



# *Policy Note*

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## THE COLLAPSE OF MONETARISM AND THE IRRELEVANCE OF THE NEW MONETARY CONSENSUS

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Twenty-five years ago, on a brilliant winter day at Alta, I skied off the top of the Sugarloaf lift and heard a familiar voice asking for directions. It was William F. Buckley Jr. I pulled off my hat and went over to say hello. Buckley greeted me, then turned to a small man at his side wrapped in a quilted green parka topped with a matching forest green stocking cap and wraparound sunglasses in the punk style. “Of course,” Buckley said, “you know Milton Friedman.”

Last fall, when I received an invitation to deliver the 25th Annual Milton Friedman Distinguished Lecture at Marietta College, my first act was to notify Buckley, already then quite ill. I warned that he couldn’t publish on it or the invitation might be revoked. The e-mail came back instantly, full of exclamation points, block caps, and misspellings. “Congratulations! What a wonderful opportunity to REPENT!”

My other close encounter with Milton Friedman came around 18 years ago, when he invited me to debate the themes of *Free to Choose* for an updated release of that 1980 television series. As I watched it recently on the Internet, so many years later, my main impression was that this format did not show Friedman at his best. Unlike Buckley, on television he would simplify and condescend, and this left him vulnerable to easy lines of attack. When I suggested that his program plainly drew no distinctions between the Big Government of Red China and the Big Government of the United States, he had no reply. It was true: that’s what he thought. If this were all there was to

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Friedman, he would not be worth talking about, and Marietta College would not have endowed a lecture in his name.

Truly, I come to bury Milton, not to praise him. But I would like to do so on the terrain that he favored, where he was strong and over which he ruled for many decades. This is the area of monetary policy, monetarism, the natural rate of unemployment, and the priority of fighting inflation over fighting unemployment. It is here that Friedman had his largest practical impact and also his greatest intellectual success. It was on this battleground that he beat out the entire Keynesian establishment of the 1960s, stuck as they were on a stable Phillips curve. It was here that he set the stage for the counterrevolution that has dominated academic macroeconomics for a generation, and that—far more important—also dominated, and continues to influence, the way in which most people think about monetary policy and the fight against inflation.

What was monetarism? Friedman famously defined it as the proposition that “inflation is everywhere and always a monetary phenomenon.” This meant that money and prices were tied together. But more than that, Friedman believed that money was a policy variable—a quantity that the central bank could create or destroy at will. Create too much, and there would be inflation. Create too little, and the economy might collapse. There followed from this that the right amount would generate the right result: stable prices at what Friedman came to call the natural rate of unemployment.

The intent and effect of this line of reasoning was to defend a core proposition about capitalism: that free and unfettered markets are intrinsically stable. In Friedman’s gospels, government is the lone serpent in Eden, while the task of policy is to stay out of the way. Just as this was the vulgar lesson of *Free to Choose*, so it turns out it was also the deep lesson of the larger structure of Friedman’s thought. Friedman and Anna J. Schwartz’s *A Monetary History of the United States, 1867–1960* (1963), for all its facts and statistics, carried a simple message: the market did not fail; the government did.

Friedman succeeded because his work was complex enough to lend an aspect of scientific achievement to his ideas and because those ideas played to the preconceptions of a particular circle. As John Maynard Keynes wrote of David Ricardo in his *General Theory of Employment, Interest, and Money* (1936):

*The completeness of [his] victory is something of a curiosity and a mystery. It must have been due to a com-*

*plex of suitabilities in the doctrine to the environment into which it was projected. That it reached conclusions quite different from what the ordinary uninstructed person would expect, added, I suppose, to its intellectual prestige. That its teaching, translated into practice, was austere and often unpalatable, lent it virtue. That it was adapted to carry a vast and consistent logical superstructure, gave it beauty. That it could explain much social injustice and apparent cruelty as an inevitable incident in the scheme of progress, and the attempt to change such things as likely . . . to do more harm than good, commended it to authority. That it afforded a measure of justification to the free activities of the individual capitalist, attracted to it the support of the dominant social force behind authority.*

Friedman’s success was similar to Ricardo’s, but not in all respects. Yes, he also explained away injustice and supported authority. But the logical superstructure was not vast and consistent. Rather, Friedman’s argument was maddeningly simple, yet slippery. He would appeal to the short run for some effects and to the long run for others, shifting between them as it suited him. Once, at an American Economic Association meeting in San Francisco, I encountered him at the business end of a television camera. “Professor Friedman,” the reporter inquired, “how will the economy do next year?” “Well,” Friedman replied, “because of the slow money growth last year, there will be a terrible recession.” “And what is your outlook for prices?” “Because of the fast money growth over the past several years, there will be a terrible inflation.” “Professor Friedman,” the reporter continued, “will the average American family be better off next year, or worse off than they are today?” “There is no such thing as the average American family. Some American families will be better off, and some will be worse off.” As I said: he could be difficult to pin down. And while the practice resulting from the teachings was indeed austere and unpalatable, Friedman actually denied this. His money growth rules promised stable employment without inflation. Their promise was not austere, but happy. Ricardo was Scrooge. Friedman was more like the Pied Piper.

Friedman’s success was consolidated in the late 1970s by facts: the strength of the monetarist regressions and the failure of the Keynesian Phillips curve. Stagflation happened. Robert Lucas called this “as clear-cut an experimental discrimination as

macroeconomics is ever likely to see.” At the same time, I played a minor role in bringing monetarist ideas to the policy market. My responsibility was to design the Humphrey-Hawkins hearings on monetary policy from 1975 through their enactment into law in 1978. In a practical alliance with monetarists on the committee staff, we insisted that the Federal Reserve develop and report targets for monetary growth a year ahead. The point here was not to stabilize money growth as such; it was to force the Fed to be more candid about its plans. But the process certainly lent weight to monetarism.

It was on the policy battleground, shortly after, that monetarism collapsed. From 1979, the Federal Reserve formally went over to short-term monetary targets. The results were a cascading disaster: 20 percent interest rates, a 60 percent revaluation of the dollar, 11 percent unemployment, recession, deindustrialization throughout the Midwest, and, ultimately, the debt crisis of the third world. In August 1982, faced with the Mexican default and also a revolt in Congress—which I engineered from my perch at the Joint Economic Committee—the Federal Reserve dumped monetary targeting and never returned to it.

By the mid-1980s, the rigorous monetarism Friedman had championed also faded from academic life. Money growth became high and variable, but inflation never came back. Perhaps inflation was “always and everywhere a monetary phenomenon,” as he observed in 1963. But monetary phenomena could happen without inflation. This vitiated the use of monetary aggregates as an instrument of policy control. At the Bank of England, Charles Goodhart stated his law: *When you try to use an econometric relationship for purposes of policy control, it changes.* Friedman himself conceded to the *Financial Times*’ Simon London in 2003: “The use of quantity of money as a target has not been a success. I’m not sure I would as of today push it as hard as I once did.”

What remained in the aftermath was a sequence of doctrines. All were far more vague and imprecise than monetarism, but they carried a similar policy message: the Fed should place inflation control at the center of its operations; it should ignore unemployment, unless that variable fell *too low*. Further, there was a sense that instability in the financial sector should be ignored by macroeconomic policymakers except when it could not be ignored any longer. The first of these doctrines, the natural rate of unemployment” or “non-accelerating inflation rate of unemployment” (NAIRU), originated with Friedman and Edmund Phelps in 1968 and had the fatal attraction of

incorporating expectations into a macroeconomic model for the first time. Macroeconomists fell for it wholesale. But it proved laughably defective in the late 1990s, when Alan Greenspan, bless his heart, allowed unemployment to fall below successive NAIRU barriers—6 percent, 5.5 percent, 5 percent, 4.5 percent, and, finally, even 4 percent. No inflation resulted. This was good news for everyone except economists associated with the NAIRU, who were, or ought to have been, embarrassed. Some retreated from Friedman to Knut Wicksell: there was a brief vogue of something called the “natural rate of interest,” an idea unsupported by any actual research or any theory since the demise of the gold standard.

And then we got Ben Bernanke and the ostensible doctrine of “inflation targeting.” This idea—Dr. Bernanke’s Monster—rests on something Marvin Goodfriend of Carnegie-Mellon University calls the “new consensus monetary policy.” This is a collection of ideas framed by the experience of the early 1980s but adapted, at least on the surface, to changing conditions since then. These are, first, that “the main monetarist message was vindicated: monetary policy alone . . . could reduce inflation permanently, at a cost to output and employment that, while substantial, was far less than in common Keynesian scenarios.” Second, “a determined independent central bank can acquire credibility for low inflation without an institutional mandate from the government. . . .” And third, “a well-timed aggressive interest-rate tightening can reduce inflation expectations and preempt a resurgence of inflation without creating a recession.” Let us take up each of these alleged principles in turn.

First, is the proposition that monetary policy can reduce inflation permanently and at reasonable cost the “main monetarist message”? The idea is absurd. The main monetarist message was that *the control of inflation was to be effected by the control of money growth.* We have not even attempted this for a generation. Money growth has been allowed to do whatever it wants. The Federal Reserve stopped paying attention and even stopped publishing some of the statistics. Yet inflation has not returned. The main monetarist message is plainly false. As for the question of cost, no one ever doubted that a harsh recession could stop inflation. But, in fact, the monetarists’ recession of 1981–82 was by far the deepest in the postwar record. It was far worse than any inflicted under Keynesian policy regimes. In misstating this history, Goodfriend also completely overlooks the catastrophe inflicted by the global debt crisis on the developing world.

Second, is the anti-inflation “credibility” of a “determined independent central bank” worth anything at all? This idea is often asserted as though it were self-evident: that workers will restrain their wage demands because they recognize that excessive demands will be punished by high interest rates. There is some evidence for such a mechanism in the very specific case of postwar Germany, where the metalworkers union implicitly bargained with the Bundesbank for a period of some years. But in that case, the Bundesbank held a powerful, targeted weapon: a rise in interest rates would appreciate the deutsche mark and kill the export markets for German machinery and metal products. This was a credible threat. Such a situation does not exist in the United States, and there is no evidence whatever that American labor unions think at all about monetary policy in their day-to-day work. It would not be rational for them to do so: in a decentralized system, restraint in one set of wages just creates an advantage for someone else. Moreover, and still more telling, there never existed any oil company that ever failed to raise the price of petroleum, when it could, because it feared a rise in interest rates might afflict someone else later on.

Third, can we safely state that a “well-timed aggressive interest-rate tightening” can avert inflation “without creating a recession”? That statement is surely the lynchpin of the new monetary consensus. It was published in the Fall 2007 issue of the *Journal of Economic Perspectives*—a flagship journal of the American Economic Association—in an article by Goodfriend titled “How the World Achieved Consensus on Monetary Policy.” It therefore represents a statement of the highest form of expression of economic groupthink we are ever likely to find. Let me quote further, just so the message is clear. Goodfriend writes: “According to this ‘inflation-targeting principle,’ monetary policy that targets inflation makes the best contribution to the stabilization of output . . . [T]argeting inflation thus makes actual output conform to potential output.” Further: “This line of argument implies that inflation targeting yields the best cyclical behavior of employment and output that monetary policy alone can deliver. Thus, and here is the revolutionary point delivered by the modern theoretical consensus—even those who care mainly about the stabilization of the real economy can support a low-inflation objective for monetary policy . . . [M]onetary policy should [therefore] not try to counteract fluctuations in employment and output due to real business cycles.”

This statement was published, hilariously, around August 2007. It is the economists’ equivalent of the proposition that the road to Baghdad would be strewn with flowers. For as of that moment, the Federal Reserve was at the crest of an “aggressive interest-rate tightening” that had been under way since late 2004, aimed precisely at “pre-empting inflationary expectations” while “averting recession.” On July 19, 2006, Chairman Bernanke so testified before the Senate Committee on Banking, Housing, and Urban Affairs: “The recent rise in inflation is of concern to the FOMC [Federal Open Market Committee]. . . . The Federal Reserve must guard against the emergence of an inflationary psychology that could impart greater persistence to what would otherwise be a transitory increase in inflation.” On February 14, 2007, he repeated and strengthened the message: “The FOMC again indicated that its *predominant* policy concern is the risk that inflation will fail to ease as expected” (emphasis added). On July 19, 2007, this is again repeated: “With the level of resource utilization relatively high and with a sustained moderation in inflation pressures yet to be convincingly demonstrated, the FOMC has consistently stated that upside risks to inflation are its predominant policy concern.”

Before the fall, Chairman Bernanke made occasional reference to developments in the financial sector. On May 23, 2006, these were actually enthusiastic. Bernanke testified: “Technological advances have dramatically transformed the provision of financial services in our economy. Notably, increasingly sophisticated information technologies enable lenders to collect and process data necessary to evaluate and price risk much more efficiently than in the past.” And: “Market competition among financial providers for the business of informed consumers is, in my judgment, the best mechanism for promoting the provision of better, lower-cost financial products.” As for consumers, education was Bernanke’s recommendation and *caveat emptor* was his rule: “One study that analyzed nearly 40,000 affordable mortgage loans targeted to lower-income borrowers found that counseling before the purchase of a home reduced ninety-day delinquency rates by 19 percent on average.”

On February 14, 2007, Bernanke was still optimistic: “Despite the ongoing adjustments in the housing sector, overall economic prospects for households remain good.” And: “Overall, the U.S. economy seems likely to expand at a moderate pace this year *and next*, with growth strengthening somewhat as the drag from housing diminishes” (emphasis added). On March 28,

2007, he was less cheerful in testimony before the Joint Economic Committee: “Delinquency rates on variable-interest-rate loans to subprime borrowers, which account for a bit less than 10 percent of all mortgages outstanding, have climbed sharply in recent months.” Still: “At this juncture, however, the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained.” Only on July 19, 2007, in his speech before the Senate banking committee, do we hear that previous assessments were a bit rosy. Only then do we hear that “in recent weeks, we have also seen increased concerns among investors about credit risks on some other types of financial instruments.” That was three weeks before interbank lending markets collapsed, on August 11, 2007.

What in monetarism, and what in the “new monetary consensus,” led to a correct or even remotely relevant anticipation of the extraordinary financial crisis that broke over the housing sector, the banking system, and the world economy in August 2007 and that has continued to preoccupy central bankers ever since? The answer is, of course, absolutely nothing. You will not find a word about financial crises, lender-of-last-resort functions, or the nationalization of banks like Britain’s Northern Rock in papers dealing with monetary policy in the monetarist or the “new monetary consensus” traditions. What you will find, if you find anything at all, is a resolute, dogmatic, absolutist belief that monetary policy should not—should never—concern itself with such problems. That is partly why I say that monetarism has collapsed. And that is why I say that the so-called new monetary consensus is an irrelevance. Serious people should not concern themselves with these ideas anymore. Meanwhile, central bankers caught in the practical realities of a collapsing financial system have had to reeducate themselves quickly. To some degree, and to their credit, they have done so. What they have not done is admit it.

What is the *relevant* economics? Plainly, as many commentators have hastily rediscovered, it is the economics of John Maynard Keynes, of John Kenneth Galbraith, and of Hyman P. Minsky that is relevant to the current economic crisis. Let me say a word on each.

Here is Keynes, who wrote in 1931, in his “Consequences to the Banks of the Collapse of Money Values,” that we live

*in a community which is so organized that a veil of money is, as I have said, interposed over a wide field between the actual asset and the wealth owner. The*

*ostensible proprietor of the actual asset has financed it by borrowing money from the actual owner of wealth. Furthermore, it is largely through the banking system that all this has been arranged. That is to say, the banks have, for a consideration, interposed their guarantee. They stand between the real borrower and the real lender. . . . It is for this reason that a decline in money values so severe as that which we are now experiencing threatens the solidarity of the whole financial structure. Banks and bankers are by nature blind. They have not seen what was coming. Some of them have even welcomed the fall of prices towards what, in their innocence, they have deemed the just and “natural” and inevitable level. . . . that is to say, to the level of prices to which their minds became accustomed in their formative years. In the United States, some of them employ so-called “economists” who tell us even today that our troubles are due to the fact that the prices of some commodities and some services have not yet fallen enough. . . . A “sound banker,” alas! is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional and orthodox way along with his fellows, so that no one can really blame him.*

In *The Great Crash: 1929* (1955), my father rejects the idea, later embraced by Friedman, that bankers and speculators were merely reflecting the previous course of monetary policy. In the summer of 1929, “there were no reasons for expecting disaster. No one could foresee that production, prices, incomes and all other indicators would continue to shrink for three long and dismal years. Only after the market crash were there plausible grounds to suppose that things might now for a long while get a lot worse.” And, “There seems little question that in 1929, modifying a famous cliché, the economy was fundamentally unsound. . . . Many things were wrong, [including] . . . the bad distribution of income . . . the bad corporate structure . . . the bad banking structure . . . the dubious state of the foreign balance . . . [and] the poor state of economic intelligence.” On the last, he also wrote, “To regard the people of any time as particularly obtuse seems vaguely improper, and it also establishes a precedent which members of this generation might regret. Yet it seems certain that the economists and those who offered economic counsel in the late twenties and early thirties were almost uniquely perverse.” On this point, John Kenneth

Galbraith is now disproved. I refer you back to the “new monetary consensus.”

Finally, Hyman Minsky taught that economic stability itself breeds instability. The logic is quite simple: apparently stable times encourage banks and others to take exceptional risks. Soon, the internal instability they generate threatens the entire system. Hedge finance becomes speculative, then Ponzi. The system crumbles and must be rebuilt. Governments are not the only source of instability. Markets, typically, are much more unstable, much more destabilizing. This fact is clear, in history, from the fundamental fact that market instability long predates the growth of government in the New Deal years and after, or even the existence of central banking. We had the crash of 1907 before, not after, we got the Federal Reserve Act.

On November 8, 2002, then-Fed Governor Bernanke spoke in Chicago to honor Milton Friedman on his 90th birthday. Bernanke said, “As everyone here knows, in their *Monetary History*, Friedman and Schwartz made the case that the economic collapse of 1929–33 was the product of the nation’s monetary mechanism gone wrong. Contradicting the received wisdom at the time that they wrote, . . . Friedman and Schwartz argued that ‘the contraction is in fact a tragic testimonial to the importance of monetary forces.’” In that era, Bernanke argued, the Fed tightened to thwart speculation. One would argue that in 2005–07, it tightened to preempt inflation. No matter. You can see the difficulty without my help. At the close of his speech, Bernanke stated, “Let me end my talk by abusing slightly my status as an official representative of the Federal Reserve. I would like to say to Milton and Anna: Regarding the Great Depression. You’re right, we did it. We’re very sorry. But thanks to you, we won’t do it again.”

Less than six years later, Chairman Bernanke faces an intellectual dilemma. He can stick with Milton, in which case he must admit that the only possible cause of the present financial crisis and evolving recession is the tightening action of the Federal Reserve, against which, when it started back in 2004, only two voices were heard: that of Jude Wanniski, the original supply-sider, and my own in a joint op-ed piece no one would publish except the *Washington Times*. Or he can stick with the so-called “new monetary consensus,” which holds that the Fed should now return to its inflation targets and pursue a much tighter policy, and that no recession will result. If Bernanke chooses the first, he must of course assume responsibility for the unfolding disaster. He cannot, logically, stay with Friedman

without admitting the error of the late Greenspan years and his own first months in office. If he chooses the second, he must repudiate Friedman, and hope for the best. The two courses are absolutely in conflict.

My own view is that Friedman and Schwartz were right on the broad principle—monetary forces are powerful—but wrong in its application. The Federal Reserve alone did not “cause” the Great Depression. Intrinsic flaws in the financial, corporate, and social structure, combined with bad policy both before and after the crash, were jointly responsible for the disaster, while the crash itself played a precipitating role. The danger, today, is that something similar could again happen. Thus, I do not think that rising interest rates alone caused the present collapse, and I do not think that cutting them will alone cure it. They did so in conjunction with the failure to regulate subprime loans, with the permissive attitude toward securitization, with the repeal of the Glass-Steagall Act of 1933, and with the general calamity of turning the work of government over to bankers.

But if Friedman was wrong, the “new monetary consensus” is even more wrong. That consensus, having nothing to say about abusive mortgage loans, speculative securitization, and corporate fraud, is simply irrelevant to the problems faced by monetary policy today. Its prescriptions, were they actually followed, would lead to disaster. Its adherents—who, of course, never had a consensus on their side to begin with—have made themselves into figures of fun. There is, mercifully, no chance that Bernanke will actually choose to follow their path.

And if those on both sides of Bernanke’s dilemma are wrong, what is a beleaguered central banker to do? I have an answer to that. Let Bernanke come over to our side. Let him acknowledge what is obvious: the instability of capitalism, the irresponsibility of speculators, the necessity of regulation, and the imperative of intervention. Let him admit the intellectual victory of John Maynard Keynes, of John Kenneth Galbraith, of Hyman P. Minsky. Let him take those dusty tomes off the shelf and broaden his reading. I could even send him a paper or two.

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