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BOOK REVIEW

Michael G. Hadjimichalakis, *The Federal Reserve, Money, and Interest Rates: The Volcker Years and Beyond* (Praeger Press, New York, 1984) pp. xvi 273.

The appointment of Paul A. Volcker to the chairmanship of the Federal Reserve System in August 1979 brought forth important changes in Federal Reserve operating policy as well as in the institutional environment in which such policy is conducted. Hadjimichalakis isolates three subperiods of the Volcker years: from October 1979 through 1980, where emphasis is placed on the switch in operating procedures from the pegging of the federal funds rate to the targeting of non-borrowed reserves; from 1981 through 1982, where the focus is on the nationwide introduction of new money market instruments; and from 1983 through 1984, where the role of market determined deposit interest rates is highlighted. Throughout the course of the book Hadjimichalakis has two basic concerns. First, he wishes to show that during the Volcker years Federal Reserve policymaking was subject to grave error, leading to, among other things, increased monetary volatility after 1979 as well as the depth of the 1981–82 recession. Second, he desires to destroy the viability of monetarist principles as guides for Federal Reserve policy.

Part I: 'The Federal Reserve and its Goals' provides a general institutional setting for the issues analyzed in the book. A description of operating, intermediate, and ultimate targets is followed by a discussion of the manner in which Federal Reserve policy is formulated. Finally, a brief overview of actual monetary policy during the Volcker years is undertaken, with a particular stress placed on the move toward traditional monetarist policy prescriptions. As Hadjimichalakis writes:

> With the October 1979 decision, the Federal Reserve reaffirmed its commitment to the first monetarist principle, namely, the use of money as the intermediate target .... Moreover, with the switch in operating procedures on October 6 the Fed also embraced two other monetarist principles, further moving the Fed into the monetarist camp. For the first time ever, the Fed committed itself to the principle of a fixed rate of growth in the monetary aggregates, regardless of the state of the economy at the time .... Furthermore, in an effort to squeeze inflation out of the U.S. economy, the Fed embarked upon a gradual reduction of the targeted annual growth rates for money, another long-advocated monetarist prescription. (pp. 37–38)

Subsequent chapters of the book are devoted to criticism of this strong monetarist reorientation on both procedural and theoretical grounds.

Part II: 'The New Operating Procedures' provides the general theoretical model to be employed throughout the book and seeks an explanation of the increased volatility of the money stock which arose after the 1979 change in policy regimes. The basic model is an adaptation of the models of financial market activity to be found in Tobin (*Journal of Money, Credit, and Banking*, 1969), Brunner and Meltzer (*Journal of Political Economy*, 1968), as well as in previous work by Hadjimichalakis (*Economics Letters*, 1981). There are four asset markets (equity, bank loans, Treasury bills, reserves) which are capable of determining different vectors of endogenous variables under alternative monetary policy regimes. Under the federal funds rate regime, the vector of endogenous variables includes the rate of return on equity, the bank loan rate, and the level of reserves, while under the non-borrowed reserves regime it consists of the three rates of return on equity, bank loans, and Treasury bills.

This model is employed immediately to account for the increased variability of the money supply subsequent to October 1979. The argument is that the Federal Reserve, in setting the forecasted level of borrowed reserves equal to their current level (a 'random walk' policy), failed to take into consideration the positive theoretical relationship between interest rates and borrowed reserves. Consequently, given greater interest rate volatility – to be predicted under the new regime – the Federal Reserve's decision to target non-borrowed reserves brought with it the implication of volatility in borrowed and total reserves and, finally, in the monetary aggregates. Hadjimichalakis sees it to be

> ... clear, then, that at least a portion of the volatility in the money stock can be attributed to combining the targeting of nonborrowed reserves with the use of the random walk formula for forecasting borrowed reserves. (p. 94)

This argument, of course, leads to the conclusion that lower volatility in the money stock would have been achieved had the Federal Reserve chosen to target total reserves as opposed to non-borrowed reserves, a policy proposal advanced at the time by Brunner and Meltzer (1982).

Part III: 'Now Accounts and Transition Period' lays the blame for the 1981–82 recession on inadvertently tight monetary policy. The introduction of NOW accounts nationwide and the Federal Reserve's reliance on information accumulated during the previous experience with NOW accounts in New England – while under the federal funds rate operating regime – led to overpredictions of money multipliers and insufficient reserve growth. As Hadjimichalakis writes, the

> ... new operating procedure has changed the financial structure, a change that rendered monetary data generated under the old regime useless and, in fact, hazardous if used. To the extent that the Fed did, indeed, rely on the New England experience in estimating money multipliers, we have one reason for the constant undershooting of the M1 targets in 1981. (p. 143)

This undershooting of the monetary targets, according to the argument, then led to high interest rates, low aggregate demand, and the resulting severity of the 1981–82 recession.

Part IV: 'The New Financial Environment' contains a broad attack on the fundamental monetarist principle of targeting monetary aggregates. The logic is that the value of targeting monetary aggregates has been eroded substantially in the new financial environment with unregulated market rates of interest on deposit accounts. In the first place, since in the new financial environment the volume of demand deposits is supply as well as demand determined, there is more opportunity for the Federal Reserve to interpret movements in demand deposits in an incorrect fashion and to undertake errant policy. Hence,

> ... the first reason why monetary aggregates have deteriorated as indicators of (future) economic activity, under the new financial environment, is that there are more instances for shocks that make the aggregates emit the wrong signals. Therefore, there is a greater chance that the Central Bank will inadvertently follow the wrong policy. In other words, the new financial environment has increased the uncertainty about the meaning of signals emitted by changes in the monetary aggregates. Other things being equal, this is a case for reconsidering, that is, abandoning, the practice of targeting monetary aggregates. (pp. 225–226)

Hadjimichalakis further argues against monetarist policies by establishing the result that the response of interest rates to a change in the monetary aggregates will be greater in the new financial environment than in the previous environment with restricted rates of return on deposits. With the relaxation of ceilings on deposit rates, monetary 'policy has become more potent, for better and for worse. Both the primary and supplementary instruments of monetary policy are more effective under the new financial environment than they were under the old' (p. 220). Already having established that the new financial environment also brought about a greater likelihood of Federal Reserve error, Hadjimichalakis now asserts that the targeting of monetary

aggregates increases the frequency and severity of cyclical fluctuations in real activity:

> In those very instances when monetary aggregates give the wrong signals, targeting these aggregates causes more damage to the economy under the new financial environment than under the old. In particular, targeting monetary aggregates results in greater response, in the wrong direction, of interest rates and associated variables for the 'real sector', say the price level (sic) and unemployment, under the new financial environment than under the old. (p. 226)

Hence, Hadjimichalakis advances the opinions that the 'theory says that we should have seen the end of monetarism ...' and that '[m]onetary policy is a powerful weapon, one that can do much good, but also much harm if not used properly. The use of such a powerful weapon cannot be left to simple and inflexible rules' (p. 232).

In place of the apparently bankrupt monetarist policies, Hadjimichalakis suggests that the Federal Reserve should target 'ultimate' variables such as, for example, the unemployment rate. In response to a rise in the rate of unemployment, the Federal Reserve should actively engage itself in the (systematic) countercyclical policy of open market purchases.

As Hadjimichalakis makes this claim, however, one cannot help wondering if the author bothered to read the professional journals over the last decade. After all, the basic thrust of the most innovative work in monetary economics during those years has been to question the traditional presumption that such countercyclical policy will be capable of affecting real variables. Sargent and Wallace (*Journal of Political Economy*, 1975) and Barro (*Journal of Monetary Economics*, 1976) show that, under conditions of market clearing and rational expectations, systematic monetary feedback may be totally incapable of altering unemployment rates. Also, even under the Keynesian assumption of nominal wage rigidity – as, for example, in Fischer (*Journal of Political Economy*, 1977) – the apparent feasibility of systematic monetary policy may be eliminated under optimal contracting arrangements which take into consideration both wage and employment determination. Further, even if countercyclical policy were feasible, it is not at all clear that the pegging of some arbitrary statistic such as the unemployment rate would, in the face of supply as well as demand shocks to the economy, result in an improvement in societal welfare.

The major failure of this book turns out to be the total lack of concern for the arguments advanced by the new-classical school in favor of monetary rules as a guide to policy. This arises as a necessary outcome of the modeling strategy which – although advanced as 'a properly specified general equilibrium framework' – is a purely partial equilibrium analysis of the financial markets. Interactions between monetary policy, expected inflation and nominal interest rates are left totally unexplored. Instead, we find shallow statements such as 'a situation that causes high interest rates' can be found unambiguously to have arisen by the 'Fed provid(ing) reserves in quantities smaller than those needed to hit its monetary targets' (p. 144).

In sum, this book would have been an interesting and important addition to our knowledge of monetary theory and policy if the 'Volcker years' had been in the 1960's instead of the 1980's. As it is, the book is not without interest – particularly to those interested in procedural and institutional issues – but is deficient on theoretical grounds. It would seem that the time is ripe for a comprehensive discussion of issues of monetary control in an explicit rational expectations environment.

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