"Monetary Overkill"

by Milton Friedman

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The rise in unemployment from 6.2 per cent in March to 7.8 per cent in May is the largest two-month rise in unemployment since the end of World War II. The decline in the rate of monetary growth from February to May is the largest three-month deceleration in monetary growth since at least 1959.

The accompanying chart strongly suggests that these two facts are not coincidental, that the sharp jump in unemployment was the direct result of the collapse in monetary growth. Unemployment has consistently moved in the opposite direction from monetary growth, not perfectly but substantially.

The gyrations in monetary growth have been pronounced during the past several years. Rapid growth prior to September 1978 spurred the boom then under way and fueled the ongoing inflation. The resultant flight from the dollar frightened Washington and led the Fed, as so often, to overreact, cutting monetary growth sharply. In May 1979, the Fed again shifted course. $M_{1\text{-}B}$ grew at an annual rate of 10.9 per cent from May to October, heating up inflation and producing yet another flight from the dollar.

That prompted what looked like a basic shift in Fed policy: chairman Paul A. Volcker hastened back from an International Monetary Fund meeting in Belgrade to rally the Federal Reserve System to take a stand, and that Saturday (Oct. 6, 1979) announced that the Fed proposed to alter drastically its operating procedures by "placing greater emphasis … on the supply of bank reserves and less emphasis on … the Federal Funds rate."

Commenting on the Oct. 6 statement, I noted that "those of us who have long favored such a change have repeatedly licked our wounds when we mistakenly interpreted earlier Fed statements as portending a change in operating procedures. I hope that this time will be different—but remain skeptical until performance matches pronouncements" (NEWSWEEK, Oct. 22, 1979). Unfortunately, subsequent performance confirms the doubts rather than the hopes. Instead of steadier monetary growth, we have had wild swings: first slow growth, then rapid growth, and then actual decline.

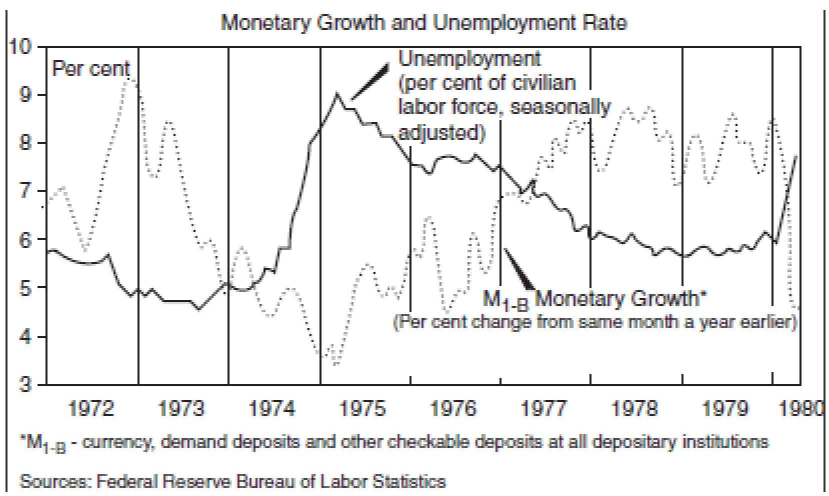
The Fed often acts as if erratic fluctuations in monetary growth are harmless so long as they average out to a reasonable level. That is a serious mistake. Growth in $M_{1\text{-}B}$ from September 1979 to February 1980 at a steady rate of 5.7 per cent would have had very different effects from those produced by the actual erratic growth at rates *averaging* 5.7 per cent. Growth in $M_{1\text{-}B}$ at a rate of 3.2 per cent in October and November 1979 was taken as evidence that the Fed would live up to its Oct. 6 statement. The dollar strengthened and interest rates fell in response. When monetary growth once again zoomed to 7.5 per cent from November 1979 to February 1980, expectations were disappointed. That disappointment was reinforced by President Carter's initial January budget, widely interpreted as inflationary, and by a frightening surge in the consumerprice index. The three together produced an extraordinary bubble in interest rates in the early months of this year.

The Fed has again overreacted—from February to May 1980, $M_{1\text{-}B}$ has actually *declined* at a 5 per cent annual rate. We need steadiness, not these wide swings. Some variation from month to month in monetary growth is unavoidable. However, the Fed has the power and the knowledge to keep monetary growth far steadier than it has been. It has lacked only the will.*

The Fed's targets for monetary growth have been reasonable. The problem is with the failure to achieve them. If a private enterprise's actual production deviated from plan as frequently and by as much, heads would roll. The Fed should be held to at least as high standards.

Given its disgraceful performance, the Fed now has no good options. To bring the monetary aggregates in the next three months to the levels that they would have attained if the Fed had met its targets would now require that $M_{1\text{-}B}$ grow at nearly 15 per cent per year—but that would revive inflationary expectations, which could do enormous harm. Perhaps the least bad alternative is to proceed at a high enough rate to reach the originally targeted levels in about a year and, at the same time, announce steadily lower targets for several years thereafter.

One thing is certain: the Fed's failure has condemned us to a more severe recession than we need have suffered. That, in turn, increases the chance of an inflationary overreaction in an attempt to counter the recession—leading to yet another inflationary surge.



Notes

*As far back as April 7, 1969, William McChesney Martin Jr., then chairman of the Board of Governors of the Federal Reserve System, wrote me, "To return to the question of the predictability of our control over some target variable selected from among monetary aggregates, I seriously doubt that we could ever attain complete control, but I think it's quite true that we could come significantly closer to such control than we do now—if we wished to make that variable our exclusive target. But the wisdom of such an exclusive orientation for monetary policy is, of course, the basic question." (Monetary growth has since been even more erratic than earlier.)

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

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