WHY IS FRIEDMAN LIKE FREUD?

Remarks of

Jeffrey M. Bucher

Member, Board of Governors of the
Federal Reserve System

to the

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Department of Economics

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WHY IS FRIEDMAN LIKE FREUD?

Lest anyone get the impression from the title of this talk that the minutes of the Federal Open Market Committee's current meetings--which will be made public five years hence--are going to disclose that a radical change has occurred in the way the Committee assesses the monetary aggregates and their behavior, let me save you a long wait. I am not hinting that we are now subjecting information about the money supply to new judgmental values akin to Dr. Sigmund Freud's examination and evaluation of human personalities. Nor will a search through these dusty records reveal that we have learned to make the economic world as predictably responsive to changes in the monetary aggregates as a young man's fancy to certain stimuli in the spring.

Unfortunately, we are still dealing with an area which, to most, is far from romantic--nevertheless there is a message in the heading I have given my remarks. In part, it is related to my days at Occidental College, where--in preparation, as it turned out, for a career in law, that led to a career in banking, that has now led to a career in bank regulation and monetary policy--I studied psychology. But, in returning to this campus, I hope that my remarks will demonstrate that a study of the ideas of Freud and his followers, Jung and Adler, may not have been a misspent youth. On the contrary, it may have alerted me to the possible dangers in certain ways of thinking and schools of thought. It also would appear to me that pioneers in the field of psychiatry and psychology and their followers are not the only ones susceptible to the dangers I am to describe. Economists, writers, businessmen, and some people in government may well have fallen ill with the same malady.

The results of such thinking can be summed up in the exasperated comment attributed to Karl Marx, late in his life, that "I am not a Marxist."

If in fact the father of communism said this, he did not mean, of course, that he had abandoned his ideas. He meant that he had seen--already in his lifetime--among those who called themselves Marxists, what he regarded as serious distortions of his ideology.

What I hear and read from the proponents of the monetarist view of economics leads me to wonder if this theory is being strained beyond its reach.

This does not mean that I believe Dr. Milton Friedman is at all inclined to abandon the basis tenets of his theory as to the relationship between the rate of change in the supply of money and changes in economic activity. But I wonder because I know that when much of what is called Freudian thought is tested against an in-depth view of Dr. Freud's theses, a great deal that passes for Freudianism is doctrine more stringently held, more rigidly applied, less subtly understood, and far less tolerant of other theories, than Freud himself intended, or would have approved.

Freud's doctrines made a contribution of fundamental importance in the fields of psychology and psychiatry. However, far too often, his followers have seized upon some of Freud's truths as the whole, and upon this inadequate foundation, they have erected a religion in place of the careful, modest, often tentative, qualified and always interacting total views of the man--very conscious of his fallibility--they idolize.

I am afraid that this is the fate of many original thinkers and it is this tendency to substitute dogma for careful thought that, I said earlier, can be very dangerous indeed.

It seems to me that monetarism also is in danger of becoming a religion patched together out of part truths. Like Freudianism, monetarism has made a valuable contribution to thinking in economics, perhaps a contribution of fundamental importance, although more time is needed to know for sure. However, it is certain that Dr. Friedman has focused a great deal of thinking on the supply side of the monetary ledger, dealing with the amount of funds that become available to the economy during a time sequence. The interaction of supply with demand affects the price of these funds in terms of interest rates and the complex of factors called 'market conditions'.

Are the
Aggregates Like Sex?

Too many of those who have taken Dr. Friedman's ideas to heart are doing what I regard as a disservice to the real present values, and future potential, of monetarist thought. Very much as the students of Freud permitted--or encouraged--the idea to develop that Freudianism was a Pandora's box of sex drives, sex repressions and sex manifestations--obscuring the deeper, more complex and broader implications of Freud's life work--so, it seems to me, monetarists are treating the aggregates.

There is an amazingly popular monetarist view--perhaps it should be called monetarist fundamentalism--that a steady supply of money fed into the economy at a given rate will cure our main economic ills, and promise steady growth of the economy. This mistreats the aggregates as the be-all and end-all of economics, as sex is mistreated as the be-all and end-all of human behavior.

Perhaps some such simple dogmatism was necessary to get the attention of those who held a fixated view that the objectives of monetary policy could--indeed, should--be sought only by affecting interest rates and credit market conditions, without concern as to the necessary supply of money. The Federal Reserve has always had some concern with the role of the supply of money in monetary policy, but the degree of emphasis has varied over time. Recently, monetary aggregates have been given increased emphasis. You need only look at any directive of the Federal Open Market Committee of the Federal Reserve System to see that full attention has for some time been given to stating monetary policy goals in terms of money supply as well as market conditions. These periodic directives to the Manager of the Open Market Account now typically read:

> To implement...(the Committee's goals)...the Committee seeks to achieve bank reserve and money market conditions that will support (slower, greater, etc.) growth in the monetary aggregates...

So let me respond to all those cards and letters telling us that a new millenium is born in economics. We see the new star. We know it is there. We are watching it. We consider it an important star. To a substantial degree we are guided by it. But we do not regard the monetary aggregates as the only important star in the firmament.

This is to say that I believe there is little, if any, tendency at the Federal Reserve Board to mistake the monetarist view of economic behavior as a viable substitute for the whole of economic thought.

Nor, let me add, can there be many who are engaged in the day-to-day struggle that the monetary policy maker must accept--to try and make theory fit real life--who believe that the monetarist prescription of a smooth optimum curve of supplied money can be implemented anywhere outside the cool recesses of the scholar's study. The Federal Reserve operates in and for a real world. It is a world that could not--and, in my view, should not--be brought to accept a serious economic upset such as, say, a liquidity crisis and its entailed output and employment crises, as the price of getting on to an optimum money supply curve. This, in my view, would be so, even in the face of strong evidence that such an ideal flow of new money would result in a highly desirable, smooth and non-inflationary optimum growth curve.

But that is by no means all. On the contrary, there is in fact no evidence that should the monetary authority close its eyes, stop its ears, grit its teeth and--abdicating real world monetary policy functions--instruct its Open Market Manager to keep letting new money into the economy at a pre-ordained rate, an optimum and non-inflationary economic growth curve would result.

This is no more realistic, in my judgment, than is the notion--torn from the body of Freud's thinking--that if we can learn enough about the origins of sex drives and their management, we can produce thereby a whole and serene human personality. Both propositions appear to me to be false for the same reason. That is, many factors are at work that cannot be reached by a single-minded prescription.

In the case of monetary policy, the central fact is that the Federal Reserve cannot alone determine the economic climate. The Federal Reserve cannot control fiscal policy--stimulative, restrictive or neutral spending and taxing policy--which is totally in the hands of the Congress and the White House. The effects of fiscal policy can at any time overwhelm the efforts of monetary policy. And fiscal policy responds chiefly to non-economic stimuli.

A number of other factors external to the powers of the monetary authority can also overwhelm, or at the very least, severely affect, monetary policy actions. Among these are changes in the propensities of people to spend or to save. The public may prefer to invest new money in savings accounts where it is used slowly, rather than to spend it rapidly on goods and services, thereby quickly affecting inventories, new orders, output and employment. Or, even when the monetary authority is in a restrictive posture, the public may become more aggressive spenders, thereby overheating an economy already working at near capacity. The effects of such action would, of course, be damaging upon the interest rate structure, the price structure, productivity, and international movements of money. Business too can go on a capital spending spree, or snap the business purse shut, and either of these actions may be at odds with monetary policy and offset its effects.

It is not only the fact that the Federal Reserve cannot ignore, and may find itself unable to control, such developments through monetary policy. It is also the fact that the Federal Reserve must observe, be alert to, make judgments about such developments, and take appropriate action.

We have neither the information nor the wisdom to insist that the Federal Reserve, and the Federal Reserve alone, knows what is best. That it has set its course and will not change no matter what. Or that the Congress and the President elected by the people, to say nothing of the judgments or desires of businesses and families as to how to use funds available to them, must all take second place to our judgment as to what is best for the economy.

The
Experiment

Let me come now to some aspects of current monetary policy and the techniques being used to effect it. I hope the foregoing remarks may be useful backgound for this concluding section of my talk.

I want to emphasize that I will be talking about a technical device for achieving the goals of monetary policy--for improving our aim. In setting monetary policy we set up objectives in the context of what we see happening in the economy and what we see coming. We set these financial objectives, I should emphasize, in the knowledge that monetary policy actions take effect with a rather extensive lag of at least three to six months and perhaps out to a year or more. It takes some time for changes in liquidity conditions to work themselves through the economy, and they reach some parts of the economy with greater or lesser degrees of delay.

As the evidence of this piles up in our computers, we are more and more keenly aware that while we cannot ignore the current scene and while our actionswill havesome.

effects on the short run situation, we are in fact making monetary policy in an economic continuum in which current policy continued for, say, as much as three to six months will have lagged effects of restraint or ease in the future. Thus, with our sword raised to slay the dragon of inflation, we must be aware that restraint--or, to take the opposite case, ease--applied today may have relatively less effect upon very near term conditions than upon conditions nine months, a year, or more ahead.

The implications of this policy making problem are many. They involve, among others, the fact that in real world conditions we cannot appear to be supplying more funds than the need to fight off present and evident inflationary trends suggests, or negatively affecting money supply and bank deposits or credit when the economy clearly needs to be stimulated. All this, however, concerns what target to select at any given time. The knowledge that the financial goals we choose will have effects far into the future is, at least, an argument for being as accurate as possible in hitting them. If you are worried that restraining actions today may result later in more restraint than you want, or that today's ease is inflationary tinder for the future, you certainly do not want to over-restrain, or over-ease today.

Just over a year ago, the FOMC adopted a revised technique, designed to give the Federal Reserve more accurate control of the monetary aggregates. This has become known as the RPD technique, standing for Reserves Available to Support Private Deposits. As Chairman Arthur F. Burns explained shortly after this new technique was put experimentally into effect, the object was to try to get a better "handle" on the problem of controlling the aggregates.

It is not a neat, clean, reproducible laboratory experiment. It takes place in the hurly-burly of the market place. There have been recent times when interest rate patterns seemed to be of such commanding importance that some thought we had abandoned the RPD experiment, and with it our interest in the aggregates, and had gone back to a fixation on money market conditions. Also, there have been outbursts of growth in the aggregates--for instance in July and December of last year--which convinced some that we must abandon the experiment because it was not working.

The fact is that the experiment is alive and well. Given the very bumpy year in which it has existed, we have seen nothing thus far to suggest that it should be abandoned. The past year has seen accelerating economic growth at home, leading to almost explosive growth conditions early in this year. There have been waves of speculative attack on the international monetary system that have at times given extraordinary prominence to our interest rate pattern, and that required close attention to money market conditions to cushion the effects at home. This has taken place at a time of winding down of our war effort and, finally, of major budget policy changes.

Given all these real world pressures, I think that the Federal Reserve can take some pride in the fact that, with the RPD technique in use at a time of unusual stresses and uncertainties, the money supply has increased near to, but somewhat less than, real economic growth. That is, we have financed real growth and not more. That of course, in view of lagged effects, leaves the question whether we should have done less or more at any particular time, but that, again, is a matter of what is the right target, not how to hit it. It is encouraging that after the massive bulge in the money supply in December of 1972, we were able to balance matters with a month of no money supply growth in January, only about 3 per cent in February and probably--as best as can be judged from now available data--no sizable gain this month.

More time is of course needed before it can be said that the RPD device has fully proved itself. In line with this, let me enter at this point a cautionary note. The RPD device cannot be used mechanically, any more than an aggregates target can be used mechanically. Demand for money is volatile over shortperiods. It takes at least three to six months to tell what the basic trend of the money supply is. All our studies at the Federal Reserve show that short-run changes in money--weekly, monthly or even bi-monthly--have little, if any, significance.

So the intense interest shown by many financial writers, and some economists, in such short term changes, is misleading.

They should keep their eye much more on the three-month, six-month and one-year changes published weekly by the Federal Reserve.[1/]

We have been asked over the past year if evidence of considerable focus at times on money market conditions does not show that we are reverting to old pre-aggregates form. One part of the answer is that the very existence of the RPD technique has helped to avoid this because it focuses the attention of the System Account Manager--who carries out our open market operations--on reserves.

These reserves, as I have already indicated, are not an end in themselves. Nor, for that matter, are money market conditions. The reserves in RPD include reserves behind all types of deposits--including savings deposits and large negotiable certificates of deposit, except for interbank and government deposits. Thus, RPD is a wide-spectrum tool.

A focus on RPD is a help in confronting the problem that increases in the reserve base may support chiefly one or another type of deposit, depending upon public preferences as to the form in which people or businesses wish to maintain their liquidity. For example, if increased reserves support mainly types of deposits that require relatively small amounts of reserves--deposits in small banks, certificates of deposits, Eurodollars, or passbook savings deposits--there would automatically be a bigger multiplier effect

1/ In the weekly statistical release titled "Weekly Summary of Banking and Credit Measures," numbered H.9.

upon the total amount of deposits that will be supported by a given amount of supplied reserves. This sets up a trade-off among M_1 and other definitions of money and bank credit, in which, while M_1 may be growing only slowly, broader money supplies and bank credit may expand more rapidly.

Problems raised by shifts in the forms in which the public holds liquidity, as well as shifting propensities to save or to spend, merely highlight the distinction that should be made between technical problems and policy problems. To the degree that monetary policy wishes to control monetary aggregates, it is a technical problem to decide how best this might be done.

In this light, the experiment with RPD can be viewed as a technical experiment. But it is a policy problem to decide how accommodative--or not--to be in the face of shifts in the demand for money, shifts in fiscal policy and changes in a number of other external forces that continually confront monetary policy makers. A technical experiment cannot make those policy choices for us, although we must have the technical basis for implementing our decisions. But making decisions as to desirable long-run growth rates in monetary aggregates or desirable effects upon credit markets is the most important part of policy making. We have no illusions that RPD will do this job for us. However, we have high hopes that it will be a genuine help to us in carrying out policy more accurately.

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GOVERNOR BUCHER'S SPEECH OF APRIL 2, 1973

ERRATA: Read last sentence, first paragraph, Page 11 as follows:

It is encouraging that after the massive bulge in the money supply in December of 1972, we were able to balance matters with a month of no money supply growth in January, about 6 per cent in February and probably -- as best as can be judged from now available data -- no sizable gain last month.