From Maverick to Mainstream: The Evolution of Monetarist Thought in Monetary Policymaking

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I would like to take this opportunity to give you a status report on the monetarist approach to macroeconomics and monetary policy--an approach that has long been associated with the Federal Reserve Bank of St. Louis. As you may know, our Bank has played a prominent role in the famous monetarist/Keynesian debate that began roughly 35 years ago. Today, I would like to emphasize the extent to which this debate has been replaced by a new landscape of ideas--a landscape in which many of the controversial views of the original monetarists are now taken for granted. This changing world view, among both economists and policymakers, helps explain why monetarism today is less of a renegade force and more of a common bond in macroeconomics.

Many once-heretical monetarist ideas now enjoy widespread acceptance. Monetary aggregates, for instance, now play an important role in Federal Reserve policymaking and in the policymaking of virtually all central banks worldwide. Monetary aggregates played virtually no role in policymaking 20 or 30 years ago. Likewise, the idea that money growth and inflation are related in the long run, once an outside view, now dominates discussions in academic and policymaking circles. Doubts about the effectiveness of economic stabilization policy, long held by the research staff at the Bank, have crept into the views of many

economists and participants in the policymaking process. In short, once-radical ideas spawned by the early monetarists now seem mundane. Let me take a few minutes to outline how this metamorphosis occurred.

Monetarist views are often associated with the work of Allan Meltzer, Anna Schwartz, the late Karl Brunner, and Nobel laureate Milton Friedman, to name a few. These economists began emphasizing the role of money and monetary policy in the macroeconomy during the late 1950s and early 1960s. At about this same time, monetarist ideas began to catch on with the research staff of the Federal Reserve Bank of St. Louis.

In 1968, the late Leonall Andersen and Jerry Jordan, then on the research staff at the Bank, published a famous paper in the Bank's Review. Jordan is now the president of the Federal Reserve Bank of Cleveland. The "St. Louis Equation," as it became known, documented a close statistical relationship between M1 growth, output and inflation. It established the short-run effects of monetary policy on economic activity, while preserving the long-run relationship between money and inflation. The Andersen and Jordan work provided a key contribution to the monetarist/Keynesian debate.

But skepticism about monetarist views reigned, especially within the Federal Reserve System. Policymaking at the time relied not on monetary aggregates, but on subjective feelings about the "tone and feel" of the

financial markets. Instead of looking at the total reserves held by banks as a measure of the thrust of monetary policy, members of the Federal Open Market Committee, or FOMC, the Fed's principal monetary policymaking body, tended to look at free reserves--that is, reserves in excess of those required by law less those borrowed from the Fed's discount window. This was so even after Brunner and Meltzer published a 1964 paper showing that free reserves could give misleading signals about policy.

Money was so under-appreciated in the System that it was not even mentioned in a FOMC directive until 1970, more than 50 years after the Fed's founding. The Federal Reserve published no statistics on money on a regular basis until 1944, and only began publishing monetary data based on daily averages in 1960.

In the 1970s, monetarist views began to gain wider acceptance, and the Federal Reserve System began to show more interest in money and monetary aggregates. The Federal Reserve Board published data on M2 and M3 for the first time in 1971. As the 1970s progressed, discussions of money began to play a greater role in the making of monetary policy, particularly when other approaches failed to control steadily rising inflation. Late in the 1970s, as a result of the Full Employment and Balanced Growth Act of 1978, the Fed was required to set target ranges for growth in certain monetary aggregates. And in 1979, the Board finally began publishing data on the monetary base, 11 years after our

Bank first published similar data. In all of these changes, the Federal Reserve Bank of St. Louis played an influential role.

But monetarist ideas were not confined solely to money. Monetarist thought encompassed a much broader world view. In the early 1970s, several authors, writing in scholarly journals, tried to define the distinguishing features of the monetarist viewpoint. I would like to briefly characterize four themes that were emphasized in these writings. In my opinion, these ideas have withstood the test of time rather well.

One theme is that monetarists tend to believe in market mechanisms. Capitalist systems allocate resources effectively and, when possible, the government should stay out of the private sector. This view has gained considerable currency in the U.S. since the 1960s. Global events of the last few years, like the fall of the Berlin Wall and the breakup of the Soviet Union, suggest that market systems are on the ascent internationally as well. A fortuitous result of these events is that the intellectual climate has shifted favorably toward the monetarist viewpoint.

A second theme is that monetarists emphasize the long-run relationship between money and prices. As I have already mentioned, this relationship is now widely accepted in academia as well as in policymaking halls. Cross-country evidence collected since the early 1960s broadly supports

this view. Countries with high inflation rates over long periods of time tend to have high rates of money growth, while countries with low inflation rates tend to have low rates of money growth. The United States, for instance, experienced an average annual rate of inflation of 5.4 percent in the 1980s, while money grew at an average annual rate of 7.5 percent. Iceland, on the other hand, experienced a 32 percent average annual inflation rate over the same period, and an average money growth rate of 38 percent. Mexico had 50 percent average annual inflation, along with money growth of 46 percent. These figures bear out the notion that a central bank can keep inflation low by keeping money growth modest and that the early monetarists were right in emphasizing the long-run relationship between money and prices.

A third theme in monetarist thought is an emphasis on quantifiable measures of the thrust of monetary policy. The writers in the early '70s felt that, if monetarists had been in charge, they would have insisted on using reserves as the measure of policy thrust and a monetary aggregate as the intermediate target of policy. The Federal Reserve Bank of St. Louis has argued both of these positions repeatedly. At times, our research staff has proposed targeting M1, and for a while, the FOMC implemented a version of that plan. Unfortunately, although M1 targeting made us famous, it ultimately was less successful than we had hoped. In the early 1980s, the empirical relationship between M1 and

nominal GNP broke down, and M1 targeting was abandoned by the FOMC.

I hesitate to write off this theme in monetarist thought, however. While targeting monetary aggregates has turned out to be more difficult than we once thought, the emphasis on quantifiable measures of the thrust of policy is still a good characterization of the monetarist viewpoint. The Federal Reserve takes action merely by adding or draining reserves from the banking system. Policymakers must pay close attention to reserves or quantities closely related to reserves if they are to keep a handle on the effects of their policy actions. There is simply no excuse for ignoring quantities closely related to actions actually taken by the Fed.

The fourth theme is that monetarists deny there is a long-run trade-off between inflation and unemployment. In other words, there is no permanent advantage to be gained by continually easing monetary policy. Few economists would argue with this view today. The catch, of course, is that you may be able to gain a temporary advantage by easing, in terms of greater real output for a time, and this is sometimes enough to persuade policymakers to pursue countercyclical policy.

I hope that by emphasizing some themes of monetarist thought, I have been able to convey how much the policymaking environment has changed in the last 20 or 30 years. But I want to expand on this last theme, as it plays

an important role in policy discussions. Few economists today would argue that there is a permanent trade-off between inflation and unemployment. But many support the notion that there is a temporary trade-off. An easing of monetary policy today, so the story goes, will raise real output growth and lower unemployment a few quarters in the future. Sooner or later, of course, that rise in real output growth must be followed by a fall in real output growth, so that the total long-run effect on the real economy is zero and the economy remains stable. But if monetary policy can have such temporary real effects, one might be tempted to offset particularly severe bouts of unemployment using this mechanism.

Monetarists have argued against such fine-tuning, largely on practical grounds. For one thing, it is difficult to forecast well enough to know when to take action. Given the state of economic forecasting today, I don't see how the FOMC is supposed to know when particularly bad times are ahead for the economy six months to a year before they happen. For example, the Blue Chip forecast--made by a consensus of 50 leading economists--failed to predict during the most recent recession that real output growth would be negative for the fourth quarter of 1990 until we were actually in the middle of that quarter.

In addition, unless the increased monetary stimulus is eventually reversed, there will be a residual impact on

prices, which will tend to rise. But because these price effects are typically felt only after long lags--two or more years--it is tempting to continue with countercyclical policies once you start. Why not? You can reap the supposed benefits now and worry about paying the bill later.

To some extent, the impetus for fine-tuning is due to multiple goals for policy, which unfortunately are legislated. The monetary policy process in this country would be greatly enhanced if policymakers were given a single goal that could be achieved with the tools we have in hand. In my judgment, that single goal should be long-term price stability. A central bank can best contribute to long-run real economic growth, which is what we all really care about, by providing a stable price backdrop that induces saving and investment.

Without such a clarification of goals, however, we need some indicator of the thrust of monetary policy at any point in time and a notion of constraining behavior at extremes. The traditional monetarist approach suggests that one should measure the thrust of policy by reserve growth or quantities closely related to reserves. The quantity measures currently in use, M2 and M3, are in my opinion too far removed from reserves to be helpful. M2 and M3 are subject to so many nonpolicy disturbances that their movements are virtually impossible to interpret. This leaves policymakers without a good quantity measure of their actions and no notion of how much is enough in one direction or the other.

As things stand, monetary policy can actually contribute to instability in the economy and create a need for a sharp policy reversal despite the best intentions of policymakers.

Let me conclude by saying that it has been a welcome development for the St. Louis Fed to see its monetarist ideas generally accepted in academic and policy circles. After all, no one wants to be a maverick forever. But it does mean a changing role for the Bank. Where once we were viewed as renegades with outspoken views, we are now sometimes confused with our critics.

Clearly, the monetarist approach at the Federal Reserve Bank of St. Louis is adapting to changing circumstances, and these circumstances have changed largely for the better in the past 20 or 30 years. Several lessons have been learned by economic observers. There is now substantial agreement that money and prices are related in the long-run. Talk about long-run inflation-unemployment tradeoffs is a thing of the past. And the idea of smoothly functioning markets is also viewed more favorably. Partly because of these changes, monetary policy in recent years has been relatively good; policymakers have laid a base that holds out the promise of a sustainable reduction in the rate of inflation from that of the late 1980s. But this battle is far from won, and there are ample challenges for the St. Louis Fed and its distinctive approach to monetary policymaking as we move further into the 1990s. I am confident that we will be up to them.