"Defining Monetarism"

by Milton Friedman

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The Federal Reserve System is criticized by some for being slavishly monetarist; by others, myself included, for not following a monetarist policy. How come?

"Monetarism" has two very different aspects: as scientific analysis, and as a prescription for policy.

Monetarism is a new term for an old empirical generalization known as the quantity theory of money.

The keystone of the quantity theory is the distinction between the *nominal* quantity of money (the number of dollars held as money) and the *real* quantity of money (the volume of goods and services that number of dollars will buy). Its central insight is that the nominal quantity of money is determined by the monetary institutions and authorities—currently the Federal Reserve System in the United States—but the real quantity of money is determined by the holders of money. Changes in the nominal quantity of money have important effects on output and employment in the short run; on prices in the long run.

Faster monetary growth tends to be followed after some three to nine months by economic expansion; slower monetary growth by economic contraction. For example, monetary growth speeded up after April 1980; an economic expansion started in July 1980. Monetary growth slowed after April 1981, and a recession started in July 1981. Monetary growth speeded up again after October 1981, the recession probably bottomed in April 1982 and we are now in the early stages of an expansion.

Because prices are sticky, faster or slower monetary growth initially affects output and employment. But these effects wear off. After about two years, the main effect is on inflation. For example, the quantity of money (as measured by M_1—currency plus checking deposits) grew at successive annual rates of 3.1, 5.0, 6.2 and 7.3 percent from 1960 to 1965, 1965 to 1970, 1970 to 1975, and 1975 to 1979. In corresponding periods (two years later) inflation, as measured by the consumer price index, was 2.0, 4.6, 7.7 and 10.7 percent. From 1979 to 1981, monetary growth slowed to 6.7 percent—and inflation fell from 1981 to 1982.

Faster monetary growth initially tends to reduce interest rates. However, after some months, the effect is reversed. As a result, continued high monetary growth means high interest rates; continued low monetary growth means low interest rates.

It is important to emphasize also what monetarism is not. It has little to say about fiscal policy, government policy toward industry or the long-term rate of growth of the economy. Bad monetary policy can destroy a healthy economy but good monetary policy cannot by itself cure a sick economy.

These statements about facts have no ideological content. In this scientific sense, Karl Marx was a monetarist and so are the bankers in Russia and China today.

These findings mean that short-term changes in monetary growth, at the right time and of the right amount, could offset other forces making for expansion or contraction and so promote economic stability. In practice, that has not worked. Whether because we do not know enough or because political and administrative pressures have intervened, fluctuations in monetary growth have been wrongly timed and of the wrong magnitude—creating a major source of instability. In addition, monetary growth has been much too high, producing our serious inflation problem.

Like many other monetarists, I have concluded that the most important thing is to keep monetary policy from doing harm. We believe that a *steady* rate of monetary growth would promote economic stability and that a *moderate* rate of monetary growth would prevent inflation.

But these are precisely the respects in which Federal Reserve practice has departed from the monetarist prescription. Since the Fed adopted monetarist rhetoric on Oct. 6, 1979, monetary growth has been more volatile than in any comparable preceding period and has averaged 6.2 percent, not much less than the rates of growth that brought double-digit inflation.

Can the Fed produce steadier monetary growth? Can it gradually lower monetary growth to end inflation? The monetarist answer is clearly yes. By changing its operating procedures and the rules and regulations it enforces on banks, the Fed could match its actions to its rhetoric. It has just taken the first step in that direction by deciding to replace lagged with contemporaneous reserve requirements. That may be a hopeful augury for the future.

Compiled by Robert Leeson and Charles Palm as part of their "Collected Works of Milton Friedman" project.

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