Research Department
Federal Reserve
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Business & Financial Letter

The Debate: Monetarists

In last week's letter, we discussed the Keynesian view of the current economic outlook and its implications for monetary policy. This week, we present the opposing position – the monetarist view – and show the relationship between the two schools of thought and recent Federal Reserve policy.

The label "monetarist," although most frequently associated with the name of Milton Friedman, is shared by a large number of economists. (Friedman actually does not like the term.) As the label suggests, monetarists pay particular attention in their analyses to the rate of growth of the money supply.

According to the monetarist view, there is currently a greater probability of worsening inflation than of higher unemployment. Despite the fact that inflation has receded from the double-digit levels of 1974 – the CPI increased at only a 3.6-percent annual rate in the August-October period – most monetarists believe that the underlying rate of inflation is still around 6 percent and may accelerate in 1978. Besides, monetarists are much less sanguine than Keynesians regarding the size of the gap between actual and "potential" GNP. They note that full capacity of the capital stock would be reached by late 1978 if real GNP grew at a relatively moderate 5.5-percent rate between now and then.

Monetarist analysis

Monetarists locate the source of current inflationary pressures in the rapid rates of money growth of the last two years. In other words, just as Keynesians see the risk of recession in what they consider to be the Fed's *tight-money* policies (measured by higher interest rates), the monetarists see the danger of continuing high inflation in what they interpret as the Fed's *easy-money* policies (measured by rapid money growth).

In measuring money growth, monetarists concentrate on the broadly-defined money supply, M_2, which includes commercial-bank time and savings deposits (except for large negotiable CD's) as well as currency and demand deposits. They tend to use this measure, rather than the narrower M_1 measure, because the various regulatory changes which have accelerated financial innovations and upset the historical relationships between M_1 and the major economic variables have had less impact on M_2.

Since the start of 1976, M_2 has grown at a 10.7-percent average rate – far above the 8.6-percent trend rate of growth of the last decade. Moreover, M_2 growth has consistently exceeded the upper bounds of the Fed's target ranges since the beginning of 1976. Monetarists take these facts as evidence of a very stimulative monetary policy. Further, given the lags between monetary acceleration and increased inflation – typically from eighteen months to two years – monetarists believe that we will be living for some time with the inflationary consequences of rapid M_2 growth.

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Monetarists reject as myopic the Keynesian notion that low real money growth implies a policy of tightness, for the very inflation which keeps real money growth low is itself the product of the rapid (nominal) money growth of earlier periods. The Fed would defeat its own efforts if it attempted to increase real money growth by allowing the nominal money supply to expand at a higher rate, since the inflation rate would increase (after a lag), once again lowering the growth rate of the real (inflation-adjusted) money supply.

Similarly, monetarists reject the view that high interest rates in and of themselves indicate a tight-money policy, because one of the determinants of interest rates is the expected rate of inflation. As people expect more inflation, lenders demand, and borrowers are willing to pay, higher rates of interest. (Most Keynesians go along with this argument, at least to some degree.) Therefore, as rapid money growth leads to higher inflationary expectations, interest rates may rise even in the context of an easy money policy. To the extent that investment decisions are based on *real* costs and *real* expected returns, a rise in interest rates which simply reflects a larger inflation premium should not deter investment.

Monetarist prescription

The monetarist analysis leads to a recommendation to pursue a gradual reduction in the growth rate of the money supply. Such a reduction in money growth is viewed as the only way to lower the inflation rate over the long run. If the slowdown is carried out gradually, it should have little adverse effect on real output. One group of monetarists (the Shadow Open Market Committee) claims that a quick, one-time reduction could be undertaken to offset recent money-supply bulges without hurting the real economy, but the monetarist literature generally argues that any *sharp* reduction in money growth could cause a recession.

Monetarists claim that a short-term decline in M_1 velocity need not imply the need for more rapid money growth. On a quarterly basis, velocity movements have a large random component, which raises questions about the effectiveness of attempts to adjust money growth frequently in order to anticipate velocity movements. An increase in money growth in response to a slowdown in velocity might begin to be felt by the economy just as velocity turned sharply upward, i.e., just when *less* money growth would be needed. Thus, monetarists eschew attempts to "fine-tune" quarterly variations in economic activity.

Just as Keynesians identify the current inflation as "structural," so monetarists see part of the continued high unemployment as structural, in the sense of reflecting such things as a changing labor-force composition, a higher minimum wage, and more liberal unemployment benefits. For example, as the fraction of recent labor-force entrants increases, the overall unemployment rate tends to rise, for new entrants typically have trouble finding a job because of their lack of skills. Monetarists would prescribe such remedies as job training and a lower teenage minimum wage to deal with these structural aspects of unemployment.

Impact on policy
Both the Keynesians and the monetarists have developed coherent, internally consistent analyses of the current situation, leading in each case to clear policy recommendations. Unfortunately, these recommendations are diametrically opposed. Furthermore, reasonable people can and do disagree regarding the correct interpretation of the available evidence.

The two factions thus present policymakers with an obvious dilemma, at a point in the current economic expansion where policy choices may be crucial. For this expansion is in its eleventh quarter — a relatively advanced age for any cyclical expansion. This does not necessarily mean that greater stimulus is needed at this stage. If the monetarists are correct — i.e., if further stimulus led to more inflation — the inflation and its attendant distortions could quickly end the recovery.

Faced with these uncertainties, the Fed has taken into account the arguments of both camps. Ever since it began the practice of specifying long-run money-growth ranges in April 1975, it has gradually lowered those ranges. This is in accordance with the monetarist prescription for fighting inflation. But rather than attempt to decide between the relative merits of M_1 and M_2, it has given roughly equal weight to both aggregates. The Fed did not restrict money growth in the fourth quarter of 1976, when M_2 grew above its specified range while M_1 remained near the bottom of its range. In this sense, it did not slavishly follow a simple monetarist rule. And when it seemed clear that steps were needed to restrain money growth, as in the spring and summer of 1977, the Fed moved cautiously because of its recognition of a number of complicating factors — including Keynesian fears of rising interest rates.

The conflict between Keynesians and monetarists remained muted during the first two years of this recovery, largely because of the contra-cyclical decline in interest rates. Now that rates have begun to advance, the lines between the two sides have become more sharply drawn. The Fed has had to balance the monetarist concern over rapid money growth against the Keynesian worry that high interest rates will choke off investment. It has also had to take into account the possibility of disintermediation — i.e., the tendency of thrift institutions to lose deposits whenever money-market rates rise above the rate ceilings set on deposits. Such an outflow of funds would hurt the housing market, since these institutions are the principal sources of mortgage loans.

The results of the Fed's balancing act have been roundly criticized by both sides in the policy debate. Keynesians, as noted, have felt that the Fed has become too restrictive. And monetarists have felt that the restrictive measures taken to date have been inadequate, as evidenced by the continuing high growth rates of M_1 and M_2. But until it becomes clearer in what direction the economy is headed, there would seem to be ample justification for avoiding what each side considers the most dangerous aspects of the other's policy.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 11/30/77	Change from 11/23/77	Change from year ago Dollar	Percent
Loans (gross, adjusted) and investments*	104,855	+ 1,287	+ 11,851	+ 12.74
Loans (gross, adjusted)—total	81,307	+ 1,244	+ 10,834	+ 15.37
Security loans	2,738	+ 742	+ 366	+ 15.43
Commercial and industrial	24,659	+ 118	+ 2,018	+ 8.91
Real estate	26,786	+ 101	+ 5,490	+ 25.78
Consumer instalment	14,081	+ 58	+ 2,129	+ 17.81
U.S. Treasury securities	8,871	+ 48	− 591	− 6.25
Other securities	14,677	− 5	+ 1,608	+ 12.30
Deposits (less cash items)—total*	101,604	+ 1,569	+ 10,262	+ 11.23
Demand deposits (adjusted)	29,346	+ 964	+ 2,422	+ 9.00
U.S. Government deposits	561	+ 300	+ 264	+ 88.89
Time deposits—total*	69,790	+ 75	+ 7,276	+ 11.64
States and political subdivisions	5,440	+ 33	+ 739	+ 15.72
Savings deposits	31,463	− 120	+ 1,873	+ 6.33
Other time deposits‡	30,246	+ 39	+ 4,190	+ 16.08
Large negotiable CD's	12,807	+ 252	+ 2,839	+ 28.48

Weekly Averages of Daily Figures	Week ended 11/30/77	Week ended 11/23/77	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves(+)/Deficiency (−)	+ 41	+ 24	+ 52
Borrowings	92	41	0
Net free(+)/Net borrowed (−)	− 51	− 17	+ 52
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales(−)	− 265	+ 32	+ 582
Transactions with U.S. security dealers			
Net loans (+)/Net borrowings (−)	+ 681	+ 518	+ 275

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

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