The Evolution of Monetary Policy: Critical Issues That Have Shaped Monetary Policy and the SOMC Over 50 Years

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Discussion

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Milton Friedman's Influence on the SOMC Framework (1/2)

- Inflation is a monetary phenomenon
- Economy is inherently stable and reverts to the natural rate of unemployment
- Demand for money is stable
- The money stock is controllable by the central bank

Milton Friedman’s Influence on the SOMC Framework (2/2)

- Keynesian structural models not reliable: reduced form models, as in Friedman and Meiselman (1963), provide coherent picture of the influence of money
- Long and variable lags render discretionary policies unstable
- To reduce policy uncertainty and the influence of political forces, policy should be rules-based
- Gradualism: should the quantity of money deviate significantly from its objective

Arthur Burns: Fed Chair, 1970 – 1978

"My close friend and former teacher Arthur Burns is not just another chairman. He is the right man in the right place at the right time."

Milton Friedman, 1956

Why Burns lost control of inflation

1. Cost-push view of inflation
2. Decisions were often politically motivated
3. Advice Burns received re-enforced his view about ineffectiveness of monetary policy: Fed-MIT-Penn (FMP) model

> "Fiscal policies … have important impacts on characteristics of the long run behavior of the economy. Monetary policy, on the other hand, will not have very substantial impacts."

Ando and Modigliani, 1975

Paul Volcker: Fed Chair in October 1979

- CPI inflation: over 12%
- Base money and M2 at 8%
- SOMC: Advised gradualism:

  "To restore stability to the economy and permanently reduce inflation, the growth rate of the monetary base should now be reduced to an annual rate of 7 percent for the year ending August 1980"

SOMC, 9/17/1979

Volcker and Central Bank Credibility

- Volcker appreciated the capacity of monetary policy to tame inflation
- Volcker understood the importance of endogenous expectations:

> Macroeconometric models "do not take adequate account of the important factor of expectations"
>
> *Paul Volcker, 1975*

Volcker versus Friedman and SOMC

1. Credibility and its effect on expectations. Gradualism approach assumes credibility has been earned
2. Credibility appears to have underlined Friedman and SOMC approaches
3. Volcker: Fed had to signal that it was hard-nosed
4. Volcker's policy anticipated New Keynesian model (Woodford, 2003; Galí, 2015) and game theory literature on credibility (Barro and Gordon, 1983)
5. Bordo and Levy: Friedman and SOMC did not account for money-demand instability

Conclusions

1970s:

Money demand was (mostly) stable:
Friedman and SOMC were right

Early-1980s:

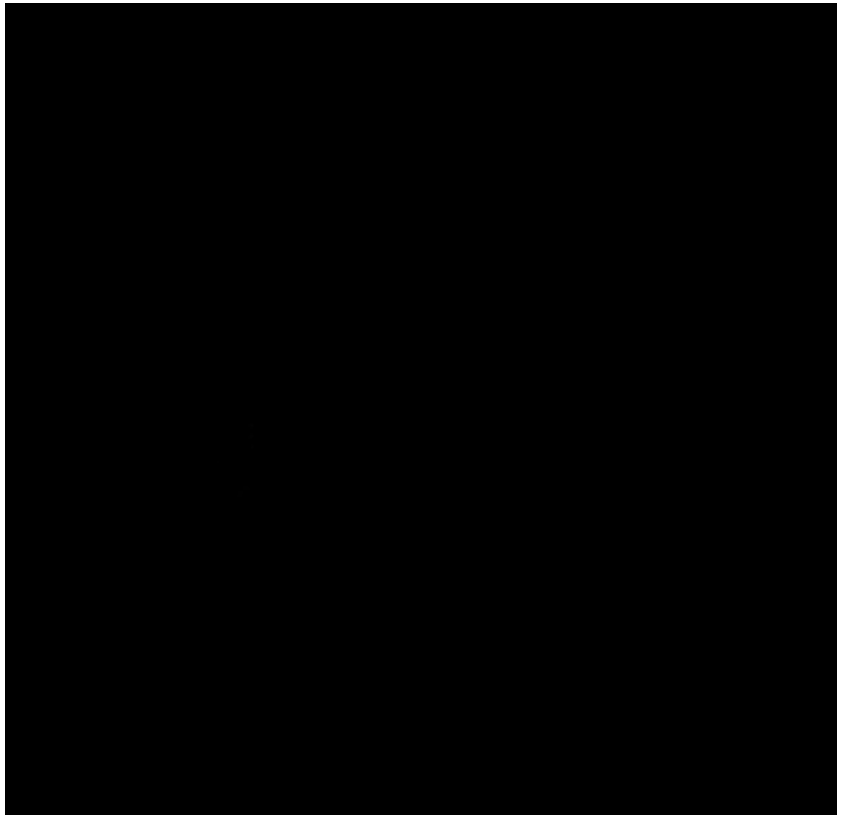
Money demand was unstable

Fed had to earn credibility

Volcker was right

Milton Friedman

John Taylor



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