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The Swing of the Monetary Pendulum

Timothy B. Lee - 9/29/2012

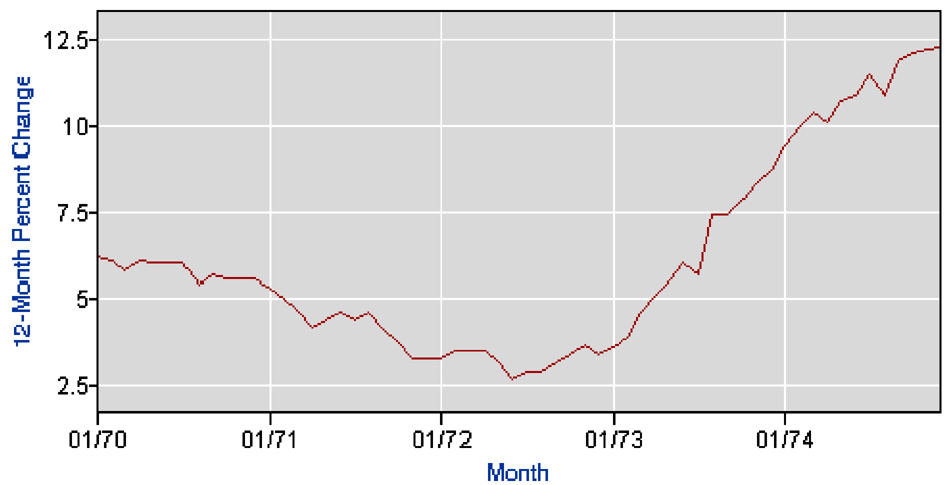
I think a lot of people underestimate how much the conventional wisdom has shifted on monetary policy over the last forty years. Take the case of Paul Samuelson, one of the most prominent economists of the 1970s. I've been reading some of his *Newsweek* columns, which he wrote opposite Milton Friedman. Here was his monetary policy prescription in October 1973:

Don't try to fight food inflation by fiscal and monetary poliies. That is putting a tourniquet around the patient's neck to check his bleeding chin. In the next couple of years, the same factors of supply and demand that sent up prices of food and fiber will send them down.

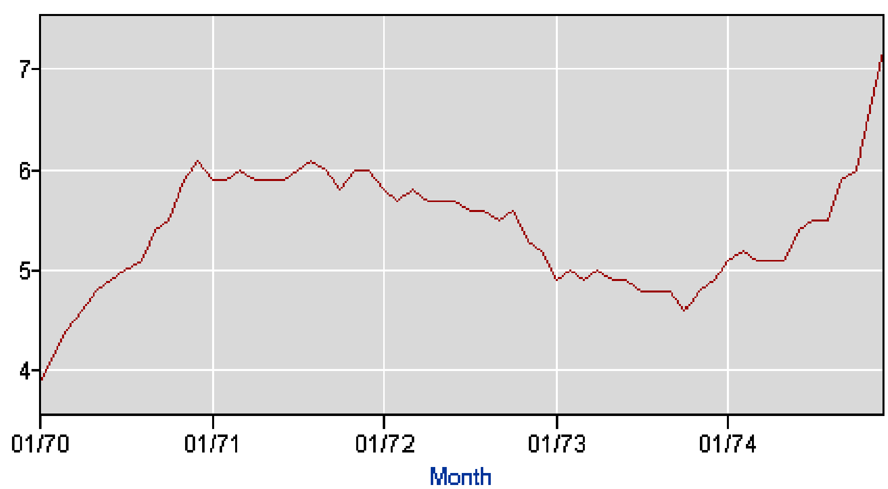
And five months later in March 1974:

> *The typical forecasters from banks, industry, universities and governments do not expect the inflation rate to be as bad at the end of 1974 as it is now. (I don't know quite how to square this with Fed chairman Burns's recent congressional testimony warning of two-digit inflation of the Latin American type. Perhaps there is something infectious in the job that makes its holder succumb to the temptation that so often seduced former chairman Martin—namedly, to issue warnings that go beyond the evidence in order to shake voters and congressmen out of policies deemed to be unsound.)…*
>
> *Now is the time for monetary policy to ease. It would be folly to try to roll back energy prics or raw-material prices by contriving recession or encouraging a maintained level of unemployment above 5.5 per cent. After healthy growth is restored, gradual anti-inflationary pressure will be in order.*

Here's what the inflation rate looked like when he penned those lines:



As it turned out, inflation rose throughout 1974. To be fair, the unemployment rate was rising at the same time:



What I find interesting about this is that the monetary conventional wisdom has shifted almost exactly 180 degrees in the last 40 years.

In 1973, elite opinion generally held that the Fed's job was to focus first and foremost on the unemployment rate. Inflation was believed to be driven largely by non-monetary factors, and most people believed that if you tried to control inflation using monetary policy, the primary effect would be to throw a lot of people out of work. Fed policy in the mid-1970s was widely described as tight despite the high inflation rates they produced.

Today, the situation is almost precisely the opposite. Everyone recognizes that the Federal Reserve's primary responsibility is to keep inflation under control. Lots of people believe the Fed is "out of ammunition" and therefore can't affect the unemployment rate. Indeed, in a precise reversal of the pattern of the 1970s, Fed policy since 2008 has been widely described as extremely loose despite the low inflation and high unemployment it has produced.

The correct view, of course, is somewhere in the middle. Fed policy can affect both inflation and unemployment. And the tendency for this kind of systematic error is exactly why we need an objective and predictable monetary policy like nominal GDP targeting.