

**The Shadow Open Market Committee:
Origins and Operations
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As best I can remember, I first met Anna Schwartz in the summer of 1963 at an American Bankers Association Monetary Conference. The late Harold Cheadle, who worked for the association, had a lifelong interest in economics. He persuaded the association to sponsor an annual conference on monetary economics in the early to mid-1960s. One of these conferences was held at Princeton.

A high point of the Princeton conference was discussion of a new book by Milton Friedman and Anna J. Schwartz. *A Monetary History of the United States, 1867-1960*. James Tobin and I were asked to review the book and start the general discussion. I think it was clear to everyone then, as it surely is now, that the book was a rare achievement, an unusual blending of economic and historical analysis. Reading the book was an overwhelming experience. It may not have been the start of the counter-revolution in economics that restored classical or neo-classical monetary analysis, but it was certainly a major step along that path.

That book is representative of the way that Anna Schwartz works, sometimes alone, sometimes with co-authors. There is a careful and full, account of the relevant history or facts, when necessary the development of new data series, sophisticated application of economic theory and statistical tools and, where warranted, statement of policy implications. The *Monetary History* had all of these.

My appreciation of Anna's work and work habits has grown over the years that we have exchanged papers and ideas. For several years, she has been an indefatigable reader, helpful commentator, gentle and, at times, not so gentle prodder of my own efforts at monetary history. Few people read as carefully or comment as fully on chapters that run to 150 or 200 pages.

A large part of my enduring relationship with Anna Schwartz has been our cooperative efforts on the Shadow Open Market Committee. Aside from a short statement that Anna wrote about ten years ago, very little of the history of that institution is written. This seems an

appropriate occasion to do so, since Anna was there at the start and is, now, the only other member who has remained through more than 50 semi-annual meetings.

Starting the Shadow Committee

In August 1991, President Nixon yielded to political pressure for price and wage controls from large parts of the business community, the Congress, many economists, and parts of his own government. This was not entirely a surprise. Discussion of controls, guidelines, and other intervention had occurred sporadically at Treasury consultants' meetings in 1970-71, and presumably at other meetings as well. Treasury Secretary Connolly was a known sympathizer and, at the Federal Reserve, Arthur Burns had been outspoken in favor of wage-price guidelines.

As reported at the time, the inflation rate in the second quarter of 1971 was 4.4%, measured by the annual percentage rate of change of the consumer price index. At the time, 4% inflation was said to be politically unacceptable. With the election approaching, President Nixon chose price and wage controls as one major element of his revised economic strategy.

Karl Brunner and I decided to organize a group to criticize the decision and point out the error in the claim that controls could stop inflation. At a time when email and fax machines did not exist, a quick response by op-ed required numerous telephone calls to the other signers. Our efforts produced an op-ed in the Wall Street Journal and a good response from people all over the country. But it taught us that our procedure was cumbersome, slow, and unsatisfactory.

Our objective at the time and after was not just to complain about the results of policy actions. We wanted to show that better policy choices were available and that inflation could be controlled at acceptable cost, if the Federal Reserve controlled money growth. We hoped also to improve policy discussion. Journalists then, and to a lesser extent now, often presented policy differences by reporting on extreme views. One person would be quoted as saying that inflation would destroy the country and could only be stopped by returning to the gold standard or adopting price and wage controls. Another might argue that inflation was not a problem. The presumption may have been that the truth is always a combination of the extremes. We hoped that a rational presentation of the issues would inform the public, the Congress and the Federal Reserve.

Bill Wolman, for many years after an editor of *Business Week*, and Jim Meigs worked at the time for a consultancy, Argus Research. They shared our view that the drift in economic

policy was toward increased policy activism and more inflation. Like us, they opposed this trend. After many conversations, we decided to organize a group of like-minded economists. In a conversation with Wolman, we chose the name Shadow Open Market Committee, combining the names of the Federal Reserve's principal policymaking body with the British term for the government's opposition, the Shadow Cabinet.

We decided to have twelve members like the Federal Open Market Committee, to include both business economists and academics, and to meet semi-annually. We hoped to show that semi-annual meetings are sufficient to set policies to meet our objective of lowering inflation at lowest social cost and keeping prices stable. To the best of my knowledge, this point was too subtle for the press. I don't believe anyone commented on it then or later.

In addition to Anna, Wolman, Meigs, Brunner and me, the original twelve members included Homer James, retired Senior Vice President of the St. Louis Reserve Bank, Beryl Sprinkel, Chief Economist of the Harris Bank, Chicago, Bob Rasche, a Professor at Michigan State, Wilson Schmidt, a Professor at VPI, James Ford of Ford Motor Company, Tom Mayer at University of California, Davis, and Peter Crawford of First National City Bank, later Citicorp.

Of the original group, Sprinkel, Schmidt, Rasche and I later served in government or in the Federal Reserve System. Jerry Jordan and Bill Poole, who joined later, also moved to the Federal Reserve System and Rudy Penner became Director of the Congressional Budget Office. There was at least some validity in our use of the British meaning of "shadow."

Karl and I served as co-chairmen until his death in 1989. Most of the organizing fell to me and my office staff. I invited the press and a few interested parties. Immediately after the meeting my office mails copies of our statement to hundreds of journalists, policymakers in the United States and abroad, and to people who have requested copies over the years. Karl, and later Charles Plosser, and his staff later mail copies of all the background papers prepared for the meeting.

The invitation to the first meeting included a statement explaining why we had organized. The statement criticized recent policies, pointed to the highest rate of inflation in the peacetime history of the United States, and complained about ad hoc measures and the shortages and waste caused by price and wage controls. The statement explained policy failures:

"The failure to control inflation was not inevitable. The policies did not fail because they were poorly executed. They failed because they were poorly conceived."¹

The invitation promised that we would propose alternative policies.

The First Meeting

The Shadow Committee (SOMC) met for the first time on Sunday, September 14, 1973. Although our invitation talked about regular semi-annual meetings, neither Karl nor I, nor, I suspect, any of the other members had much sense about what would happen. One of Karl's favorite expressions was: "Let's give it a try." We did.

The SOMC's first statement pointed to high interest rates, forecast rising unemployment, and urged that money growth be reduced gradually from the prevailing 6-1/2% to about 5-1/2% as the first of a series of steps to lower inflation. The statement considered, and rejected, alternatives such as stabilizing inflation at the prevailing 4-1/2% rate or a very restrictive policy to end inflation within a year.

The SOMC never took output, employment, or any other real variable as a monetary policy objective, but it always proposed gradualist policies believing that pre-announced, gradualist policies would reduce the social cost of disinflation, thereby sustaining public support of the policy.

From the start, the SOMC did not regard maintained (and fully anticipated) inflation as costless. Costless inflation is a textbook abstraction. The SOMC's first statement ended this way:

"There are costs of maintaining inflation and costs of ending inflation, but there is no way to end inflation without cost. Sharp and sudden swings between extremes, attempts to break expectations, false promises, ringing statements of commitment to anti-inflationary policy and controls have not succeeded during the past eight years. Less dramatic policies will cost less and will, perhaps, be more effective. They are unlikely to be less effective."²

Beryl Sprinkel missed the first meeting. Everyone else agreed to the statement. We never permitted dissenting views. If we were closely divided on an issue, we did not include it.

¹ "Economists Form Shadow Open Market Committee," August 23, 1973, (unpublished).

² Statement, Shadow Open Market Committee, September 14, 1973.

This happened very rarely. In fact, usually we don't vote formally on our recommendations; we reach a consensus through discussion.

While writing this paper, I discovered that we kept minutes of the first meeting, so I know that the meeting began at 10, broke for lunch from about 12 to 1:30 and ended at 5:15.

The meeting was open to the press, since our purpose was educational. Over the years, many reporters have attended the Sunday meeting, none more faithfully than John Berry of the *Washington Post*. From the very first meeting, the SOMC took questions and comments from the press during our working session. Berry often had up-to-date information that he made available to the SOMC.

The format of the meeting set a pattern that we followed subsequently. A month or more before the meeting I talk to several members to find out what they think the topics for the meeting should be. Some members accept an assignment to prepare an analysis or position paper on a particular topic. I am responsible for preparing a draft of the policy statement. We usually began our discussion with one or two forecasts of economic activity and inflation, followed by discussion of the outlook. Mickey Levy has had this assignment since he joined. Then we discuss the position papers prepared by the members, ending with the draft statement that I prepare. Anna usually works on issues such as the Exchange Stabilization Fund, exchange rates, and related issues.

Karl prepared a commentary, usually on some aspect of monetary policy or inflation, but on other topics as well. Often he would coin a particularly apt phrase. One of my favorites is his piece in September 1984 called from "The Upper Tail Theory of Inflation" to the "Lower Tail Theory of Deflation." This piece made the point that the press, policy officials, and many economists have a relative price theory of inflation. Inflation is caused by the price that is rising most rapidly or, in the case of deflation, falling most rapidly. We seem unable to get rid of this nonsense.

The group suggests changes in the draft statement. A drafting committee edits or rewrites parts of the statement. The first drafting committee had Homer Jones, Anna Schwartz, Rasche, Ford, Wolman, and me. That was much too large to be useful. For most subsequent meetings, we had two or three members. Anna and I are always there.

If we measure success by newspaper coverage, our first meeting was one of the most successful. The New York Times sent a photographer and a reporter, John Allan. They gave our

statement and meeting a prominent place in Monday's paper. The Washington Post, the Wall Street Journal, the Associated Press and several foreign papers gave us good coverage. Lindley Clark was a good friend to the SOMC, never failing to give our report a prominent place in the Journal.

Although we were critical of the Federal Reserve, Arthur Burns later told me that he liked our effort. We wanted low inflation, or price stability. Others wanted him to be less concerned about inflation. Our criticism gave him more room to do as he pleased. That wasn't the purpose we had in mind.

Subsequent Changes

The format changed slightly after the first meeting. It was difficult to meet and get a statement out on one day. Rewriting and reprinting the statement took time. The journalists had to return after several hours. We adopted a two-day format, meeting on Sunday and holding a press conference on Monday.

The two-day meeting and press conference gave an opportunity for the members to summarize their work orally and to answer questions from the press. At first the presentations followed a luncheon. Later, we held the press conference first, followed by lunch and continued discussion.

After a few years, press coverage came mainly from journalists who covered interest rates and financial markets. Their focus was on interest rate forecasts or guesses about forthcoming Federal Reserve actions. To avoid that focus, the SOMC moved its meeting from New York to Washington in 1988. Moving meant giving up the excellent lunches and pleasant surroundings of the Harmony Club, where we met as guests of the late Robert Brimberg, a great friend of the Committee. But, in moving to Washington, we gained the services of Kathy Ulman. Kathy took charge of the organization of our meeting, reminded the journalists, and brought us coverage on several TV programs.

Membership also changed over the years, partly because members joined the government or, in a few cases, became working journalists, and partly because the group was too large to permit everyone to participate.

Eric Heinemann joined us in 1976 after he left the New York Times to join Morgan Stanley. Jerry Jordan joined later the same year. He left to serve on the Council of Economic

Advisers, returned after that service, and remained until he became President of the Cleveland Reserve Bank.

By the late 1970s, we gave in to "mission creep," expanding our concerns to include budget policy and trade policy. Rudy Penner joined us in 1977, remaining until he became Director of CBO. Mickey Levy replaced him in 1983. He remains an active member.

Jan Tumlir, Research Director of GATT joined in September 1983 and remained until his untimely death in 1985. Later Jagdish Bhagwati joined us for two meetings. We were unsuccessful in interesting the press in trade issues, possibly because the responsibility of journalists who attend our meetings usually does not include trade policy.

Five other economists have been SOMC members -- Robert Genetski, Gregory Hess, Lee Hoskins, Charles Plosser, and Burton Zwick. The SOMC now has six members. In addition to Anna and me, Greg Hess, Lee Hoskins, Mickey Levy, and Charles Plosser serve currently.

Issues and Recommendations

The SOMC's main purpose is to encourage the Federal Reserve to adopt policies that keep the inflation rate close to zero. Some of our members refer to that as price stability. It is important to keep in mind that, under this policy, the price level would approximate a random walk around zero inflation. Some may find that a peculiar definition of price stability, so I prefer to avoid the term. For the SOMC, controlling money growth is a necessary condition for zero inflation, so the semi-annual statement typically starts by suggesting an appropriate monetary policy by which we mean a sustained average rate of money growth. At its start, the SOMC focussed on currency and demand deposits as a readily accessible measure. For most of its history it has used the St. Louis monetary base as its measure of money.

Two problems arose very early in our experience. First, the Federal Reserve did not follow our recommendations. As proponents of gradualism, we had to either propose a large correction or rebase our recommendation in the light of what had happened. We almost always chose the latter course. Second, the oil embargo and increase in oil prices occurred soon after our first meeting. The Federal Reserve had allowed money to rise rapidly in advance of the series of oil shocks. Then, as borrowing declined, money growth first fell, then collapsed to zero.

The SOMC took the gradualist approach because it believed that the social cost of reducing inflation should not be ignored. Using the numbers available at the time, money growth had remained at zero in the three months before our third meeting, in September 1974. We urged a one-time increase in the level of money, to bring money growth back to its path, to be followed by a gradual reduction in the path. This outraged those who wanted the reported 8.5% inflation rate reduced quickly. That decision cost us the editorial support of The Wall Street Journal.

We learned two lessons from that experience. First, it is easy to be pulled off course by short-term movements. The sharp slowdown in money growth was a measurement aberration. Annualized growth of M_1 in the third quarter was soon raised above 4%. If we had known that, we would not have recommended the one-time increase. Second, the measured rate of inflation rose above 11 or 12% in 1975, industrial production and real GNP fell at average annual rates of 26% and 8.5% in the two quarters ending in March 1975.

Our September 1975 statement distinguished one-time changes in price and output levels from maintained rates of change. We wrote:

"A distinction between a decline attributable to real shocks and a decline attributable to cyclical forces is important for rational policy making. A cyclical decline creates an output gap. Real shocks reduce potential output and capacity."³

Both the Federal Reserve and the administration failed to distinguish the two. Later, Charles Plosser and others developed the point so that it is now more widely understood. The National Bureau continues to treat the 1970s decline in output as a cyclical disturbance. And few economists even now distinguish between one-time changes in the price level and changes in the trend rate of change. Both are called inflation.

My concern is substantive, not terminological. There is now considerable evidence for two very different propositions. First, sustained changes in the inflation rate are well predicted by changes in money growth in excess of output growth. To the extent that all economists accept any macroeconomic proposition, they accept the long-run neutrality of money. Second, there is considerable evidence that money growth is not a particularly reliable predictor of short-term changes in the measured rate of inflation.

³ SOMC Statement, September 12, 1975, p. 2.

Many other measures have been proposed in recent years. For a time the spread between long- and short-term interest rates appealed to many economists. These were market-based measures, hence relatively free of measurement error compared to measures of money, GDP, unemployment, or the so-called natural rate of unemployment. This measure of future inflation worked much better in periods like the 1970s when changes in prices were the principal reason that interest rates changed. At low inflation, changes in the term structure of real rates take on a larger role in movements of the term structure. Perhaps that explains why this method was a more accurate predictor for the United States than for Germany, a country with lower expected and actual inflation and why it is less useful now than in the 1970s.

Predictions based on some type of Phillips curve, for a time, worked better than monetary models at predicting the inflation rate. As is well known, Phillips curves predicted rising inflation from the mid-1990s on. Since base money growth remained low, the SOMC expressed no concern about rising inflation until its March 1998 meeting. At that point, it warned of higher inflation for the first time since 1993-94. But, we noted also that "reported rates of inflation will be misleading in the near term. Reduction in oil prices or a decline in import prices are one-time events that mask the underlying rate of inflation."⁴

To bring out some of the issues about one-time changes and maintained rates of change, let me propose a simple model where, as in Milton Friedman's much quoted statement, inflation is always a monetary phenomenon. It does not strain credibility to add that his statement did not mean that all increases in the price level are inflationary, only those that are maintained or persistent changes in the rate of price change.⁵

Start with an equation based on the quantity theory.

$$m_t + v_t - y_t^* = p_t + y_t - y_t^* \quad (1)$$

All variables are relative rates of change; m and v are money and velocity growth. y and y^* are the actual and permanent or maintained rates of output growth. Solving for p_t makes the rate of price change depend on money growth and velocity growth but also on the permanent growth of output and on the deviation of output from its growth path. Cyclical slowdowns reduce the measured rate of inflation without necessarily changing the maintained rate of inflation or, perhaps, changing it very little.

⁴ SOMC Statement, March 16, 1998, p. 1.

⁵ The model is from A. Meltzer (1998) "Monetarism: The Issues and the Outcome", *Atlantic Economic Journal*, 26 (March), pp. 8-31.

We formalize that statement in equation (2) distinguishing the current relative rate of price change, p_t , from the maintained rate of inflation, π_t . Call the difference ρ_t .

$$p_t = \pi_t + \rho_t \quad (2)$$

We could think of ρ_t as random or transitory noise and π_t as the expected rate of inflation. Or, we can use a version of the Phillips curve, based on growth of output in place of level, as in (3)

$$p_t - p_{t-1} = a(y_t - y_t^*) \quad (3)$$

The lower the growth of output relative to the sustained growth rate, the smaller is p_t . If p_{t-1} is close to π_t ,

$$\rho_t = a(y_t - y_t^*)$$

Current rates of price changes now have two components, as shown in (4).

$$p_t = m_t^* - y_t^* + a(y_t - y_t^*)$$

The first component explains the drift or trend in inflation, the second is the short-term deviation of p_t from π_t .

The simple model helps to clarify three points. First, the Phillips curve term focuses on the short-term deviation of the measured from the maintained rate of inflation. Central banks like the Bundesbank or the European Central Bank that follow medium-term strategies find it useful to monitor money growth. The Federal Reserve, most financial market economists, and many others in the United States concentrate on short-term changes. For a time they found it more useful to emphasize a Phillips-type relation. This strategy works best in periods when ρ_t dominates π_t and when y_t^* remains relatively constant. Changes in y_t^* and uncertainty about its persistent value, however, have now made the relation more unreliable than earlier.

Second, the relation suggests why long-term interest rates declined slowly in the disinflation of the 1980s. Ex post real interest rates on long-term bonds remained very high after several years of disinflation. Long-term rates are governed mainly by π_t . Although p_t had fallen, π_t remained high until there was an economic recovery without a return of high inflation. Several previous experiences had taught wealthowners that brief periods of slower inflation in the 1970s did not last.

Third, the great monetarist mistake was the failure to forecast the decline in inflation from 10.9% in 1981 to 3.2% in 1983 and 4.3% in 1984 (as reported at about that time). Money growth in 1983 and 1984 averaged 9%. We believed that the Federal Reserve was about to

repeat the mistakes of the 1970s. It is worth noting that members of the Federal Open Market Committee projected an inflation rate of 6 to 7% in 1984. With hindsight, we recognize that we underestimated the increased demand for money per unit of income. Our error came mainly from velocity or money demand, not from the Phillips curve term.

What lesson can be drawn from this and other mistakes? Our efforts on the SOMC to set policy have taught us that our model makes large errors at times. It is not much comfort for us that all other models, and non-model judgments, make similar or larger errors.

Many countries have tried to respond by adopting medium-term strategies to control inflation. One of the SOMC's failures, on which I am sure Anna and I agree, is that we have not persuaded the Federal Reserve to adopt a medium-term, rule-based strategy.

There is much more that could be said about our attempts to use a rule-based strategy to U.S. monetary policy. I will simply assert that, if the Federal Reserve had followed our policy, we would have avoided much of the inflation of the 1970s. It would have removed Regulation Q and, with lower inflation, avoided the high cost of the disinflation, including the deep recession of 1981, the destruction of the savings and loan industry, and the large tax on heavily capitalized industries in the United States in the 1970s.

Conclusion

The idea of a Shadow Committee to both criticize and praise policy decisions has spread widely. There are now macro shadow committees in several European countries, including Germany, France, the U.K., and Spain. Other shadow committees discuss banking and financial regulation in the United States, Europe, and even Japan. An SEC shadow group operated for a time. These efforts involve academics and practitioners face to face with real problems. They have encouraged useful analytic work on policy problems by making academics more concerned with policy issues and institutional constraints. That is a welcome result.

Let me conclude by saying a few words about the choice of topic and its relation to Anna's career. I come at the end of more than a day of celebrating Anna Schwartz's lifetime achievements as an economist and historian. Others will have talked about her accomplishments in these areas. I would like to add that I learned a great deal from Anna, particularly about the monetary history of the U.S. and the U.K. and the success in Britain of Bagehot's rule for

banking crises after 1870. I have tried to put those lessons to work, most recently in the Report of the International Financial Institution Advisory Commission.

There is another reason for choosing this topic. The SOMC is the place where Anna and I have worked together most closely over almost thirty years. We have had half a lifetime of shared experiences, successes as well as failures.

My respect for her, and our friendship, has grown during these years. I am, therefore, pleased to have had the opportunity to share some of this experience with others and to have the chance to express my appreciation for all that she has done for me, and with me, these many years.