

COMMENT ON MONETARY POLICY

Lee Hoskins

Senior Fellow, Pacific Research Institute

Shadow Open Market Committee

April 29-30, 2001, Washington, D.C

“We are in danger of assigning to monetary policy a larger role than it can perform, in danger of asking it to accomplish tasks that it cannot achieve, and, as a result, in danger of preventing it from making the contribution that it is capable of making.”

Milton Friedman, 1968

At the time Milton Friedman made this statement many economist and policy-makers had adopted the view that monetary policy could and should be used to manage fluctuations in employment and output. What followed in the decade of the 70's was the worst monetary policy performance in the last 50 years. We started the decade of the 70's with low single digit unemployment and inflation rates and finished the decade with double-digit unemployment and inflation rates. What happened? We had great expectations for monetary policy, expectations that went far beyond the ability of monetary policy to achieve. Every slowdown in the economy was pursued with an expansion of money growth and when inflation began to rise the Fed belatedly slowed money growth to stop it, sending the economy back into a slowdown. This decade long policy produced rising peaks in both inflation and unemployment rates. The Fed spent the better part of the next two decades unwinding the results of this policy process. Fed policy-makers gave overriding policy importance to long-term price stability. As the Fed tamed inflation the unemployment rate fell to lows not seen since the 60's.

Today, we are again placing great expectations on monetary policy. Fed policy-makers are chasing a slowing economy with an expanding money supply. Businessmen are pressing for lower interest rates to spur sales and

reduce inventories. Wall Street players are looking for lower interest rates from the Fed to boost the stock market. Politicians and pundits applaud Fed actions to lower interest rates. Are we again asking too much from monetary policy and preventing it from making the real contribution it can make?

Price stability is the only contribution to the economy the Fed can make over time. Yet when the Fed began to rapidly increase money growth last year, it did so facing an inflation rate above 3 percent and rising. Now, 3 percent may not sound like much but it is twice the rate of inflation that we averaged annually between the Korean and Vietnam wars. Perhaps, Fed policy-makers believe they can curb monetary expansion once economic growth picks up without harming the economy. But is this not what the Fed believed it could do during the 70's?

Monetary policy is always made in an environment of uncertainty about the course of the economy and inflation. Policy-makers do not control the course of the economy over time but they do control the rate of inflation. And the lesson from the 80's and 90's is that a central bank that has an overriding objective of price stability promotes sustainable economic growth. Other great expectations for monetary policy should be relegated to history's dustbin. Hopefully, Fed policy-makers remember these lessons as they try to boost economic growth.