POLITICS AND FED POLICYMAKING
The More Things Change the More they Remain the Same

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This paper seeks to explain why the Fed's professed monetarist control strategy tends to break down at politically critical moments. It identifies strong political forces that constrain the Fed to dampen the size of short-run increases in nominal interest rates. Because interest increases impose heavy burdens on economically vulnerable but politically powerful sectors, Fed officials are compelled to give increasing weight to interest-rate targets whenever accelerating inflation or other forces threaten sharp cumulative movements in the level of nominal interest rates. The paper argues further that the Fed's ultimate political function is to be a policy scapegoat for incumbent politicians, showing how well this hypothesis can explain the perennial incompleteness of Fed control strategies and the Fed's principal bureaucratic features.

1. Introduction

Economist critiques of FOMC (Federal Open Market Committee) policy choices typically treat the Federal Reserve System as a sovereign decisionmaker, whose managers seek singlemindedly to promote the public interest at every turn. From this perspective, choosing strategy and tactics for monetary control becomes a straightforward exercise in applied welfare economics, albeit one with difficult stochastic complications [Wood (1967), Poole (1970), Waud (1975), Andersen and Karnosky (1977), Higgins (1978), Lombra and Struble (1978)]. With Fed bureaucracy and bureaucrats having no contending interests of their own, the central bank's policy task becomes merely to maximize the expected value of a constrained social welfare function. This 'utopian' objective function is defined over a set of policy goals (ideal values for specific dimensions of national economic performance) and is represented as a decreasing function of squared (or absolute) deviations from these goals. Operative constraints consist of information describing both the developing state of the aggregate economy and the ways in which variables directly under the Fed's control (policy instruments) link up with

*Everett D. Reese Professor of Banking and Monetary Economics. The author is indebted to Richard C. Aspinwall, Raymond Lombra and Will Mason for comments on earlier treatments of this material. The paper was presented at the November 1978 meetings of The Southern Economic Association.
the goal variables [Wood (1967), Friedlaender (1973), Potts and Luckett (1978)]. In this view, the Fed's principal problems are informational: how to quantify its goals and restraints.

This utopian conception of Fed intentions and tactics is carefully nurtured in Fed publications and official statements. Fed leaders depict themselves as waiting in anguish for the economics profession finally to develop an adequate model of how monetary policy truly works. By this subtle open-mouth policy, Fed officials distribute some of the guilt from poor policy performance to economists and shape the way that the Fed is portrayed in money-and-banking textbooks and in most professional research. However, this public-relations campaign has had precious little effect on the thinking of ordinary citizens. In the popular mind and in the financial press, the Fed is a politically beleaguered institution whose chief task is to act as the arbiter of nominal interest rates. During times of monetary restraint, this adversary perception subjects the Fed to political pressures from sectors hurt by rising interest rates. These sectors' political action leads elected officials to resist increases in the level of nominal interest rates. This political response system focuses attention on changes in market interest rates and reinforces the mistaken popular notion that changes in the level of nominal interest rates are reliable indicators of the macroeconomic thrust of current monetary policy.

Monetarism bridges these discordant views, presuming that the Fed's political task is to lead the fight against inflation and that it can do so best by reshaping the focal issues of monetary-policy controversy. Viewed from this perspective, monetarism can be interpreted as a compromise movement whose principal goal is to liberate the Fed from procyclical political pressures by refocusing the Fed's intermediate policy targets from sectorally non-neutral interest rates to average rates of growth in monetary aggregates. The monetarist control strategy holds out the hope that the Fed can validate the utopian conception by loudly and steadfastly denying all responsibility for stabilizing nominal interest rates in the short run.

2. Things the FED has changed

During the 1970s, two striking changes in the structure of FOMC policymaking moved the Fed in the direction of the monetarist solution. First, in January 1970 (at Chairman Martin's last FOMC meeting), the Committee decided that 'increased stress should be placed on the objective of achieving modest growth in the monetary aggregates'. Two months later, at the second FOMC meeting chaired by Arthur Burns, this change in emphasis was formally incorporated into the Committee's directive to the System Open Market Account manager. From that date forward, he was told in the short run to maintain 'money-market conditions' (i.e., nominal interest rates)
consistent with specific patterns of growth in the major monetary aggregates. Beginning in 1975, two-month target rates of growth for monetary aggregates were published as part of the monthly 'Record of Policy Actions' of the FOMC. Second, in response to a Congressional Resolution passed in March 1975 (and transformed finally into a legal requirement in November 1977), the FOMC began to vote each quarter a set of target annual growth rates for M1, M2, and M3. Called 'tolerance ranges', these annual targets are reported to Congress every quarter, in testimony delivered alternately before the House and Senate banking committees. Table 1 lists the annual targets adopted in the 31 years this procedure has been in operation. Table 2 compares the targets with actual experience.

It is not easy to interpret the targets. First, the FOMC does not specify precisely what value in each range it would most prefer. Hence, the 'tolerance ranges' may not be symmetric about the FOMC's estimates of the best growth rate for each aggregate. Second, one wonders why three targets are given and how they are weighted relative to each other. Higgins indicates that M1 and M2 are weighted equally, with little or no weight given to M3. He argues that uncertainty about the relations: (1) between each aggregate and the goal variables and (2) between the aggregates themselves, justifies the

<table>
<thead>
<tr>
<th>Date</th>
<th>Reported 12-month target range (in percent)</th>
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</thead>
<tbody>
<tr>
<td>May 1975</td>
<td>5.0 to 7.5</td>
</tr>
<tr>
<td>Aug. 1975</td>
<td>4.5 to 7.5</td>
</tr>
<tr>
<td>Nov. 1975</td>
<td>5.0 to 7.5</td>
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<tr>
<td>Feb. 1976</td>
<td>4.5 to 7.5</td>
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<td>May 1976</td>
<td>4.5 to 7.0</td>
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<tr>
<td>Aug. 1976</td>
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<tr>
<td>Nov. 1976</td>
<td>4.5 to 6.5</td>
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<tr>
<td>Feb. 1977</td>
<td>4.5 to 6.5</td>
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<tr>
<td>May 1977</td>
<td>4.5 to 6.5</td>
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<td>Nov. 1977</td>
<td>4.0 to 6.5</td>
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<tr>
<td>March 1978&quot;</td>
<td>4.0 to 6.5</td>
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<tr>
<td>May 1978</td>
<td>4.0 to 6.5</td>
</tr>
<tr>
<td>July 1978</td>
<td>4.0 to 6.5</td>
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</tbody>
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Chairman Miller's testimony was delayed until March 13 by difficulties in clearing his appointment through the Senate Banking Committee.
Table 2
Growth in monetary aggregates relative to 12-month FOMC targets, May 1975 to July 1978 (in percent per annum).

<table>
<thead>
<tr>
<th>Date of congressional testimony</th>
<th>Observed rate of growth of M1 during designated control period</th>
<th>Excess over midpoint of FOMC tolerance range</th>
<th>Observed rate of growth of M2 during designated control period</th>
<th>Excess over midpoint of FOMC tolerance range</th>
<th>Observed rate of growth of M3 during designated control period</th>
<th>Excess over midpoint of FOMC tolerance range</th>
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<tr>
<td>May 1975</td>
<td>5.3</td>
<td>−0.95</td>
<td>9.7</td>
<td>0.20</td>
<td>12.3</td>
<td>1.30</td>
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<tr>
<td>Aug. 1975</td>
<td>4.4</td>
<td>−1.60</td>
<td>8.8</td>
<td>−0.20</td>
<td>11.3</td>
<td>0.80</td>
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<tr>
<td>Nov. 1975</td>
<td>4.6</td>
<td>−1.65</td>
<td>9.8</td>
<td>0.80</td>
<td>11.9</td>
<td>1.40</td>
</tr>
<tr>
<td>Feb. 1976</td>
<td>6.2</td>
<td>0.20</td>
<td>11.4</td>
<td>2.40</td>
<td>13.2</td>
<td>2.70</td>
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<tr>
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<td>6.5</td>
<td>0.75</td>
<td>10.9</td>
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<td>12.7</td>
<td>2.20</td>
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<tr>
<td>Aug. 1976</td>
<td>7.0</td>
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<td>10.9</td>
<td>2.40</td>
<td>12.5</td>
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<td>8.2</td>
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<td>0.15</td>
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<td>8.4</td>
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<td>8.5</td>
<td>0.75</td>
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<td>0.15</td>
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<tr>
<td>March 1978</td>
<td>8.8&quot;</td>
<td>3.55</td>
<td>8.7&quot;</td>
<td>0.95</td>
<td>9.3&quot;</td>
<td>0.55</td>
</tr>
<tr>
<td>May 1978</td>
<td>10.5&quot;</td>
<td>5.25</td>
<td>9.7&quot;</td>
<td>1.95</td>
<td>10.2&quot;</td>
<td>1.35</td>
</tr>
<tr>
<td>July 1978</td>
<td>9.2&quot;</td>
<td>3.95</td>
<td>10.3&quot;</td>
<td>2.55</td>
<td>11.7&quot;</td>
<td>2.95</td>
</tr>
</tbody>
</table>

*Source: Rates of growth calculated from the end-date of the preceding quarter to the same date in the following year, using data supplied in October, 1978 by The Research Department of the Federal Reserve Bank of St. Louis.

*Arithmetic extrapolation of growth observed from beginning of the control period through September 30, 1978.

use of a weighting scheme. Alternatively, one could cite the need to proxy the growth of demand-deposit substitutes and the desirability of setting out enough targets that Fed arrows are bound to score at least one hit. Finally, the FOMC provides only a loose qualitative assertion that the System Open Market Account Manager should adjust his operative interest-rate targets when monetary-aggregates growth falls outside the target range.

In the last eight accounting periods (three of which are still in progress), the growth rate for M1 has exceeded the FOMC tolerance range. For several consecutive earlier accounting periods, the M2 and M3 growth rates surpassed their target ranges, too. Given that the ranges are fairly wide to begin with and change only slightly from one Congressional appearance to the next, the Fed's failure to meet them leads one to doubt whether in any meaningful sense they are targets (or limits of 'tolerance') at all. In the 1970s, the Fed may be paying more attention to monetary aggregates than ever before, but its policy focus remains very much on the short run.
This paper develops two propositions. First, it argues that strong political forces exist that compel the Fed to dampen the size of short-run increases in nominal interest rates. Because such changes threaten to impose heavy burdens on economically vulnerable but politically powerful sectors, Fed officials are compelled to give increasing weight to interest-rate targets whenever accelerating inflation or other forces induce sharp cumulative movements in the level of nominal interest rates. The monetarists long-run control strategy tends to break down at the politically critical moment. The easy-money policies of the first half of 1978 constitute the latest evidence for this political conception. Actual monetary growth rates exceeded targets because: (1) to raise real interest rates, nominal interest rates would have had to rise unusually rapidly, and (2) congressional elections were scheduled in November. Second, the paper advances the hypothesis that, as an institution, the Fed's ultimate political purpose is to serve as an economic-policy scapegoat for incumbent politicians. It goes on to show that this scapegoat hypothesis can explain a number of seeming anomalies in the structure of Fed decisionmaking.

3. The Fed's incomplete control strategy

A strategy for policy control has three basic elements: policy instruments, intermediate policy targets, and policy goals. Policy instruments are variables that the Fed controls absolutely, while policy goals are socially desirable developments that Fed officials want ultimately to promote. Fed goals relate to various dimensions of good macroeconomic performance: low unemployment, price stability, a strong dollar, sustainable economic growth, and an improved distribution of income. Instruments include the Fed's reserve requirements, discount procedures, and open-market portfolio.

As the name intermediate target implies, targets stand between instruments and goals. Target variables differ from goals in that hits come easier, if only because misses are easier to monitor and correct. A goal variable is an index of one aspect of macroeconomic welfare, such as the unemployment ratio or the average rate of inflation in consumer prices. Hard information on goal variables becomes available infrequently (once a month or once a quarter) and even then observations lag behind events and remain subject to subsequent revisions in value. Because information on goal variables is dated, sparse, and unreliable, policymakers tend to identify alternative indices that can be tracked closely and that theory and empirical evidence agree should move predictably with goal variables. These proxy variables may be conceived as sighting devices that aid policymakers' to take aim on hard-to-track goals. This conception is illustrated in fig. 1. The policy instrument is portrayed as a cannon that aims proximately at a wheeled intermediate target that in turn pivots to track a heat-seeking missile (intermediate target
Fig. 1. Aligning instruments with goals in a policymaking framework that uses intermediate targets.
number two), which itself follows the tiny goal variable (more accurately, the current flock of goal variables) as it wings along.

For its policy strategy to be complete, the Fed must not only list its instruments, targets, and goals. It must go on to spell out projected links between its targets and goals over different time spans and to explain the feedback processes that lead it to alter the intermediate targets [Brunner and Meltzer (1964), Guttentag (1966)]. But the Fed steadfastly refuses to take these additional steps. Only the first step in the feedback loop that links the three types of variables is laid out and this only for very short control periods.

3.1. The Fed's current day-to-day strategy of open-market operations

In the Fed's current framework its first and close-at-hand target is the federal-funds rate, FFR: the market interest rate on one-day loans of member-bank reserve balances on deposit at Fed Banks. The second more-distant target is the growth rate of the money stock, $g_M$. Observations on the first target are precise and up-to-the-minute, while observations on the second are only available weekly and, even then, are subject to substantial measurement error, some of which is ultimately reduced by interpolating subsequent benchmark-date survey data.

Taking a monetarist view, Fed officials anticipate that the monetary growth rate will closely track the less frequently observed growth rate of aggregate demand. The targeted range of monetary growth rates, $g_M^*$, is to be changed whenever data show one or more goal variables developing along an unacceptable track. Between readings on the goal variables, the $g_M^*$ range remains a firm target. However, with readings on $g_M$ themselves infrequent, Fed officials focus in the short run on the FFR. Their plan is to establish a range of federal-funds rates ($FFR^{10}, FFR^{30}$) consistent with the $g_M^*$ target and to supply or absorb reserves via open-market operations whenever the FFR threatens to depart from its targeted boundaries. In turn, the FFR boundaries are to be adjusted when data on $g_M$ show substantial shortfalls or over-runs and when the $g_M^*$ target is itself revised.

Interpreted in terms of fig. 1, this Rube Goldberg system of multiple gunsights seems designed for use by hopelessly nearsighted gunnery crews. The Fed high command takes it for granted that the vision of its cannoneers is too weak to track either the goal variables or even the monetary-growth variable chasing along in their wake. Fed open-market operatives, located just off Wall Street in the Federal Reserve Bank of New York, train their guns on interest rates that are determined just a few yards away in the offices of federal-funds brokers. FFR bullseyes are virtually guaranteed, but relative to goals and more-distant targets, the resulting angle of fire can wander far astray. To reduce the chance of this, Fed staff economists act as artillery
scouts, collecting and analyzing information about hits and misses both on $g^*_M$ and on the goals and recommending compensatory changes in FFR and $g^*_M$ targets. But this part of the process is too arcane for an outsider to diagram.

3.2. The value of incompleteness

The speed and adequacy of FOMC revisions in targeted trajectories are critical to the success of this chain-of-targets open-market strategy. One reason for the Fed's adopting this strategy in the 1970s was to stop academic economists from poking fun at Fed officials by characterizing the cannoneers (and their field commander, the 'Desk') as suffering perennially in Brunner and Meltzer's famous phrase from 'money-market myopia'. However, until the Fed spells out the link between its policy misses and future angles of fire, charges of myopia of some sort must be left on the docket.

Maisel (1973) has made the point that an incomplete strategy makes it easier month by month for disparate elements within the FOMC to agree on a specific FFR target. The ultimate question is whether leaving these loose ends somehow leads to more satisfactory levels for goal variables. Fed pronouncements glorify the incompleteness of its control strategy as giving officials the 'flexibility' they need to tailor adjustments in Fed instruments at any time to the economy's precise constellation of needs. I believe that in the Federal Reserve lexicon flexibility is a code word for openness to procyclical direct and indirect political influences. In my view, the incompleteness of the Fed's control strategy survives in part because of its role in surmounting internal dissent, but more importantly because it makes it relatively unembarrassing for Fed officials to adapt operative monetary-policy priorities to the ebb and flow of external political pressure. Incompleteness gives the Fed bureaucracy day-to-day freedom to deal politically with Congress and the White House, but by no means should it be presumed that these dealings lead over time to better macroeconomic performance.

Since Congress and the President have chosen not to force the Fed to adopt a complete strategy, it is reasonable to presume that they also find advantages in incompleteness. The advantage that I see is that by leaving the Fed high command a substantial amount of ex ante discretion, elected officials leave themselves scope for blaming the Fed ex post when things go wrong [Kane (1975)]. Overseeing a complete strategy would undercut Fed 'independence' and implicate incumbents in monetary policy before the fact. Looking always toward the next election, holders of elective office prefer to position themselves so that they can choose after the fact which policies to claim and to disclaim. Currently, it's heads they win and tails the Fed loses. Whenever monetary policies are popular, incumbents can claim that their
influence was crucial in their adoption. On the other hand, when monetary policies prove unpopular, they can blame everything on a stubborn Federal Reserve and claim further that things would have been worse if they had not pressed Fed officials at every opportunity.

4. Discovering the public interest

Inherent in the utopian view of the Fed is the presumption that the Fed can somehow evaluate the public interest on its own. In the contemporary United States, it is hard to conceive of the public interest except as a delicate balance of conflicting private interests. Though influenced by the ebb and flow of intellectual and journalistic argument this interest finds legitimate expression only through juridical, legislative and regulatory decisions. In these arenas, to a large extent, Might makes Right. A sector’s Might is exercised by influencing the politics of representative democracy and the party process. The effective public interest is determined via adversary proceedings. Hence, it shifts with the sectoral distribution of political power.

It is no accident that those sectors most vulnerable to increases in nominal interest rates have made themselves strong politically. The low-interest lobby is led by builders and construction unions and by financial institutions that earn their living by borrowing short to lend long. It is supplemented by securities dealers who interact on many levels with System Open Market Account officials in New York. Because dealer balance sheets are highly levered, dealers continually press Fed personnel to gradualize any and all cumulative increases in nominal interest rates. During inflationary episodes, these constituencies help Fed officials to decide just how quickly it is ‘feasible’ to push up nominal interest rates (i.e., how vigorously in the short run to wage the battle against inflation).

These institutions’ political muscle constitutes the bulk of their hedge against interest-rate risk in general and against inflation risk in particular [Kane (1976)]. Acting through and on cabinet departments, specialized agencies, and Congressional committees charged administratively with monitoring their economic welfare, elements of the low-interest constituency exploit an implicit social consensus that no identifiable subset of the population should be forced to bear an inordinate (i.e., certifiably unfair) portion of the burden of stabilizing the national economy. Ironically, their incontestable exposure to interest-rate risk is the source of the low-interest advocates’ ability to shape the public’s perception of how monetary policy works.

They also exploit pressures that electoral and business cycles place on elected officials [Tufte (1978)]. In election years, Congress and the President typically join in trying to rally support for lower interest rates by publicly warning the Federal Reserve that ‘excessive’ interest rates would (by the
definition of 'excessive') cause a recession. Often they do this despite overwhelming evidence that monetary policy is highly expansive, on the theory that higher levels of employment improve incumbents' chances for re-election even when purchased at the cost of higher inflation later. (The alternative hypothesis was tested and rejected in an electoral test conducted in 1976 by Gerald Ford.)

5. A political theory of Fed doubletalk: The Fed as scapegoat

In an election year, perhaps the least-reliable indicator of the state of U.S. monetary policy is what Federal Reserve Chairmen tell us about FOMC intentions. Particularly in the late stages of any business-cycle expansion, the occupant of this political hotseat is virtually forced to talk out of both sides of his mouth. To placate the Fed's own constituency in the business and financial community, the Chairman must emphasize how vigorously Fed officials are fighting inflation with high and rising nominal rates of interest. However, to keep Congress and the Administration off their backs, Fed officials must simultaneously fight unemployment by expanding the money stock. Since monetary growth can produce rates of inflation high enough to undo the restrictive effects of high nominal interest rates, the conflicting effects of monetary policy can most easily be explained by focusing public attention on real interest rates.

For me (and recently for the President and staff of the Minneapolis Federal Bank as well), the burning question is why doesn't the Fed make a greater effort to educate the public to the dual effects of money-supply changes. Why don't Fed officials refocus the public's perception of how monetary policy works so that they can build a consensus for anticyclical movements in real interest rates? Why aren't they in the forefront of the effort to provide better measures of anticipated inflation?

During the summer of 1978, University of Michigan surveys of consumers' inflation expectations over the next year rose almost two percentage points above the inflation forecasts prepared by the major econometric forecasting services. In the first half of 1978, Fed officials claimed repeatedly that monetary policy was highly restrictive, even though survey-based and post real interest rates were falling. By not putting the policy issues in proper perspective, the Fed ill serves its anti-inflation constituency. It helps to take pressure off elected officials by deceiving the public into believing that, even when no one else is, the Fed is waging an effective fight against inflation. That Fed officials would cite changes in nominal interest rates as evidence of anti-inflationary policies indicates that they value the political options that public confusion currently confers on them.
For anyone schooled in the utopian tradition, this cynical hypothesis is hard to swallow. However, as a working hypothesis, it is best tested by asking what it can explain that competing theories cannot. The doubletalk theory is fully consistent with the microeconomics of Federal Reserve bureaucracy. After all, the Fed is a political institution designed by politicians to serve politicians. Its chief officials (i.e., the Board of Governors) are nominated by the President and their appointments cleared with the Senate. They are forced to defend their performance before Congressional committees several times a month and must be prepared to respond expeditiously to letters and telephone calls from individual Congressmen and Senators at a moment's notice.

However good or bad this performance may be, Fed officials are expected to let Congressmen and Senators blame them for whatever financial or economic developments their constituents back home dislike. In exchange for playing economic-policy scapegoat, Fed officials are offered unusually long terms in office and substantial budgetary autonomy.

This duality and ambiguity of function are paralleled in the very language of the Federal Reserve Act, which sets up a uniquely confusing bureaucratic structure that makes the Fed appear both ‘independent’ of short-run political influence and decentralized in its internal organization. Later legislation — The Employment Act of 1946 and the Humphrey-Hawkins Act of 1978 — enlarges the Fed’s statutory mission without providing legislative guidance as to how Fed officials should execute politically sensitive tradeoffs among conflicting goals. The Fed has allowed elected politicians to make it responsible for a series of impossible economic-policy tasks, with the implicit understanding that, when the Fed fails, how loud these politicians and their successors will bark (and whether or not they will also bite) depends on the quality of Fed efforts to get along.

Sherlock Holmes’ acid remarks on the undeserved reputation of Scotland Yard detectives would apply as well to Congress’ conception of the Federal Reserve System and might well be mounted over the doorway of the FOMC’s meeting room:

‘What you do in this world is a matter of no consequence. The question is, what can you make people believe that you have done?’ (A Study in Scarlet.)

Being programmed to fail repeatedly at its policy assignments, the Fed is led to glorify its lesser accomplishments as the Treasury’s fiscal agent and as the banking system’s chief correspondent. Its officials learn to talk in a code that makes it hard for hind-sighted critics to scold them effectively. This code masks their openness to political influence and facilitates the formulation of quasi-contradictory explanations both of the mechanics of their policies and of the rationale behind them. To protect itself from criticism and political
punishments, the Fed tends systematically to misemploy its unique opportunities for educating the U.S. public about the macroeconomic consequences of alternative economic policies.

6. Summary

Although money-and-banking textbooks oversell the utopian conception of Fed policymaking, the profession has always known better. I do not want to emphasize the vacuous proposition that, when the going gets tough, the Fed acts first and foremost as a political animal. What I do want to emphasize is how many seemingly inexplicable structural and policy phenomena can be developed as consequences of this proposition. On my analysis, the perennial incompleteness of Fed control strategies and most of the Fed's special bureaucratic features (its independence, its acceptance of impossible policy assignments, and its murky lines of internal authority) serve definite political ends. Once the Fed is viewed as a policy scapegoat for elected officials, these developments emerge as intelligible adaptations to recurring political pressures.

Fed officials desire better performance. They make changes in the structure of Fed decisionmaking and in procedures for monitoring the effects of open-market operations with the best of intentions. However, since these changes have no palpable effect on the balance of political forces, they have precious little effect on the short-run compromises Fed leaders find it prudent to make among alternative policy goals.

References

Doyle, A. Conan, 1938, The complete Sherlock Holmes (Garden City Publishing Co., Garden City).