



Macrolens on the Classics: Friedman's Presidential Address of 1967

Friedman's seminal address underscored a foundational economic truism: monetary policy has no long-run effect on real economic variables and ultimately determines only the price level.

The Role of Monetary Policy

Presidential Address to the American Economic Association

Milton Friedman

December 29, 1967

<https://www.andrew.cmu.edu/course/88-301/phillips/friedman.pdf>

Friedman's address is perhaps best known for its contention that the Phillips curve's purported "unemployment-inflation tradeoff" exists *only in the short-run*, and at that is a result not of inflation per se but of a burst of *unexpected* inflation. To sustain any such tradeoff, monetary policy would have to be eased continually to produce not just inflation, but *accelerating inflation* (the concept which gave birth to the term "Non-accelerating inflation rate of unemployment" or "NAIRU").

But it was Friedman's perhaps more mundane expositions of some of the "monetary basics" that hold relevance for the monetary policy debates of today, such as the effects of quantitative easing and the efficacy of inflation-targeting.

Regarding QE, Friedman reveals today's consensus, which sees these policies working through a suppression of long-term rates, as illogical. If QE is meant to address a liquidity crisis and the threat of debt-deflation – conditions which tend to produce very low long-term interest rates, wouldn't a policy that effectively fixes the problem be expected to produce *higher* long rates? Friedman speculated so:

The initial impact of increasing the quantity of money at a faster rate than it had been increasing is to make interest rates lower for a time than they would otherwise have been. But this is only the beginning of the process not the end. The more rapid rate of monetary growth will stimulate spending, both through the impact on investment of lower market interest rates, and through the impact of other spending, and thereby relative prices, of higher cash balances than are desired. But one man's spending is another man's income. Rising income will raise the liquidity preference schedule and the demand for loans; it may also raise prices which would reduce the real quantity of money. These three effects will reverse the initial downward pressure on interest rates fairly promptly, say, in something less than a year. Together they will tend, after a somewhat longer interval, say, a year or two, to return interest rates to the level they would otherwise have had.

Or, more succinctly:



As an empirical matter, low interest rates are a sign that monetary policy has been tight – in the sense that the quantity of money has grown slowly; high interest rates are a sign that monetary policy has been easy.

Many commentators made this error with regards to Fed policy of the past decade, by simply assuming that optically low rates (and QE) meant, ipso facto, that monetary policy was exceedingly loose. But if Fed policy had been as uber-easy as the ZeroHedge crowd likes to suggest, why did it take so long for long-term rates to go up?

Friedman continues with a nod to Wicksell:

The preceding analysis of interest rates can be translated fairly directly into Wicksellian terms. The monetary authority can make the market rate less than the natural rate only by inflation. It can make the market rate higher than the natural rate only by deflation. We have added only one wrinkle to Wicksell – the Irving Fisher distinction between the nominal and real rate of interest. Let the monetary authority keep the nominal market rate for a time below the natural rate by inflation. That in turn will raise the nominal natural rate itself, once anticipations of inflation become widespread, thus requiring still more rapid inflation to hold down the market rate.

Friedman then dispenses with the idea that a central bank could or should attempt to suppress the rate structure:

Paradoxically, the monetary authority could assure low nominal rates of interest – but to do so it would have to start out in what seems like the opposite direction, by engaging in a deflationary monetary policy. Similarly, it could assure high nominal interest rates by engaging in an inflationary policy and accepting a temporary movement in interest rates in the opposite direction.

These considerations not only explain why monetary policy cannot peg interest rates; they also explain why interest rates are such a misleading indicator of whether monetary policy is “tight” or “easy.”

The lesson for today is that the Fed cannot be “suppressing interest rates” by “printing money.” In fact, the lengthy quiescence of long-term U.S. interest rates is strong evidence that U.S. monetary policy has **not** been overly easy.

Friedman concludes Section One, entitled “What Monetary Policy Cannot Do,” with the statement of what we consider to be a quintessential truth of monetary policy:

To state the general conclusion still differently, the monetary authority controls nominal quantities – directly, the quantity of its own liabilities. In principle, it can use this control to peg a nominal quantity – an exchange rate, the price level, the nominal level of national income, the quantity of money by one or another definition – or to peg the rate of change in a nominal quantity – the rate of inflation or deflation, the rate of growth or decline in nominal income, the



rate of growth in the quantity of money. It cannot use its control over nominal quantities to peg a real quantity.

In Section Two, Friedman tells us “What Monetary Policy Can Do.” New Fed Chairman Jerome Powell might be sympathetic to Friedman’s “keep-it-simple-stupid” message:

The first and most important lesson that history teaches about what monetary policy can do – and it is a lesson of most profound importance – is that monetary policy can prevent money itself from being a major source of economic disturbance.

Some five decades after Friedman’s address one would be hard-pressed to conclude that central bankers had taken this admonition to heart. In fact, **modern macro investing has become primarily a game of navigating monetary disturbance.**

Friedman concludes by suggesting three potential monetary targets in a final section entitled “How Should Monetary Policy be Conducted?”

...the monetary authority should guide itself by magnitudes it can control, not by ones that it cannot control.

Of the various alternative magnitudes that it can control, the most appealing guides for policy are exchange rates, the price level as defined by some index, and the quantity of a monetary total...

Friedman (summarily in our view) dismisses exchange rate targeting as unsatisfactory in that it would simply expose monetary policies to the vagaries of overseas monetary authorities. (This is true as far as it goes. Note that Friedman has seemed to dismiss the Gold standard variation of “exchange-rate” targeting as politically unworkable):

For the United States in particular, exchange rates are an undesirable guide. It might be worth requiring the bulk of the economy to adjust to a tiny percentage consisting of foreign trade if that would guarantee freedom from monetary irresponsibility – as it might under a real gold standard. But it is hardly worth doing so simply to adapt to the average of whatever policies monetary authorities in the rest of the world adopt.

Friedman next takes on price-level targeting and makes a prescient prediction that real-world problems in execution would lead to “stop start” policymaking:

The link between the policy actions of the monetary authority and the price level, while unquestionably present, is more indirect than the link between the policy actions of the authority and any of the several monetary totals. Moreover, monetary action takes a longer time to affect the price level than to affect the monetary totals and both the time lag and the magnitude of the effect vary with circumstances. As a result, we cannot predict at all accurately just what effect a particular monetary action will have on the price level and, equally important, just when it will



have that effect. Attempting to control directly the price level is therefore likely to make monetary policy itself a source of economic disturbance because of false stops and starts.

This is an important insight which cuts right to the problem with inflation-targeting: the lack of timely feedback. Throw in the additional the problem of potential measurement error in the inflation statistics, and inflation-targeting becomes so inherently uncertain that “rear-view mirror” policymaking is inevitable. The result, as history has shown, is an ongoing cycle of undershoots and overshoots with concomitant volatility in financial markets. (Ed. note: nominal GDP targeting presents similar problems, but likely of a less severe magnitude. It would prove a marginal upgrade on inflation targeting in our view).

Of course, it wouldn't be a Friedman address if it didn't close with a plug for money-supply targeting:

Accordingly, I believe that a monetary total is the best currently available immediate guide or criterion for monetary policy.

He makes a great case in theory. In practice, not only is an accurate measurement of “money supply” impossible because of the amorphous nature of the concept, but money velocity – that tautological link between money supply and nominal output – has proven highly unstable.

Recall, this 1967 address took place at the very tail end of the long history of the gold standard, a period in which the unit of account was held steady with a high degree of discipline, one result of which seems to have been a relatively stable money velocity over time. Once the Dollar delinked from gold, inflation expectations went haywire and stable velocity quickly became a thing of the past, rendering Friedman's dream of “managing the Ms” unworkable. Increases in the complexity of the financial system and the money-creation process have only made these problems all the more insurmountable since Friedman's heyday.

Yet, we should not let that fact distract us from the critical lessons in the Friedman address:

- Monetary policy can only be used to affect nominal quantities
- Low interest rates are an indication that monetary policy has been tight, and vice versa
- Monetary policy can influence employment only in the short-term, and at that only by producing unexpected bursts of inflation or deflation
- Inflation-targeting suffers from the uncertainty inherent in the fact that the target is only indirectly affected by the central bank's actions. Stop-start policymaking is the inevitable result