"More Double Talk at the Fed"

by Milton Friedman

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A senior Federal Reserve Board official [subsequently identified as chairman Paul A. Volcker] said ... "If the inflation outlook is as good as I think it is, long-term interest rates are far too high" ... The central banker cited concerns ... about recent surges in the nation's money supply ... However, the official reported that the Fed sees "some evidence" that the recent surge in money-supply growth "is diminishing now."

—*The Wall Street Journal*, April 5, 1983

These comments remind me of nothing so much as Leo Rosten's classic definition of chutzpah as "that quality enshrined in a man who, having killed his mother and father, throws himself on the mercy of the court because he is an orphan."

The Federal Reserve's major monetary function is to determine the money supply. It has the power to increase or decrease the money supply at any rate it chooses—not perfectly from day to day or week to week, but certainly very closely over a few months. The recent "surge"—I would say explosion—in the money supply occurred because the Federal Reserve permitted it to occur or wanted it to occur. The Fed certainly could have prevented the surge if it had wanted to do so.

Similarly, if there is "some evidence" that the surge "is diminishing now," that is because the Fed has decided that it should.

The money explosion puts the economy in a no-win position. Continued monetary growth at anything like recent rates would mean an upsurge in inflation in 1984 or 1985 at the very latest and higher long-term interest rates much sooner, as more and more participants in the financial market came to anticipate the rise in inflation.

A drastic reversal that produced low or negative monetary growth—something that the Fed has often done in the past—would produce a sharp if temporary increase in short-term interest rates, abort the economic expansion now in process and lead to a renewal of recession by early 1984.

Even the least harmful course—prompt reduction in monetary growth to the Fed's own target limits (4 to 8 percent for M_1) will, unless we are very lucky indeed, mean a rise in short-term rates, a slowdown in the expansion and a moderate increase in inflation.

Past experience gives little reason to put much confidence in the judgments of the "senior Federal Reserve Board official." Herewith a small—but not unrepresentative—sample of past predictions by the four most recent Federal Reserve chairmen in testimony to congressional committees.

Chairman William McChesney Martin Jr., Feb. 26, 1969: "I am optimistic about the prospects for gradual success of the stabilization policies now in force." (Inflation during the prior two years, 4.0 percent; during the next two years, 5.7 percent.)

Chairman Arthur F. Burns, Feb. 19, 1971: “While a high rate of growth of the narrowly defined money supply may well be appropriate for brief periods, rates of increase above the 5 to 6 percent range—if continued for a long period of time—have typically intensified inflationary pressures … The Federal Reserve will not become the architects of a new wave of inflation.” (M_1 growth during the next two years, 8.1 percent; during the next seven years, 6.4 percent; inflation, during the next two years [under price controls], 3.5 percent; during the next seven years, 6.8 percent.)

Chairman G. William Miller, July 28, 1978: “Monetary policy has been … designed to restrain inflation. But monetary policy cannot do the job alone.” *Miller, again, Nov. 16, 1978:* “You can be assured that monetary policy will do its part in achieving that objective.” (M_1 growth during chairman Miller’s term of office, March 1978 to August 1979, 8.6 percent; inflation, 11.1 percent.)

Chairman Paul A. Volcker, Nov. 13, 1979: “We are now placing more emphasis on controlling the provision of reserves to the banking system … to keep monetary growth within our established targets.” (M_1 growth target, fourth quarter to fourth quarter: 1979–80, 4 to 6.5 percent; actual, 7.2 percent. 1980–81, target 6 to 8.5 percent; actual, 5.1 percent. 1981–82, target 2.5 to 5.5 percent; actual, 8.5 percent.)

Times at bat, 3; hits, 0; runs, 0; errors, 3.

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Clearly, the problem is not the person who happens to be chairman, but the system. How is it that an institution that has so poor a record of performance nonetheless has so high a public reputation and even commands a considerable measure of credibility for its forecasts?

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

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