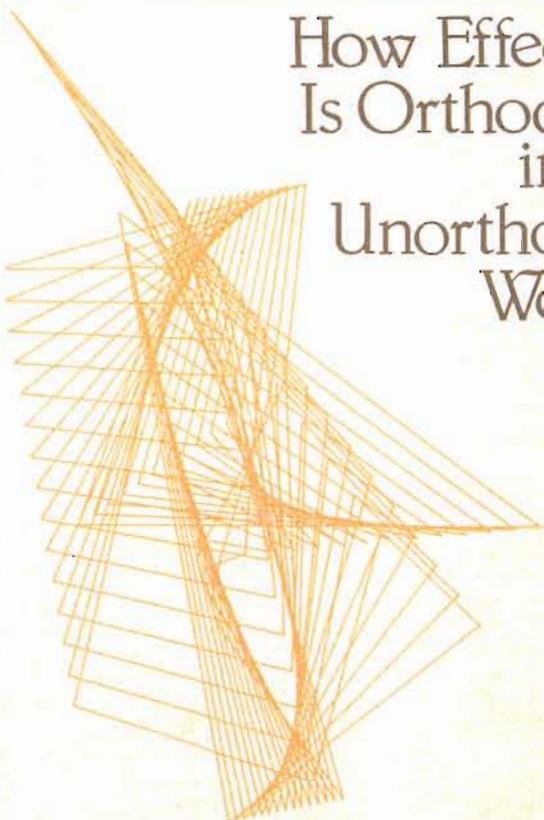


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COMMENTARY

Monetarism and Practical Policymaking*

*by Edward G. Boehne, Senior Vice President
Federal Reserve Bank of Philadelphia*

Nearly 75 years ago a professor at Yale University—named Irving Fisher—turned a truism into a policy prescription that Milton Friedman has popularized as “Monetarism.” The truism is that GNP equals the amount of money available for spending multiplied by the number of times money is used. If the number of times money is used (velocity) is predictable, then GNP can be controlled simply by regulating the supply of money. On this proposition rests the foundation of modern monetarism.

Why then doesn't the Federal Reserve

religiously follow such a simple, neat policy prescription to stabilize the economy and rid it of inflation? Paraphrasing H. L. Mencken, it is because for every human problem there is a solution which is simple, neat, and unrealistic. This is not to say that the Fed has not made mistakes; it has. Or, that the Fed knows all that it needs to know about the economy; it doesn't. But it is to say that the actual implementation of monetary policy—whether through the targeting of the reserve base or the Federal funds rate—is much more imprecise and complicated than many have come to believe.

For one reason, as we have learned particularly in recent years, the use of money is not always that predictable. Velocity can bounce around for meaningful periods of time for

*Based on a talk given to the Philadelphia Investment Group at the Union League, Philadelphia, Pennsylvania, September 5, 1979.

known and unknown reasons. For example, in 1975, velocity grew at a faster rate than it had in the first year of any economic recovery since 1950, thus making it more difficult for policymakers to set goals for appropriate monetary growth rates. Or, more recently, with the onset of telephone and automatic transfer services, money market funds, and other new services and innovations, velocity has been much more unpredictable than usual. The economic significance of the commonly measured money supply, therefore, has been difficult to interpret. To have followed the aggregates strictly early in the year would have led to unwarranted declines in interest rates.

True, many of these financial innovations are related to Regulation Q and the prohibition against paying interest on demand deposits. But the fact is that market impediments do exist and innovations do occur that affect the velocity of money and distort the meaning of the money supply.

The second and more important reason for not adhering to textbook monetarism is that the economic and social costs are just too great to be generally acceptable. Economists have charts showing that monetary growth and inflation move closely together. That they do this over long periods of time is undeniable, but the linkage between them is not so direct or painless as simple charts would portray.

As the 1974-75 recession demonstrated, tight money can reduce inflation, but it reduces jobs, production, incomes, and profits far more in the process. The link is not between money and inflation, it is between money, prosperity, and then inflation. While as a nation we are pretty good at sharing our gains, as yet we haven't figured out a socially acceptable way to share our losses. As a consequence, a policy of prolonged recession and high unemployment to dampen inflation is not acceptable. Some monetary accommodation, even in a period when financial discipline is underscored, may be necessary

to allow for the effects on the rate of inflation of such nonmonetary forces as oil-price hikes, bad harvests, Federal deficits, and the like. The more intense these inflationary pressures are, the more difficult becomes the Fed's job of restraining monetary growth without excessively adverse effects on jobs, sales, output, and financial markets. In short, monetary policy can "lean against the wind," as the saying goes, but because we live in a political economy it alone cannot change the direction of the wind.

Implementing an effective anti-inflation policy, therefore, requires initiatives on a wide front. Clearly, fiscal restraint is essential along with monetary restraint. But so are policies that stimulate investment, rejuvenate productivity, cut back on regulatory burdens, help brake the wage-price spiral, and foster competition, especially in markets where government itself contributes to higher prices. None of these is a substitute for the essential ingredient of monetary restraint, but monetary restraint can't go far enough, long enough to unwind inflation without some help. Hopefully, after more than a decade of persistent and worsening inflation, the national resolve is firming to the point where it is possible to maintain in place a broad-based policy that will lead in time to price stability.

Despite the simplicity, neatness, and attractiveness of Irving Fisher's equation, the implementation of monetary policy is still an art—not because the Fed wants it to be, but because that is the nature of the economy and policymaking environment in which the Fed operates. There are always hard-to-gauge trade-offs in society between long-term and short-term considerations, employment and inflation, and equity and efficiency, that have to be made with imperfect knowledge by imperfect people with imperfect results. And there are always those who make the job sound easier than it really is.