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What Would Milton Friedman Say About Fed Policy Under Bernanke?

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Four years after his death, Milton Friedman's thoughts on monetary policy remain as relevant today as they were 30 years ago. Even Fed Chairman "Helicopter Ben" Bernanke (whose nickname comes from Friedman's famous "helicopter drop" idea for overcoming deflation) has referenced the Chicago don as an inspiration for his actions.

However, Friedman's views may not be well understood even by those who would claim him as their intellectual fountainhead — which could be problematic for policy-making. So what would Milton Friedman say about our current monetary policy?

First, low interest rates do not necessarily mean monetary policy is loose.

Friedman criticized the policies of the Fed in the 1930s and the Bank of Japan in the 1990s on this very point. Both central banks claimed to be highly accommodative at these times, pointing to low interest rates as evidence of easy monetary policy. Friedman countered, however, that low interest rates may reflect a weak economy rather than easy monetary policy.

Back in 1997, in fact, he called the idea of identifying low interest rates with easy monetary policy an interest-rate fallacy. The only time low interest rates do indicate loose monetary policy is when they are below the neutral interest-rate level, which is the interest-rate level where monetary policy is neither too simulative nor too contractionary and is pushing the economy toward its full potential.

The implication for today's Fed is that although its target federal funds rate is low, its stance still may not be very stimulative given that the neutral interest rate is also low. The Fed should not rely on the level of the federal funds rate to measure the stance of monetary policy to determine whether its actions are supporting or hindering the economy.

Second, the Fed should aim to stabilize inflation expectations.

In his 1992 book "Money Mischief," Friedman called for legislation requiring the Fed to stabilize the spread between the nominal yield on regular Treasury bonds and the real yield on inflation-protected Treasury bonds (TIPS). This spread is the market's estimate of future inflation.

Friedman wanted the Fed to target expected inflation, and to promote price stability. As a forward-looking approach, this would also avoid the "long and varying lag" problems associated with backward-looking monetary policy.

Though it has recently picked up, expected inflation, as measured by this spread on five-year Treasuries, has declined for most of the year. If nothing changes, this downward march of inflation expectations will lead to deflation expectations in spring 2011.

The market is expecting aggregate spending to further weaken in the future and, consequently, inflationary pressures will weaken too. If left unchecked, faltering aggregate spending could eventually result in deflation. This troubling possibility is exactly why Friedman believed the Fed should stabilize inflation expectations.

Third, the Fed should try to minimize swings in nominal income.

Throughout his life, Friedman promoted the importance of money and price stability as a means to macroeconomic stability, with stable nominal income growth as one manifestation of this goal. He considered stable nominal income growth desirable because sudden swings in it (and thus in nominal spending) cause huge macroeconomic problems when wages and prices fail to adjust quickly.

Today, slow adjustment of wages and prices is common and underscores the importance of maintaining stable nominal income growth.

Thus, in 2003 Friedman praised the Fed for offsetting a "velocity bubble" in the 1990s with slower monetary growth, a move that stabilized nominal income growth. On the other hand, Friedman also lamented that the Bank of Japan had allowed nominal income growth to collapse in Japan in the 1990s.

Had he been alive, Friedman would have been shocked to see the Fed in late 2008 and early 2009 allow nominal income, as measured by nominal GDP, to experience its sharpest downturn since the Great Depression. He would also be amazed to learn that nominal GDP forecasts are once more headed down.

Given these developments, Friedman would likely be calling on the Fed again to do a better job stabilizing nominal income.

Fourth, the Fed is not out of ammunition.

Friedman believed central banks are never constrained in their ability to shape nominal values. The only requirement is a desire to do so. Thus, Friedman argued that the Bank of Japan could have removed deflation and stabilized nominal income in the 1990s had it persistently stuck to a higher money growth rate.

For Friedman, worries about "pushing on a string" (because the Bank of Japan had almost reached the zero bound on its policy interest rate during this time) were a red herring. Only a commitment to a higher money growth rate was necessary.

Similarly, were Friedman alive today, he would balk at the notion that the Fed is out of ammunition. He would remind us that in the early-to-mid-1930s, when the economic environment was far worse and short-term interest rates were near the zero bound, monetary policy easily generated a recovery. Therefore, the Fed could do likewise today.

Friedman would likely make the case today for more aggressive monetary action. It is time for "Helicopter Ben" to earn his nickname.

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