesting conclusion that an inflation bias may arise from the policy process he has modeled without reference to distortional taxation, as in the explanation provided by Barro and Gordon [1983a].

Garfinkel questions some aspects of Cukierman’s model and results, such as his consideration only of a Nash game when it is arguable that the Federal Reserve could be a Stackelberg leader, his examination only of a white-noise stochastic environment, and his abstraction from reputational considerations of the type considered by Barro and Gordon [1983b] and Canzoneri [1985]. One could add to this listing of concerns the strong constraints imposed on bank behavior in Cukierman’s framework, an oversimplified analysis of the role of bank credit lines and commitments, and the absence from the model of important gross substitutability properties.

Nevertheless, Cukierman’s work joins that of Cosimano and Van Huyck [1989] as a pathbreaking start on an important topic. Goodfriend [1987] has shown that a desire to smooth interest rates is a sufficient condition for the Federal Reserve to permit base drift in monetary aggregates and to accept associated non-trend-stationarities of the price level. Walsh [1986] has shown that base drift may in some instances be optimal, and VanHoose [1989] has demonstrated that monetary targeting, like interest rate smoothing, is sufficient to induce base drift and price level non-trend-stationarities. On the other hand, Bordo, Choudhri, and Schwartz [1990] have concluded that the variance of trend infla-