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Knowing The Limits Of Monetary Policy

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The Federal Reserve's attempt to stimulate the economy by creating another $600 billion of government fiat money is an act of hubris. It presumes that a few people sitting around a table in Washington can determine the optimal quantity of money by manipulating interest rates and allocating credit.

The attempt to reduce unemployment by artificially lowering longer-term interest rates on government debt, increasing the appetite for risk and moving inflation expectations closer to the Fed's target of 2% is being driven by the Fed's "dual mandate."

Under the Humphrey-Hawkins Act of 1978, the Federal Reserve is required to pursue policies consistent with full employment and stable prices. With low inflation but high unemployment, the Fed hopes that monetary stimulus will increase economic growth and reduce unemployment.

The problem is that monetary policy can only permanently affect nominal variables.

At a recent meeting on Jekyll Island, Ga., to commemorate the 100th anniversary of the 1910 blueprint for the Federal Reserve, Ben Bernanke channeled Milton Friedman and claimed that the Nobel laureate economist would support the second round of quantitative easing known as QE2.

In doing so, the Fed chairman echoed Wall Street Journal columnist David Wessel's conclusion that "the Friedman logic ... makes the case for QE2." Nothing could be further from the truth.

In a book I edited with Anna J. Schwartz, "The Search for Stable Money" (Chicago, 1987), Friedman advocated abolishing the Fed as we know it, freezing the monetary base and allowing private currencies to compete alongside the limited quantity of Federal Reserve notes.

His longstanding defense of individual freedom led him to argue that "the power to determine the quantity of money ... is too important, too pervasive, to be exercised by a few people, however public-spirited, if there is any feasible alternative."

Friedman looked beyond the tactics of monetary policy to the question of strategy, and concluded: "Until the proper monetary framework is adopted ... we should not expect good intentions of Fed officials to secure sound money."

Using QE2 to monetize government debt — and thus to remove any constraint on the size and growth of government — would not be something Friedman would support. He understood that monetary stimulus doesn't create jobs or economic growth, but does increase government power and reduce individual freedom.

Using monetary policy to increase inflation is also something he would sharply oppose. The Fed's fear of deflation is misplaced; we are not in the 1930s when the money supply contracted by a third between 1929 and 1933. The Fed's balance sheet has rapidly expanded from $800 billion in February 2006 to $2.2 trillion today. The price level is rising, not falling.

Engineering 2% inflation means the average level of money prices would increase by 22% in 10 years and by 49% in 20 years — debasing the value of the dollar. That is not sound money.

Friedman wanted a monetary framework that would safeguard the value of money. He did not oppose a mild deflation to increase the

purchasing power of money brought about by strong real economic growth.

The stagflation of the 1970s should have taught us that more inflation does not mean less unemployment. Fed Governor Kevin Warsh recognizes the absurdity of depending on more monetary stimulus to foster growth: "Given what ails us, additional monetary policy measures are poor substitutes for more powerful pro-growth policies."

U.S. monetary policy has become a tool of fiscal policy, and uncertainty characterizes both. Friedman preferred rules to discretion in the conduct of monetary and fiscal policy. He would certainly agree with Charles Plosser, president of the Federal Bank of Philadelphia, who recently stated at Cato's Annual Monetary Conference, "Sound policymaking requires us to understand the limits of what we know."

Recognizing the limits of our ability to plan or forecast a complex market system is an argument for rules over discretion. The function of government should be to protect persons and property — not to set interest rates and allocate credit — so that a spontaneous market order can emerge that allows individuals the maximum freedom to choose. Monetary freedom should be part of that "constitution of liberty," as F.A. Hayek called it.

The new Congress will face major challenges in trimming the size and scope of government. The Fed's dual mandate should be re-examined, as proposed by Rep. Paul Ryan, R-Wis., and others, and the overall monetary framework should be debated.

Chinese central bank adviser Xia Bin correctly warns that "as long as the world exercises no restraint in issuing global currencies such as the dollar, then the occurrence of another crisis is inevitable." Unlike the classical gold standard, there is no market-based feedback mechanism to bring the supply of pure fiat money in line with the demand and maintain long-run price stability.

Recognizing the limits of monetary policy and holding hearings on a new monetary framework would be steps in the right direction.

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