



## **What the Political System Can Do to Help the Fed**

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The Federal Reserve faces mounting political pressures. Their intensity levels have reached -- and may even exceed -- those last felt during the days of the Volcker disinflation, three decades ago. Critics of the Fed have raised their voices, using colorful language that has taken many listeners aback. Recent examples have been so striking that they need not be mentioned specifically -- their sound still rings in our ears.

Partly, these heightened emotions must reflect building frustration with the slow pace of the U.S. economy's recovery from the "Great Recession" of 2008 and 2009. Probably, too, they represent delayed reactions to the tough and controversial decisions that U.S. economic policymakers, both inside and outside the Fed, made during the financial crisis that precipitated the Great Recession. And, one must surely concede, at least some of this is just campaign jive -- "more reflective of political maneuvering than policy," as someone once said -- differing in detail but similar in intent and meaning to what one always hears during the lead-up to a national election.

My preferred interpretation of recent comments on and criticisms of Federal Reserve policy from within the political arena, however, casts them in a more positive light. I take them as evidence that politicians do care about monetary policy and want to say and do everything they possibly can to improve policymaking in the United States today. My purpose here, therefore, is to suggest one way in which participants across the entire political spectrum can help the Federal Reserve succeed. They can do this by endorsing a broad, overarching objective for monetary policy, namely, the goal of stabilizing the long-run growth rate of some nominal aggregate -- ideally an economy-wide measure of prices like the consumer price index or the implicit price deflator for the personal consumption expenditures component of gross domestic product, excluding food and energy.

By endorsing this objective for the Federal Reserve, politicians can simultaneously do three things. For themselves, politicians can join with a long tradition of clear and careful thought in monetary economics, a tradition that has its origins in the same intellectual milieu, sometimes called "the Enlightenment," out of which sprang many of the basic ideals on which our country was founded. For us, their constituents, politicians can help the members of American public understand exactly what economic outcomes we can and cannot reasonably expect the Federal Reserve to deliver. And, most important, for the Fed itself, politicians can contribute to shaping an economic environment within which monetary policymakers can respond most effectively to the many and various challenges that they are likely to face in the near and distant future. All of that is a lot to accomplish! But, in fact, it can all be done quite easily.

## **A Long Intellectual Tradition**

Two basic principles run deep throughout all writing and research, old and new, in monetary economics. Important early references to these principles can be found, for example, in David Hume's essay, "Of Money," first written in 1752 and eventually incorporated into the posthumous, 1777 edition of his *Essays: Moral, Political, and Literary*.

The first of these two basic principles is the "classical dichotomy," which distinguishes between real variables, like gross domestic product, industrial production, and employment, which make

reference to physical units of goods or the number of available workers, and nominal variables, like prices, which are measured in “units of the local currency” -- dollars in the United States. The second is the theory of “long-run monetary neutrality,” which predicts that in the long run -- generally taken to mean a period extending beyond four or five years -- Federal Reserve policy actions that change the quantity of money in circulation have important effects on nominal variables, while leaving real variables unchanged.

The logic behind the theory of long-run monetary neutrality, and the classical dichotomy on which it builds, can be found in Hume’s thought experiment, presented right at the start of his essay on money. Imagine two economies, identical in every respect: equal in population size and demographics, with all of the same productive capacities and access to natural resources, and so on. Then technological considerations dictate that physical, or real, output of goods and services should also be equal across these two economies. Thus, if the money supply in one of these countries happens to be twice as large as the money supply in the other, then all nominal prices in the first country should be twice as high as well. The same logic, when used to compare a single economy at two different points in time instead of two different economies at a single point in time, implies that a doubling of the money supply should generate a doubling of nominal prices, leaving output and all other real variables unaffected.

This logic has proven so powerful and compelling -- not surprising, given its source! -- that it has been weaved into every theory of money and monetary policy developed since the days of David Hume, Adam Smith, John Locke, and Benjamin Franklin. And equally if not more important -- though again, not surprising in light of its source -- the theory enjoys overwhelming empirical support.

In his Nobel Lecture, titled “Monetary Neutrality” and published in 1996, Robert Lucas reviews evidence assembled and summarized in a pair of graphs by George McCandless and Warren Weber (1995). The first graph, which is reproduced as figure 1 in Lucas (1996), shows a remarkable coincidence between average money growth rates and average rates of price increase, that is, rates of inflation, across 110 countries in the post-World War II period. The second graph, reproduced as Lucas’ figure 2, shows zero correlation between average money growth rates and average real GDP growth rates across the same countries in the same period. Lucas (1996, p.666) concludes:

How many specific economic theories can claim empirical success at the level exhibited in figure 1? ... The kind of monetary neutrality shown in this figure needs to be a central feature of any monetary or macroeconomic theory that claims empirical seriousness.

A coherent theory that actually works! Could any politician -- could any thoughtful human being -- wish for a better guide to action?

### **What Americans Can and Cannot Expect From the Federal Reserve**

After Hume but before Lucas, Milton Friedman drew directly on these two basic principles -- the classical dichotomy and the theory of long-run monetary neutrality -- to explain in the most practical and specific of terms what monetary policy can and cannot do. These two ideas

organize Friedman's Presidential Address to the American Economic Association, titled "The Role of Monetary Policy" and published in 1968. Friedman (1968, p.11) says:

The monetary authority controls nominal quantities -- directly, the quantity of its own liabilities. In principle, it can use this control to peg a nominal quantity -- an exchange rate, the price level, the nominal level of national income, the quantity of money by one or another definition -- or to peg the rate of change in a nominal quantity -- the rate of inflation or deflation, the rate of growth or decline in nominal national income, the rate of growth of the quantity of money. It cannot use its control over nominal quantities to peg a real quantity -- the real rate of interest, the rate of unemployment, the level of real national income, the real quantity of money, the rate of growth of real national income, or the rate of growth of the real quantity of money.

Friedman himself is quite quick to point out that none of this means that monetary policy has no effect on real variables. Almost immediately, he (1968, p.11) goes on to explain:

Monetary policy cannot peg these real magnitudes at predetermined levels. But monetary policy can and does have important effects on real magnitudes. The one is in no way inconsistent with the other.

Indeed, Milton Friedman's monumental work with Anna Schwartz, their 1963 volume *A Monetary History of the United States, 1867-1960*, teaches all students of monetary economics how, by failing to focus on the aberrant behavior of key nominal variables during the Great Depression, the Federal Reserve followed incorrect principles and implemented misguided policies that had disastrous consequences for the behavior of real variables, including real GDP and unemployment, as well.

Milton Friedman's use of the classical dichotomy and the theory of long-run monetary neutrality informs politicians and their constituents of what economic outcomes they can and cannot expect the Fed to deliver. The Federal Reserve cannot reliably stabilize the growth rate of real GDP, nor can it lower persistently the rate of unemployment. No one should blame the Federal Reserve for slow economic growth or high unemployment, because each of those real variables is affected not just by monetary policy, but also by a myriad of other forces that lie far beyond the Fed's control. What Americans should expect the Federal Reserve to deliver is stable long-run growth in nominal aggregates, including and especially broad measures of prices economy-wide. Therefore, politicians *should* hold the Fed accountable when it allows prices to spiral upward into inflation, as happened during the 1970s, or downward into deflation, as occurred during the 1930s.

At this year's Economic Policy Symposium in Jackson Hole, Wyoming, sponsored by the Federal Reserve Bank of Kansas City, Federal Reserve Chairman Ben Bernanke pointed out that "most of the economic policies that support robust economic growth in the long run are outside the province of the central bank." Politicians should help Americans understand that, in light of the classical dichotomy and the long-run neutrality of money, this is absolutely true. But,

politicians should also help Americans understand that *all* of the economic policies that support stable prices in the long run are *squarely within* the province of the central bank. The goal of maintaining stable prices is the key criterion against which any central banker's performance and legacy should be judged.

### **A Background for Effective Monetary Policymaking**

Towards the end of his Presidential Address, Milton Friedman proposes and evaluates three more specific strategies that the Federal Reserve might use to achieve the goal of stabilizing nominal aggregates. The first option focuses on stabilizing the exchange rate between the U.S. dollar and a diversified basket of foreign currencies. This possibility strikes Friedman as the least promising. It would "guarantee freedom from monetary irresponsibility," he explains (1968, p.15), but mainly by importing into the United States "the average of whatever policies monetary authorities in the rest of the world adopt." Most, if not all, monetary economists would agree with Friedman on this point today. Fixing the nominal exchange rate can make sense for a deeply troubled economy, seeking to end destructively high inflation. To cite one clear example, Zimbabwe's leaders were almost certainly right in their 2009 decision to simply abandon their own dollar and legalize the use of foreign currencies to end one of the worst hyperinflations in human history. But fixing the nominal exchange rate would not improve the performance of the U.S. economy today.

Instead, Friedman finds it difficult to choose between his two other options: attempting to stabilize, directly, the price level itself or stabilizing, first, the growth rate of a broad monetary aggregate like M1 or M2 that includes various kinds of bank deposits as well as currency. Among all nominal aggregates, "the price level is clearly the most important in its own right," Friedman (1968, p.15) acknowledges. But, he hesitates to endorse fully a monetary policymaking strategy that focuses only on prices, citing the "long and variable lags" that he, Anna Schwartz, and many other monetary economists have observed between monetary policy actions and their effects on inflation:

As a result, we cannot predict at all accurately just what effect a particular monetary policy action will have on the price level and, equally important, just when it will have that effect. Attempting to control directly the price level is therefore likely to make monetary policy itself a source of economic disturbance because of false stops and starts. Perhaps, as our understanding of monetary phenomena advances, the situation will change. But at the present stage of our understanding, the long way around seems the surer way to our objective.

Milton Friedman's preferred "long way around" is the monetary policymaking framework that most students associate with his name: a strategy that stabilizes prices in the long run by aiming, first, to stabilize the growth rate of a broad measure of the money supply such as M1 or M2.

Given Friedman's stated willingness to reconsider the case for the more direct approach of focusing directly on prices should the state of knowledge change, however, two sets of developments in monetary economics since 1968 seem particularly important. Up until the mid-1970s, stable statistical relationships linking money growth, prices, output, and interest rates could be identified in the U.S. data; these "money demand" relationships provided reliable

guides as to how inflation could be controlled, indirectly, by stabilizing M1 or M2 growth first. Stephen Goldfeld's 1976 article on "The Case of the Missing Money," however, turned out to be the first among many to document how rapid changes in the American financial system, driven by a combination of technological innovation and government deregulation, have caused those once-stable relations to break down.

It should be noted that some monetary economists, influenced by William Barnett's (1980) work on the theory of monetary aggregation, have argued repeatedly that at least some of these statistical problems can be traced back to the mechanics according to which "simple-sum" measures of the money supply like M1 and M2 are constructed in the first place. Rather than just adding up the nominal or dollar values of very different assets like currency and money market deposit accounts, Barnett's preferred "Divisia" aggregates weight different assets according to the different flows of "monetary services" they provide, in exactly the same way that the U.S. GDP statistics weight a compact car and a luxury sport utility vehicle differently according to the different flows of "transportation services" they provide. Michael Belongia (1996), and others, have shown that when these Divisia measures of money are used, the monetary aggregates regain much of the statistical power that simple-sum M1 and M2 have lost. Still, one must concede that this first set of developments -- the empirical evidence on money demand instability that has accumulated since the mid-1970s -- is seen by many monetary economists as a reason to pause before advocating a monetary policy strategy that focuses first and foremost on measures of the money supply.

Happily, however, the second set of developments in monetary economics strengthens the case in favor of Friedman's alternative option of placing the price level itself at the center of the policymaking process. In particular, "New Keynesian" models like those developed and studied by Peter Ireland (1996), Richard Clarida, Jordi Gali, and Mark Gertler (1999), Michael Woodford (2003), and Carl Walsh (2010) point to several distinct advantages of a policymaking strategy that focuses directly on prices or inflation.

First, these New Keynesian models imply that to the extent that short-run economic fluctuations have their origins in what more traditional Keynesian analyses refer to as shocks to "aggregate demand," there is no meaningful trade-off between stabilizing prices or inflation on the one hand and stabilizing output or employment on the other. The reason is that an adverse shock of this type causes real economic growth to slow, but reduces prices economy-wide as well, so that a monetary policy response aimed at offsetting the effects of the shock on nominal variables will offset the effects on real variables at the same time. Although this might seem like an obvious point, it happens to be an extremely important one. As emphasized by Marvin Goodfriend (2010), a commitment by the Federal Reserve to stabilize prices both implies as a matter of logic and calls for as a matter of practice decisive monetary policy action not only to defend against a rise in inflation but also to prevent deflationary pressures like those at work throughout the Great Depression and, at times, the Great Recession as well from taking hold.

Second, these New Keynesian models indicate that to the extent to which macroeconomic fluctuations are driven by fluctuations in productivity growth, as suggested by the once controversial but now highly influential "real business cycle" theory of Finn Kydland and Edward Prescott (1982), there is again no meaningful trade-off between stabilizing real and

nominal variables. The intuition behind this surprising result is provided in my own 1996 article on “The Role of Countercyclical Monetary Policy.” Productive efficiency requires that output growth decelerate when productivity growth declines as it did, for example, in the United States during the 1970s. Indeed, demonstrating the possibility and plausibility of such “efficient” business cycles was the main goal of Kydland and Prescott’s original paper. What Ireland (1996) shows, in addition, is that if Keynesian-style rigidities *prevent* output from responding efficiently to productivity shocks, then those same rigidities *allow* monetary policy to facilitate the real economy’s adjustment, and that these accommodative monetary policy actions work, coincidentally, to stabilize the aggregate price level as well. Once again, therefore, by acting first to stabilize prices, the central bank also stabilizes a welfare-theoretic measure of the output gap, defined as the difference between the actual and efficient levels of GDP.

Third, as discussed by Clarida, Gali, and Gertler (1999), Woodford (2003), and Walsh (2010), “cost-push” shocks, such as disturbances to the price of imported oil or other commodities that give rise to inefficient fluctuations in both output and inflation, do confront the central bank with a painful trade-off in New Keynesian models: should monetary policy respond to insulate output from the effects of these shocks at the cost of tolerating more volatility in inflation? Each of these studies emphasizes, however, that in attempting to best manage this trade-off in the short run, a benefit accrues to a central bank that is committed to a policy that stabilizes inflation in the long run. New Keynesian economics demonstrates how the ability to stabilize *both* output *and* inflation more effectively in response to an adverse cost-push shock emerges as the dynamic extension to the classic finding, associated with Finn Kydland and Edward Prescott’s (1977) work, that shows how a central bank acting by “rules rather than discretion” can use monetary policy to simultaneously achieve better outcomes for both output and inflation.

### **A Critical Time to Help the Fed**

Thus, we see how a monetary policymaking strategy that commits to stabilizing a measure of aggregate prices in the long run rests of two basic principles -- the classic dichotomy and the long-run neutrality of money -- that form the basis of an intellectual tradition in monetary economics extending back to the eighteenth-century writings of David Hume and that enjoy more empirical support than perhaps any other ideas in all of macroeconomics. This policymaking strategy also provides politicians and their constituents with a clear and accurate idea of what we can and cannot expect the Federal Reserve to deliver, and identifies clear and unambiguous standards against which we can judge fairly the Federal Reserve’s performance. Finally and most importantly, this strategy works to create an overall political and economic climate that allows Federal Reserve officials to react most effectively against a wide range of disturbances and shocks, including those that might otherwise lead to a period of inflation as in the 1970s or a period of deflation and depression as in the 1930s, including those that generate longer-run trends in productivity growth like the slowdown of the 1970s or the “new economy” miracle of the 1990s, and including those that generate troublesome volatility in the prices of oil and other imported commodities of the kind American consumers and businesses have been forced to get used to lately.

As noted above, however, the benefits that accrue to the Federal Reserve, enhancing its ability to react to disturbances of all sorts, can be secured only when consumers, workers, businesses, financial market participants, and monetary policymakers themselves perceive that the central

bank is *firmly committed* to a strategy that stabilizes prices in the long run. And this is precisely what presents the American political system with its greatest opportunity to help the Fed today.

Two very recent studies, one by Gabriele Galati, Steven Poelhekke, and Chen Zhou (2011) and the other by Petra Gerlach, Peter Hordahl, and Richhild Moessner (2011), present disconcerting evidence, especially from information about long-term inflationary expectations extracted from the prices of U.S. Treasury securities, suggesting that the credibility of the Federal Reserve's commitment to keeping inflation low has been compromised, at least somewhat, by the unusual and controversial policy actions -- the departure from rules in favor of discretion, one might be tempted to say -- taken during the financial crisis of 2008. And, indeed, Americans have good reasons to worry about the long-term outlook for inflation.

The Fed has expanded the monetary base -- currency plus bank reserves, which Friedman (1968, p.11) identifies as "the quantity of its own liabilities" -- dramatically since the onset of the crisis, in an effort to accommodate an equally dramatic expansion in financial institutions' demand for safe and highly liquid assets. When normal times return at last, the Fed will have to take action to ensure that these extra dollars of base money do not begin to propagate through the banking system in a way that leads to excessive growth in the broader monetary aggregates and, from there, to higher prices as well. By endorsing a policy framework that emphasizes the central bank's responsibility for inflation first and foremost, politicians will provide crucial support for Federal Reserve officials to act, as needed, to reduce the size of the central bank's balance sheet appropriately.

Likewise, to avoid the most disastrous consequences, federal budget deficits that are already large today and projected to become even larger still in the future must be closed through major adjustments in tax and spending policies. Politicians will differ, reasonably, in their views of which set of adjustments -- to taxes or to spending -- ought to be emphasized most. At the same time, however, all politicians must agree that the necessary adjustments will have to come through taxes and spending and *not* through higher inflation that would represent, in the eyes of observers both domestic and foreign, a partial default by the United States government on its debts. With the benefits so immediate and the stakes so high, participants in the budget debates could do much to help themselves and their country by sounding one common chorus in support of the Federal Reserve's commitment to maintaining stable prices.

On the other hand, Americans remain shocked by the Great Recession and have become increasingly frustrated by the sluggishness of a economic recovery that, even after two full years, has yet to return aggregate income and spending, let alone employment, to their 2007 levels. The Great Recession's origins remain far from being fully understood, and when careful analysis finally does provide a complete and compelling story, it will likely trace out a complex chain of events, many or even most of which have little to do with the Federal Reserve. Nevertheless, recent studies by Robert Hetzel (2009), Peter Ireland (2011), and John Tatom (2011) do point to overly restrictive monetary policy as a factor contributing both to the severity and length of the Great Recession. And along the similar lines, the financial market indicators used in the articles by Galati, Poekhekke, and Zhou (2011) and by Gerlach, Hordahl, and Moessner (2001) referred to above have at times, both during and since the Great Recession, provided warning signs of sharply falling as opposed to rising inflation. This backdrop of extreme uncertainty, in which



neither inflation nor deflation can be confidently ruled out, is obviously quite troubling in itself. But it also provides politicians with another opportunity to help, by emphasizing that a monetary policy that stabilizes prices works, both logically and in practice, to guard against both sets of undesirable outcomes.

Importantly, therefore, the proposals and arguments made here do not require or even ask Congress to reopen and reconsider the Federal Reserve Act, so as to simplify the “dual mandate” that instructs the Federal Reserve to help provide both for “maximum employment” and “stable prices.” Indeed, several points made above highlight, specifically, that a central bank that is committed to stabilizing nominal variables, like prices, in the long run can also do a better job of stabilizing real variables, like employment, in the short run. The proposals made here are simple and modest and, by emphasizing points of consensus over points of contentious debate, might actually prove more effective as well. The best way that politicians can help the Federal Reserve and improve the monetary policymaking process in the United States today is to send a clear and common message to the American people, that we expect the Fed to remain firmly committed to its goal of stabilizing nominal prices in the long run.

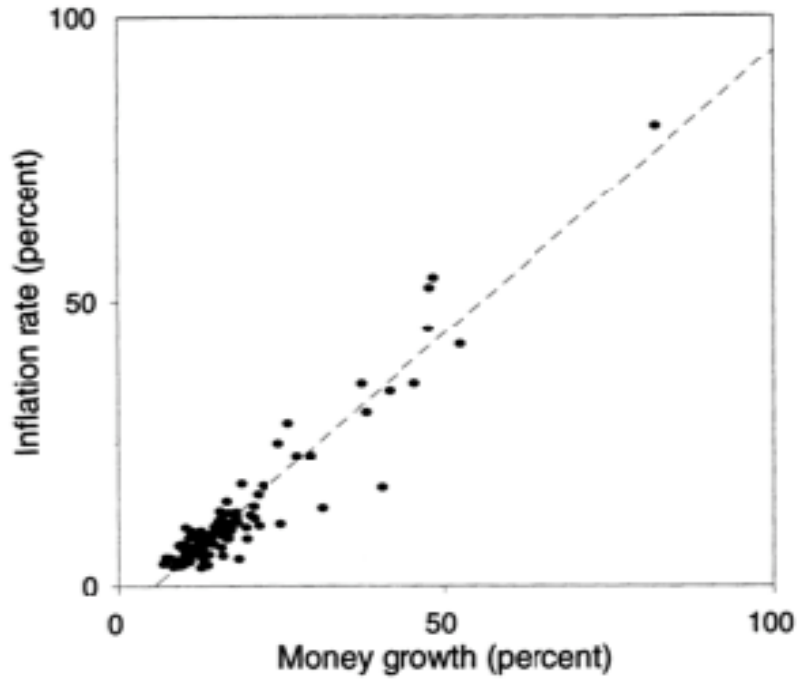


FIG. 1

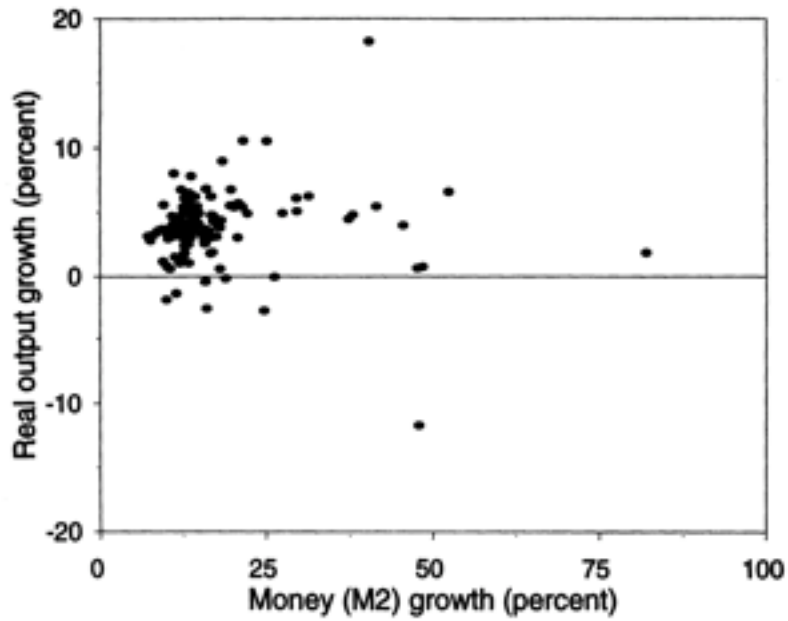


FIG. 2

Lucas' (1996) figures 1 and 2, illustrating the classical dichotomy and long-run neutrality of money: across 110 countries in the post-World War II period, money growth is highly correlated with nominal price inflation, but not at all correlated with real output growth.

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