“The Needle Got Stuck”
by Milton Friedman
Newsweek, 25 July 1983, p. 66

"Paul Volcker, the newly named chairman of the Federal Reserve System, has his job cut out for him if he is going to end the Fed’s 65-year-old addiction to an unstable monetary policy.” That sentence from a column written four years ago (“Volcker’s Inheritance,” Aug. 20, 1979) is unfortunately just as relevant today, after Volcker’s reappointment as chairman, except that the 65 years have become 69 years.

The accompanying chart extends and slightly modifies a chart from the earlier column, described as depicting “the record Paul Volcker inherits.”* The black line shows the growth of a key monetary magnitude over one-year periods—from the first quarter of one year to the first quarter of the next, the second quarter to the second quarter, and so on. A one-year period averages out the shorter and wider swings. But, in the words of the earlier column, “It leaves two notable features: an upward trend in the rate of monetary growth over the [more than] two decades and wide fluctuations around that trend.

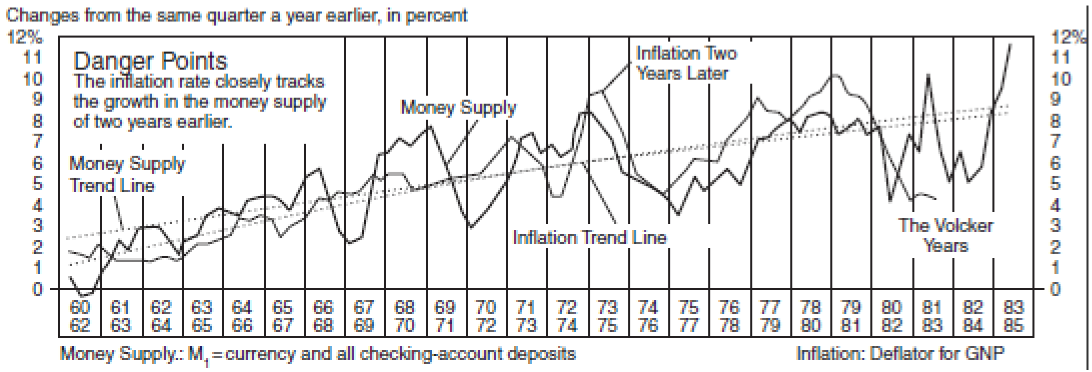
“Unstable and rising monetary growth has been the major reason for the correspondingly unstable and even more rapidly rising inflation depicted by the red line. The inflation rate is for a date two years later than the monetary-growth rate, in order to allow for the time it typically takes for a change in monetary growth to work through to inflation.”

Referring to the situation in mid-1979, I went on to say, “although the inflation rate has not yet peaked, it is very probably headed for a downturn.” The downturn did come, although not until 1981. Inflation has since fallen drastically.

The question now is whether the fall in inflation betokens a break in the upward trend of recent decades or is simply the downward phase of another gyration about that trend—somewhat wider but a member of the same family as the earlier gyrations.

The monetary record for the past four years is hardly comforting. Not only has monetary growth been even more unstable than earlier, but also the monetary explosion since mid-1982 has pushed monetary growth to a new record high.

Part of the instability—the sharp V in 1980 (see chart)—derives from President Carter’s ill-starred imposition of credit controls in early 1980 and their subsequent removal. But whatever the cause, the instability of monetary growth explains the recent erratic behavior of the economy and of interest rates: a 6-month recession from January 1980 to July 1980; a 12-month expansion from July 1980 to July 1981; a 17-month recession from July 1981 to December 1982, the vigorous expansion since. The ups and downs in the economy and interest rates and the severity of the recession undoubtedly made the drop in inflation greater than it would otherwise have been. Monetary growth fell by 3 percentage points from late 1978 to mid-1982; inflation by 5 percentage points from the end of 1980 to mid-1983.



We have paid a high price for the extra 2-point decline, especially since it may prove temporary. As I wrote in this space three months ago (May 2), the recent "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 …

"A drastic reversal that produced low or negative monetary growth … 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."

The hour is later now, and additional damage has been done by the Fed's well-intentioned efforts to fine-tune the reduction in inflation and the return to prosperity. We shall be fortunate indeed if we escape either a return to double-digit inflation rates or renewed recession in 1984.

*It has been modified in three ways: the use of (1) quarterly instead of monthly data; (2) the new Fed M_1 series instead of the old M_2 series (the present M_1 is a better approximation of the old M_2 than the present M_2); (3) the GNP deflator instead of the consumer price index to measure inflation in order to reduce the bias imparted to the CPI in the past four years by the overweighting of interest rates.

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

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