The Shadow Open Market Committee and Its Role in Monetary Policy

Some Personal Observations[1]

Robert Heller

At the Conference on: A 50-Year Retrospective on the SOMC and Its Role in Monetary Policy

October 14, 2024

Hoover Institution, Stanford University

1. Karl Brunner and the Origins of the SOMC

Karl Brunner, who along with his student Alan Meltzer was the Founder of the Shadow Open Market Committee, was a distinguished Professor of Economics at UCLA when I joined that faculty in 1965 – almost six decades ago. I was lucky enough to have an office near Karl's office in Bunche Hall on the UCLA campus. Just about every day, after we returned from lunch at the Faculty Club, it was very quiet on the eighth floor of Bunche Hall as many of the older professors took a little nap. But more often than not, their siestas were interrupted when Karl Brunner opened his office door and blew a small bugle – Karl called it a Swiss *Waldhorn* -- that he kept in his office. Typically, the bugle call was followed by Karl's booming voice yelling down the corridor: "Jerry – Where are the regressions?"

Dutifully, Jerry Jordan, who was his research assistant and whose office was at the other end of the long corridor, would come racing down the hallway with a stack of IBM printouts of the latest research results

[1] I am grateful to Frank McCormick for comments on an earlier draft and to Dan Van Dyke of the Rosen Consulting Group for assistance with Figure 1.

showing the influence of the money supply on prices or some related topic. As you all know, Jerry Jordan became the Director of Research of the St. Louis Fed and President of the Federal Reserve Bank of Cleveland as well as a member of the SOMC.

Having obtained my Ph.D. at UC Berkeley, that was my real introduction to monetary economics and the significance of the money supply in monetary policy making.

The influence of Karl Brunner on my thinking was further enhanced by Milton Friedman, who was a frequent visitor to UCLA – especially during the winter months when it snowed in Chicago. Thanks to these discussions with Karl Brunner and Milton Friedman, I became a firm believer in the importance of controlling the money supply to achieve a stable price level.[2]

2. *Money Matters*

Milton Friedman popularized the dictum that "inflation is always and everywhere a monetary phenomenon". I find it therefore inexplicable that the word "money" is not even mentioned once in the Fed's most recent *Monetary Policy Report to Congress*. Even more astonishing, you will look in vain for the word "money" in any of the FOMC Statements published during the last four years. It is nowhere to be found!

This is abundant evidence that today's Fed pays no attention to the money supply and its role in the economy. If Milton Friedman were alive today, he would be aghast!

---

[2] Robert Heller, *The Unlikely Governor*, Maybridge Press, 2015, Chapters 13 and 15.

It was not always this way. Almost half a century ago, the Humphrey-Hawkins Act of 1978 actually *required* the Federal Reserve to set targets for the growth of the monetary aggregates and to report these benchmarks to Congress twice each year. [3] When Chairman Paul Volcker tackled the inflationary surge of the late 1970s and early 80s, he did so by focusing firmly on the control of the money supply.

At the same time, the high interest rates of up to 20 percent engendered by the inflationary surge – together with the regulatory restrictions on interest paid on demand deposits by banks and savings and loan associations -- led to a record high number of bank failures and the almost complete elimination of the savings and loan industry. I remember these catastrophic events very well because I had a front-row seat as Chairman of the Fed's Committee on Bank Supervision and Regulation. Every year during my tenure we experienced approximately 800 bank failures – or about 2,500 in total.

Into the breach stepped numerous newly created non-bank financial service institutions whose liabilities were not counted in the traditional definition of the money supply. Consequently, the heretofore tight relationship between the money supply as defined by the Federal Reserve and inflation broke down and money supply targeting lost its attractiveness. But as Karl Brunner has pointed out, there is an important distinction between the *official definition* of the money supply and what people *actually use as a medium of exchange*.[4] It is that latter concept

---

[3] *Full Employment and Balanced Growth Act*, Pub. L. 95-523, October 27, 1978. Also see: James A. Dorn, "Myopic Monetary Policy and Presidential Power: Why Rules Matter", *Cato Journal*, September 2019

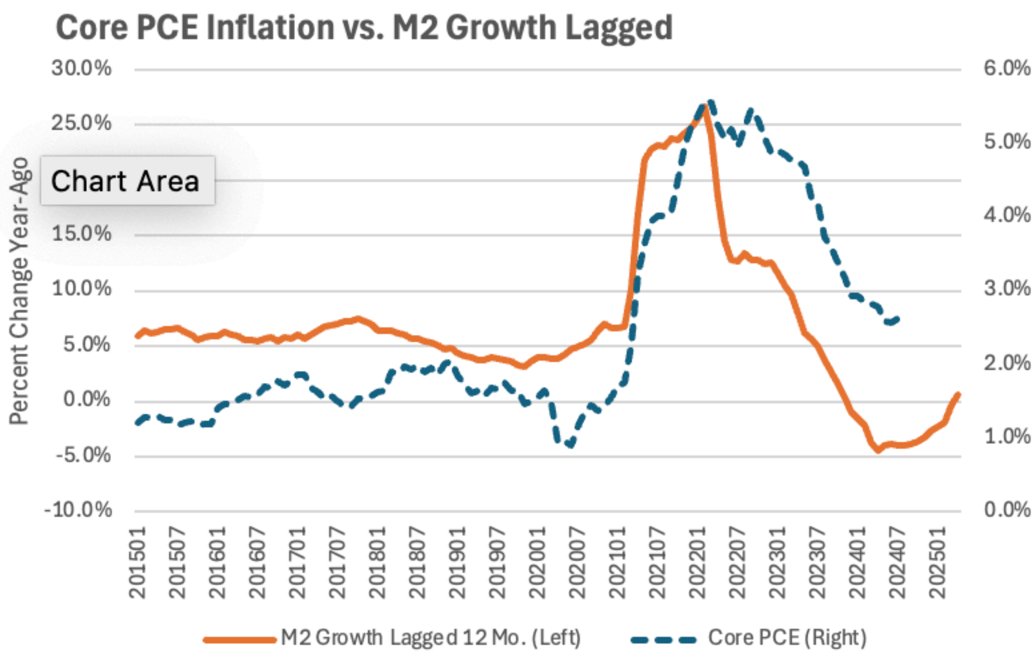
[4] Karl Brunner, "Has Monetarism Failed?", CATO Journal, Vol. 2, No. 1, Spring 1983, P. 40 and p. 51

that is important for actual economic behavior and should be used in the analysis of the relationship between money and prices. As the Fed was unable to produce such a dynamic time series of the money supply, it began to focus on interest rates as a control variable to reach its Congressionally mandated goals of price stability and maximum employment.

But I would argue that even if the money supply is no longer used as a *control* variable, it is still most useful as an *indicator* of financial conditions in the economy. Paying attention to the money supply would have helped the Fed most certainly to avoid the recent surge in inflation.

The accompanying graph shows the Money Supply, M2, (the solid red line) for the last few years as well as the Consumer Price Index (blue dashed line) one year later.

FIGURE 1



Even an economic greenhorn will recognize the tight correlation between the two timeseries. Karl Brunner and Milton Friedman, as well as numerous SOMC researchers, devoted much of their work to prove in detail the causal linkage between money and prices. [5]

For the Fed to ignore these findings amounts to a virtual dereliction of duty. Indeed, if the Fed had at least paid rudimentary attention to the money supply during the last few years, the recent bout in inflation would not have gotten out of hand and might have been much better controlled -- if not entirely avoided.

3. The Goal of Price Stability

The Federal Reserve Act directs the Federal Reserve to "maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates." The Fed refers to these three goals traditionally as the "Dual Mandate". For many years now, the Fed has interpretated the Congressional mandate for "stable prices" as being consistent with two percent inflation.

However, with a two percent inflation rate, the price level will actually double every 36 years. Over a normal lifespan of some 72 years,

---

[5] See, for instance, Michael Bordo, "Monetary Aggregates Still Matter", SOMC, October 20, 2023, and Peter N. Ireland, "U.S. Monetary Policy, 2020-23", SOMC, October 20, 2023, as well as the Op-Ed Piece by Kevin Warsh, "Interest Rates are a Sideshow in the Fed Drama", *Wall Street Journal*, July 29, 2024.

The Fed's Congressional Mandate is for "Price Stability" Or ZERO Inflation

The 2 % Inflation Target is Misguided

With 2 % Inflation, the Price Level will **Double** every 36 years.

the price level will therefore quadruple. I would argue that very few people would characterize this state of affairs as "price stability". [6]

Also, it is virtually impossible for any policy maker to hit a point-target like a two percent inflation rate precisely. So, the Fed will almost always be accused of erring on either the high or the low side of the inflation target. It might therefore be much more advisable to specify a *target range* of zero-to-two percent inflation as the goal of monetary policy. [7]

---

[6] For a history of the two percent inflation target see: Robert Heller, "Monetary Mischief and the Debt Trap", *The Cato Journal*, Vol. 37, No. 2, Spring 2017, pp. 248-250.

[7] *Ibid*., pp. 250-251.

4. Policy Signaling

When I joined the Federal Reserve Board in 1986, Paul Volcker was the Chairman -- and he ruled the Fed with an iron hand. Not only was he determined to bring inflation back under control, but he also had a tight rein on what could be said by the other Board members about policy. Preston Martin was the Vice Chairman of the Board, and when he gave a speech about possible solutions to the international debt crisis, Volcker publicly rebuked him and told the press that he found Martin's remarks "incomprehensible". [8] Totally chagrined, Pres Martin resigned from the Federal Reserve Board soon thereafter.

Preston Martin's resignation created a vacancy on the Board, and soon President Reagan appointed me to fill that vacancy. In those days, Federal Reserve decisions on monetary policy were tightly guarded secrets – even *after* they had been made. There was an entire coterie of "Fed Watchers" on Wall Street that made its living by "reading the tea leaves" and attempting to discern whether the Fed had actually changed policy or not.

I vividly recall one episode where the FOMC had not changed policy at the regular FOMC meeting. But as usual, the formal directive gave the Chairman and the Open Market Desk some latitude to tighten or loosen policy ever so slightly in the inter-meeting period. So, a few days after the meeting, Chairman Volcker was testifying in front of Congress and a Congressman asked him whether policy had actually changed. The Chairman replied: "Yes, we have been snugging up a bit".

---

[8] Robert A. Rosenblatt, "Martin's Comments on International Debt Called Incomprehensible: Volcker Rebukes Fed Vice Chairman", *Los Angeles Times*, June 21, 1985

I had never heard that term before. So, after consulting with my Webster's Dictionary, I learned that he had quietly tightened policy a bit.

Not long thereafter, I talked with a reporter about current monetary policy. The next day, Volcker called me into his office, and he told me in no uncertain terms: "If you don't keep quiet about monetary policy, I'll ruin your professional reputation!" Because I did not want to follow in Pres Martin's footsteps, I kept forthwith quiet about monetary policy.

This stands in stark contrast to today's FOMC, where all the Members frequently give speeches "signaling" what future monetary policy actions the Fed might look like. As a result, all the professional Fed watchers are nowadays trying to discern how policy is likely to change in the *near future* -- as opposed to whether it had *actually* changed. The only difference is that these days markets may change a few days *before* a Fed action is actually taken, while during the Volcker days the markets would react soon *after* the policy change was made. The difference amounts to a few days.

5. Fed Gets a Flag

When I joined the Board, I was lucky enough to be assigned the best office in the entire building: the corner office on Constitution Avenue and 20th Street. It had a head-on view of the Washington Monument. The Director of Supply Services, Robert Frazier, helped me to move in and made sure that I had everything that I needed. When he kept insisting that there must be something else that he might be able to do for me, I finally asked him: "All right, why don't you get me some of those flags like Chairman Volcker has behind his desk?" He quickly begged off and said: "I cannot do that – those are the Chairman's *personal* flags from his service at the U.S. Treasury".

I responded to him: “Fine, then just get me an American flag and a Federal Reserve flag!” His answer was: “Governor, I cannot do that either because the Federal Reserve does not have a flag”! I was surprised at that answer but was content to get my American flag.

Shortly thereafter, Chairman Volcker appointed me as the Administrative Governor. In those days, that task was usually assigned to the most junior member of the Board. It occurred to me that I was now in a position to get the Federal Reserve an official flag – similar to the many government agencies nearby.

So, I called Bob Frazier back in and told him about my plan. When he asked what kind of design I had in mind. I replied: “Well, something like all the other government agencies have, like the State Department or the Treasury Department”. Bob came back a few days later and told me: “Well, the State Department does not have a flag either!” I asked him what the banner on top of their building was and he replied: “They told me that they display their seal on cloth!”

That gave me an idea. I had him make a few Xerox copies of the official seal of the Federal Reserve Board and took these papers home with me. Then I gave them to my son Christopher and my daughter Kimberly, along with a set of crayons and asked them to design a flag for the Fed.

Nine-year old Chris, who was very much enamored with pirates in those days, came back with a rather bold design that really looked like a pirate flag.

But my daughter Kimberly Allison, who is now a Professor of Medicine right here at Stanford, came up with an elegant design that showed the official seal on a stylish blue background surrounded by a golden rim.

I took Kimberly's design back to the Fed and the Graphics Department came up with the final design for the Federal Reserve flag.

The Board of Governors adopted the flag officially on June 22, 1987 and here is the proud family holding up the new flag of the Federal Reserve System. It is probably the only lasting contribution that I have made to the Federal Reserve.

But considering that the current FOMC members continue to disregard the contributions by Milton Friedman, Karl Brunner, Mickey Levy, Michael Bordo and many other members of the Shadow Open Market Committee on the importance of the money supply for economic policy making, I should probably have suggested to the Board to adopt a slightly different flag -- a flag that would have always reminded the Federal Reserve's policy makers of keeping a close watch of the money supply.

This flag might have looked like this:

Thank you very much!