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30 November 2006

Online at https://mpra.ub.uni-muenchen.de/17780/
MPRA Paper No. 17780, posted 10 Oct 2009 06:10 UTC

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John A. Tatom

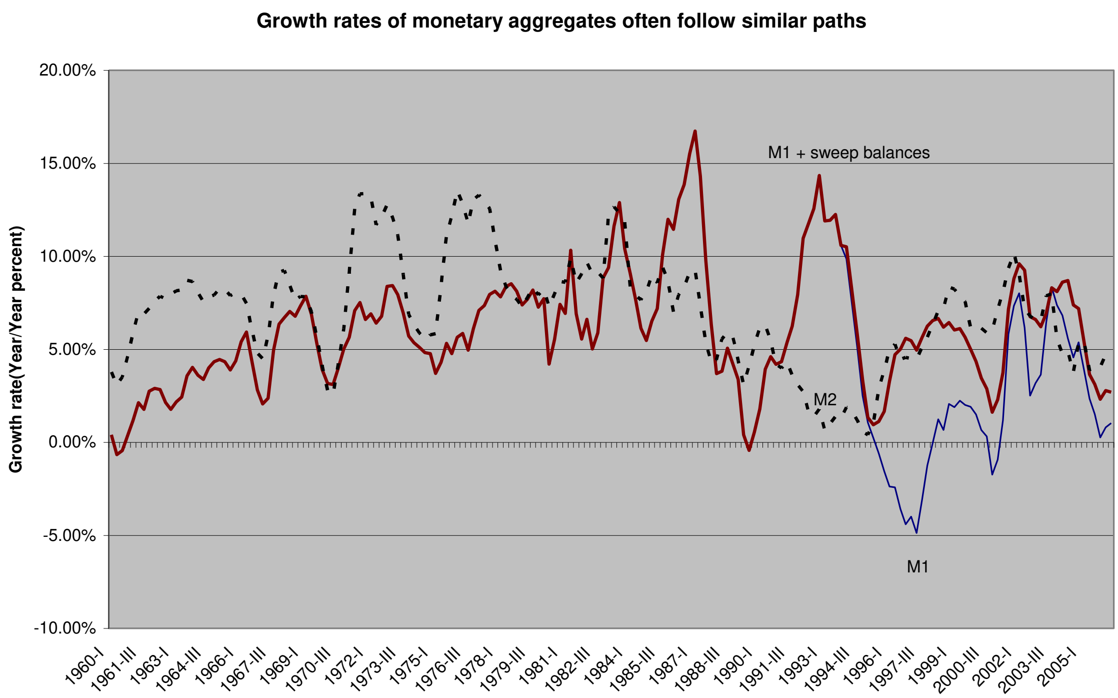
Milton Friedman, the most influential economist of the 20th century and one of greatest economists of all time, died on November 16, 2006 at age 94. He will be remembered as the most articulate and insightful advocate since Adam Smith of free markets and capitalism. He was the winner of the prestigious John Bates Clark award in 1951 and the Nobel Prize in 1976. He made major contributions to monetary theory and policy issues. He was famous for his conclusion that "inflation is always and everywhere a monetary phenomenon," and for the related notion that ultimately the only thing a central bank, such as the Federal Reserve System, can control is inflation, and not output, employment, interest rates or other items that politicians and other interest groups typically urge central banks to control.

This article focuses on some of his more important ideas about money and monetary policy, both as a memorial and because his views remain controversial in their application, although not in their general acceptance. Friedman emphasized the role of the quantity of money and its growth rate in determining the pace of inflation and, when volatile, in causing business cycles. He also was a strong advocate of "rules versus discretion" in the conduct of monetary policy. In his view, the Federal Reserve has been the principal source of cyclical instability and major inflation episodes since its founding. He concluded that central banks should be given a rule to increase a measure of the nation's money stock at a given fixed rate per year so that discretion in trying to improve economic performance would be removed.

By the 1980s, Friedman had been extremely persuasive so that economists, policymakers and ordinary citizens had learned the lessons of the importance of money and how to properly conduct monetary policy. For example, the US Congress mandated in 1975 (House Concurrent Resolution 133) that the Fed report annual targets for the growth rates of money and credit. This directive was formalized in amendments to the Federal Reserve Act in 1977. By 1987, however, the Fed stopped reporting a target for the narrow measure of money used in transactions called M1 and by 1992 they downplayed targets for a broader measure, actually preferred by Friedman, called M2. When the relevant statute expired in 2000, the Fed ceased stating any target which might influence market expectations or be useful as a standard for performance or accountability.

The reason that US policymakers ignore monetary aggregates is that deregulation and financial innovations have distorted the measures of money so that there is no stable empirical relationship between monetary aggregate measures and nominal spending or income, or with inflation. As a result, while Friedman's greatest contribution to monetary policy, the importance of controlling the quantity of money in the economy in order to control inflation and stabilize output and employment, has been widely accepted, it has only been implemented in highly abstract and immeasurable terms.

Friedman always argued that it did not matter which measure of money one chose in order to conduct monetary policy because they all usually moved up and down in similar patterns. The chart shows that for M1 and M2, this is generally true, as well as for a measure of M1 adjusted for retail sweep accounts that, due to a technical innovation in 1994, began to be swept into higher-interest bearing accounts that did not have reserve requirements and were not part of M1. The innovation and its effects are discussed in Anderson and Rasche (2001). There are periods when the two measures, and after 1993 the three measures, showed divergent movements, but generally their growth rates did move up and down together, as Friedman suggested.



The adjusted M1 series is the least distorted by financial innovation and bears the closest relationship to economic activity and inflation. Sharp slowings in adjusted M1 are accompanied, or soon followed, by the onset of recessions. Recently this was visible for the slowing in M1-adjusted growth in 1999-2000, which was followed by the slowing of the economy in 2000-01, and for the subsequent monetary-led rebound. The latest slowing in monetary growth occurred from mid-2004 to the end of 2005 and is presumably related, at least in part, to the slowing in real GDP growth that began earlier this year.

Why has the Fed done so well?

The economy has been spared a replay of earlier monetary policy mistakes despite the reduced focus on the quantity of money. Friedman recognized the superior job that the Fed has done since 1987 in bringing inflation down and in keeping it down during the Greenspan era. (See *He Has Set a Standard*). This was an astounding vote of approval by an economist who had built a reputation for seeing no positive benefit to having a Fed with discretionary power to change the quantity of money, ever in the history of the Fed. But he was quick to point out that the achievements of the Fed from 1987 to 2006 were the result of the leadership of Chairman Greenspan, not to some new found institutional process or procedure. He also neglected to mention the two recession in 1990-91 and 2001. Speaking Alan Greenspan's support for discretion and opposition to rules, Freidman said,

> "Now that his 18-year stint as Chairman of the Fed is finished, I must confess that his performance has persuaded me that he is right – *in his own case."* (emphasis added)

In his letter to Gregory Mankiw, a leading Harvard economist and recent Chairman of the President's Council of Economic Advisers, Friedman reiterated his critique of central bankers, noting that:

> "I have come to the conclusion that central bankers have done a wonderful job of pulling the wool over the eyes of economists. They led us all to believe that maintaining a relatively stable price level is a very difficult problem that requires the judgment of the wisest of experienced bankers and business people. …Nothing that I have observed in recent decades has led me to change my mind about the desirability of a monetary rule which simply increased the quantity of money at a fixed rate month after month, year after year. That rule would get rid of the mistakes and that is probably about all you could expect to get from a monetary system."

Perhaps the deterioration of acceptance of Friedman's insight is most evident in Gregory Mankiw's suggestion in recent correspondence with Friedman, that the earlier poor performance of the Fed was due to bad luck, and the successes under Greenspan were simply good luck (See his response in Friedman, ("Letter from Milton" 2006)

A middle view, and perhaps the dominant view today, is that the Fed has focused on monetary aggregates and inflation control by more aggressive settings of the federal funds rate, the rate at which financial institutions borrow and lend, generally overnight, funds held on deposit at the Federal Reserve as reserves. A given change in the fed funds rate will bring about the appropriate change in the growth rate of money, even if the latter cannot be observed or measured with precision. It is reminiscent to many observers of the story of the emperor who had no clothes. Policymakers are victims of the same cognitive dissonance as academic economists: they study and prepare policy views on monetary policy without mentioning, measuring, or being accountable for money growth.

A Focus on Money is Still Important Abroad

In the rest of the world, attention to monetary aggregates remains stronger. For example, the founding of the European Central Bank (ECB) in 1998 was premised on a continued focus on monetary aggregates, following the famous success of the German Bundesbank in targeting monetary aggregates in order to secure price stability. On November 9-10 of this year, the ECB held a conference on "The Role of Money and Monetary Policy in the

Twenty-first Century." The purpose of the meeting was fundamental. The President of the ECB, Jean-Claude Trichet, reflected the depth of the issue when he concluded that, while there is room for refinements to the intellectual framework used as a basis for monetary policy deliberations, "I remain convinced that we should not discard elements – such as monetary analysis – that have served central banks well in the past."

President Trichet highlighted that the use of a monetary growth pillar and its associated "careful analysis of monetary developments in real time" as "helping the ECB shape its assessment of the economic situation and the associated risks to price stability," as well as "improve its policy decisions." Further, he noted the importance attached to the monetary pillar has "contributed to shaping agents' expectations in a manner which enhanced the credibility of the ECB."

The absence of monetary targets in the US provides a vacuum, of sorts. Policymakers are aware that a policy regime change and/or poor performance in achieving low inflation could incite pressure on the Fed to restore monetary aggregate targets in order to provide a means to monitor, assess and hold accountable their behavior. The drive to implement an inflation target is part of Fed's response to this potential problem. It is doubtful that the Fed will restore a monetary aggregate target, but at least a few policymakers will secretly be reviewing monetary developments before decisions are taken, even in America. And a consensus of analysts and policymakers will continue to propagate the mantra that "inflation is always and everywhere a monetary phenomenon."

Milton Friedman continued to be active right up to his death. The *Wall Street Journal* published his last article on November 17, the day following his death. In it, he compared the path of money growth surrounding the Great Depression and the end of stock price bubbles in the early 1990s in Japan and in 2000 in the US. He showed that cyclical slowdowns were predicted by slowing money growth and that the cyclical slowing was larger, the larger was the slowing in money growth.

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