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

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In their superb paper, Mike Bordo and Mickey Levy (2024) provide a comprehensive analysis of the 50-year history of the SOMC. The authors affirm that during those 50 years the Fed has made three major costly monetary policy errors: the high inflation of the 1970s, the low-interest rate policy of the early-2000s, which facilitated the debt-financed housing bubble, and the high inflation of the early-2020s. In my remarks, I will focus on the high inflation of the 1970s and the taming of inflation in the first half of the 1980s, although I will also comment on the surge of inflation of the early-2020s. In addition to the Shadow Open Market Committee (SOMC)'s views, I will discuss and compare the views of three economists who helped shape monetary policy during those years, Milton Friedman and two Fed chairs, Arthur Burns and Paul Volcker.

I start with Friedman. Friedman's role in the formation of the SOMC was pervasive, even if he was not a member. The conceptual framework that underpinned the SOMC's policy advice in the 1970s and early-1980s was developed by Friedman in the 1950s and 1960s, sometimes in collaboration with Anna Schwartz, an original member of the SOMC. That framework featured the following propositions, all based on Friedman's research findings.[1]

- Inflation is a monetary phenomenon: the key to controlling inflation is to control money growth.
- The economic system is inherently stable and reverts to the natural rate of unemployment; there is no long-run Phillips curve trade-off.
- The demand for money is a stable function of only a few variables and relatively independent of the supply of money. Friedman (1956) noted that it would be possible to approach perfect stability in the demand-for-money function by adding more and more variables to the function. Doing so, however, would empty the function of its predictive power.
- The money stock is controllable by the central bank.

[1] For discussions of Friedman's development of these propositions, see Nelson (2020) and Tavlas (2023). The above listing is consistent with the six principles of monetarism identified by Bordo and Levy (2024, 5). It is also consistent with the more-detailed listing presented in Poole, Rasche, and Wheelock (2011).

- Keynesian structural macroeconometric models are not reliable as guides to policy. Reduced form models based on money, as in the classic study by Friedman and Meiselman (1963), give a coherent picture of the influence of money on the economy.
- The long and variable lags associated with changes in the money supply render discretionary monetary policy unstable.
- To reduce both policy uncertainty and the influence of political forces on policy formation, policy should be rules-based. Under Friedman's rule, the M2 measure of the money supply would grow by 3 to 5 percent annually. Friedman believed that such a rule would correspond with a roughly stable price level.
- Should money growth deviate significantly from its objective, it should be brought back to that objective in a gradual manner under the presumption that gradualist policies reduce the social costs of disinflation.

The main difference between Friedman's framework and that of the SOMC is that Friedman favored targeting M2 whereas the SOMC favored the monetary base.

Enter into this picture, Burns, who served as Fed Chair from 1970 to 1978. Burns had been Friedman's undergraduate teacher at Rutgers in the late-1920s. It was Burns who initiated the Friedman-Schwartz collaboration on their historical work on money, beginning in 1948. Friedman thought that Burns shared his views about the importance of monetary policy. Shortly after Burns became Fed chair, Friedman wrote: "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." Friedman added that Burns was the first Fed chair to have "the right qualifications for the post."[2] Friedman would soon be deeply disappointed. Under Burns, the Fed permitted rapid monetary growth which contributed to the surges in inflation to double-digit levels in the mid-1970s and the late-1970s. Monetary policy, as Bordo and Levy (2024, 11) argue, "was in disarray." Why did Burns permit this to happen? There were three main reasons.

[2] The above remarks were made in a *Newsweek* column by Friedman published on February 2, 1970. The source of these remarks is Nelson (2020, vol. 2, 322).

First, as Ed Nelson (2024) has documented, Burns arrived at the Fed holding a cost-push view of inflation. He did not believe in the effectiveness of monetary policy; nor had he ever subscribed to Friedman's advocacy of mandating the Fed to follow a strict policy rule (Nelson, 2024, chap. 12, 147). Soon after he became Fed chair, he championed wage-price controls to tame inflation. These policies failed, and this failure was likely a reason why the SOMC was formed in 1973.

Second, as Bordo and Levy point out, Burns' decisions were often politically motivated, with the aim of ensuring President Richard Nixon's re-election -- precisely the kind of situation that a policy rule aimed to avoid.

The third reason has to do with the technical advice that Burns received. The 1970s were the heyday of large-scale macroeconometric models at the Fed, and elsewhere. The Fed's model, the FMP model, was developed by a team of researchers at MIT, the University of Pennsylvania, and the Board of Governors. The principal architects of the model were Franco Modigliani (MIT) and Albert Ando (University of Pennsylvania), who wanted to develop a tool to resolve their inconclusive debate in the 1960s with Friedman and Meiselman on the relative importance of fiscal and monetary policies. Here is how Ando and Modigliani described the Fed's (FMP) model in 1975:

> Fiscal policies, by influencing the savings-income ratio, by inserting a wedge between the rates paid by borrowers and received by lenders, by determining the size of government debts, and by a number of other means, will have important impacts on characteristics of the long-run behavior of the economy. Monetary policies, on the other hand, will not have very substantial impacts other than to determine the level of wages and prices and, perhaps, if one believed that the Phillips curve retained its importance in the long run, the level of unemployment. With a few minor exceptions, these statements all apply to the MPS model" (1975, 559).

For someone untrained in macroeconometric modeling, and who had been away from academic research for 20 years, Burns was susceptible to the views and advice of his staff.[3] The advice that Burns received from at least some of his technical experts reinforced his prior beliefs about the ineffectiveness of monetary policy. And so Burns got inflation wrong.

[3] For a recent discussion of the role of the Fed staff on decision-making, see Kuvvet (2022).

During the 1970s, Friedman and the SOMC got it right. During the first half of that decade, money demand relationships were stable. Inflation forecasts from macroeconometric models were wide of the mark. The Great Inflation of the 1970s was largely a failure to control money growth. And the way to bring down excessive money growth for both Friedman and the SOMC was through gradual adjustment.

Enter into this picture Paul Volcker, who became Fed Chair in October 1979. CPI inflation was over 12 percent. Base money and M2 were both growing by 8 percent. In its semi-annual statement around that time, the SOMC continued to advocate gradualism in the reduction of base money growth. Specifically, the SOMC stated: "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" (Poole, Rasche, and Wheelock, 2011, appendix 1, 42).

Volcker had other ideas. In contrast to the SOMC, Volcker believed that the volatility of money velocity made monetary targeting an unreliable approach for conducting monetary policy (Bordo and Levy, 2024, 12). Nevertheless, and unlike Burns, Volcker appreciated the capacity of monetary policy to control inflation. But he also appreciated something else. As William Silber (2012, 134) has documented, Volcker understood the importance of endogenous expectations, which he learned from traders while he had been working on the New York Fed's trading desk in the 1950s. In 1975, when he was president of the New York Fed, he warned his FOMC colleagues not to be encouraged by projections of reduced inflation from macroeconometric models because those models "did not take adequate account of the important factor of expectations."[4] The following year, in a speech to the Boston Economic Club, Volcker argued:

> It is no historical accident that the past few years have seen the rise ... of so-called rational expectations ... in effect arguing that the ultimate inflationary consequences [of economic policy] will be promptly taken into account in today's actions ... Some versions ... actually seem to imply that systematic demand policies will be wholly impotent to affect the real economy. I would not go nearly so far, but I do think ... that what people think and expect ... is a fact of economic life that we cannot escape... (quoted from Silber, 2012, 134-35).

[4] Volcker made those remarks at his first FOMC meeting on August 19, 1975.

And so I come to a crucial difference between what Friedman and the SOMC prescribed in the early-1980s, and the policy implemented under Volcker. That difference has to do with the acquisition of central-bank credibility and its effect on expectations. Credibility, once earned, allows for a gradual monetary tightening because the markets trust – they expect -- that, once a tightening has begun, the central bank will continue to tighten. This was plausibly the assumption underlying the gradualist approach of Friedman and the SOMC. This is precisely what happened during the past several years when inflation expectations remained near 2 percent in both the United States and the euro area even though actual inflation spiked upward.

Volcker's actions, in contrast, were consistent with a central bank that lacks credibility and tries to acquire it. In the early 1980s, the Fed lacked credibility. To bring down inflation expectations, Volcker believed, monetary policy had to tighten abruptly and needed to remain tight, even if it meant bringing the economy into recession. In the jargon of the literature, the Fed had to signal that it was "hard nosed." In the absence of credibility, a central bank that embarks on a gradualist approach would not be believed. As Bordo and Levy point out (2024, 14), leading members of the SOMC Karl Brunner and Allan Meltzer were initially critical of Volcker's aggressive monetary tightening strategy, although that criticism gradually eased over the 1980s and they came around to admire Volcker's efforts.[5]

It took several years and two recessions for Volcker to establish the Fed's credibility and for long-term interest rates to come down. As Sargent and Silber (2022) noted, although inflation fell from more than 12 percent in 1980 to under 4 percent in 1984, the 10-year Treasury note averaged 11.5 percent in 1980 and rose to above that level in 1984. The 10-year note did not average in the single digits until 1986 (Sargent and Silber, 2022).

This difference in optimal monetary response to an inflationary shock plays a central role in the New Keynesian model exposited by Galí (2015) and Woodford (2003). Volcker's policy response anticipated this literature. It also anticipated the

[5] Reflecting, in part, Volcker's "hard nosed" policy, Nelson (2024, chap. 12, 147) reported that "Friedman was very far from a friendly commentator with regard to the Volcker Federal Reserve."

game theory literature on the importance of central bank credibility developed in the 1980s and 1990s (see, for example, Barro and Gordon, 1983). This was one reason for the difference in policy prescriptions between Volcker, on the one hand, and Friedman and the SOMC, on the other.

But, as shown by Bordo and Levy (2024, 18), there was another reason. Both Friedman and the SOMC were misled in the 1980s by high rates of money growth. They thought that inflation would rise. In March 1983, annual CPI inflation had fallen to 3.6 percent, compared with 6.8 percent in March 1982.[6] Base money growth, however, was 7 percent in early 1983. M1 growth was 10 percent. The Shadow Committee's semi-annual statement in March 1983 advised: "The current inflationary policy should end. The growth of money should return to a disinflationary path. We recommend an annual growth rate of money (M1) not to exceed 5-1/2% in the year ending fourth quarter 1983" (Poole, Rasche, and Wheelock, 2011, appendix 1, 43). They did not account for money-demand instability. Meltzer acknowledged that circumstance:

> The monetarist mistake was the failure to forecast the decline in inflation from 10.9% in 1981 to 3.2% in 1983 and 4.3% in 1984 (as reported at about that time). Money growth in 1983 and 1984 averaged 9%. Like the bondholders, we believed that the Federal Reserve was about to repeat the mistakes of the 1970s. It is worth noting that members of the Federal Open Market Committee projected an inflation rate of 6% to 7% in 1984. With hindsight, we recognize that we underestimated the increased demand for money per unit of income. Our error came mainly from velocity or money demand, not from the Phillips curve term (Meltzer, 2000, 126-27).

In contrast, Volcker emphasized high interest rates as the indicator of policy tightness, not money growth. Once credibility was earned, the Fed maintained it – and built on it -- by following, if implicitly, a Taylor rule during the Great Moderation of the mid-1980s to the early-2000s.

My final comments concern the inflation surge associated with the pandemic. Bordo and Levy (2024, 48) show that SOMC members accurately predicted that surge. Ireland (2022), for example, warned that the rise in inflation would persist based on

[6] Monthly (year-on-year) inflation would rise to a range between 3.9 percent and 4.8 percent in 1984, before falling again in 1985.

the unprecedented surge in M2 growth. In this regard, an important issue that emerged from the recent inflation was the relative contributions of demand and supply factors -- different policy responses would be warranted if the surge in inflation had been due to supply factors rather than demand factors. Ireland's view that M2 growth would play a leading role was confirmed by Hall, Tavlas, and Wang (2023), who found that, of the cumulative rise in U.S. inflation in the 24 months through April 2022, 7.0 percentage points was due to the rise in M2 and 8.5 percentage points to the rise in government spending as a share of GDP. Those authors also found that the situation in the euro area had been different: during the same period, supply factors dominated, accounting for 9.5 percentage points of the cumulative rise in inflation in the 24 months through April 2022; the rise in euro area M2 accounted for only 0.4 percentage point.

What are the conclusions? In the 1970s, a money supply rule would have prevented the steep rise in inflation and its entrenchment. Friedman and the SOMC got it right. In the early-1980s, such a rule would not have worked. Money demand was unstable. The Fed not only had to bring down inflation, but had to convince the markets that it was hard nosed. Volcker got it right. Once that was done, policy that was consistent with a Taylor rule proved to be effective. The mantle of policy rules had passed from Milton Friedman to John Taylor.

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