Money in the Search for a Nominal Anchor

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The SOMC's Founding and Purpose

- Founded by Karl Brunner and Allan Meltzer, the SOMC first met on September 14, 1973, when US inflation had reached 7.4 percent.

- The SOMC's objective was to reject the price and wage controls and to "show that better policy choices were available and that inflation could be controlled at acceptable cost, if the Federal Reserve controlled money growth." (Meltzer 2000).

The SOMC’s Money-Based Framework

- Throughout the 1970s, the SOMC urged the Fed to gradually reduce the rate of money growth along a pre-announced path until it reached a level consistent with price stability.

- Specifically, the SOMC (1978) recommended “reductions of 1% per year in the average rate of monetary expansion until a noninflationary rate … is achieved.”

The SOMC's Money-Based Framework

- Milton Friedman appealed to "long and variable lags" to support his constant money growth rule.

- Similarly, Brunner and Meltzer emphasized that policymakers lack the timely information and detailed knowledge of the economy that would allow them to successfully target nominal income growth or inflation via a feedback rule, let alone pursue a discretionary policy.

- Over time, however, these views softened somewhat.

The SOMC's Money-Based Framework

- In Fall 1978, the introduction of NOW accounts and money market mutual funds led the SOMC to de-emphasize M1 and focus its attention on the monetary base.

- In 1990 and 1991, the SOMC recommended growth rates for M2, which it compared to the FOMC's announced targets.

- Continuing financial innovations, however, led William Poole to propose MZM as a replacement for M2.

The SOMC's Money-Based Framework

- Also in the early 1990s, rapid growth in the monetary base reflected increased demand for US currency from abroad.

- Meltzer (1993) proposed a new rule: setting a target for monetary base growth equal to two percent plus the three-year average of real GDP growth minus the three-year average of base velocity growth.

- Meltzer's rule varies the money growth target to achieve two percent inflation on average, but does not include feedback terms involving inflation, real growth, or nominal GDP growth.

The SOMC's Money-Based Framework

- In November 2000, Allan Meltzer retired both as member and chair of the SOMC.
- Charles Plosser and Anna Schwartz became SOMC co-chairs, and Bennett McCallum joined as a new member.
- Starting in November 2002, SOMC policy statements began referring to prescriptions from the McCallum (1987, 1988) rule.

The SOMC's Money-Based Framework

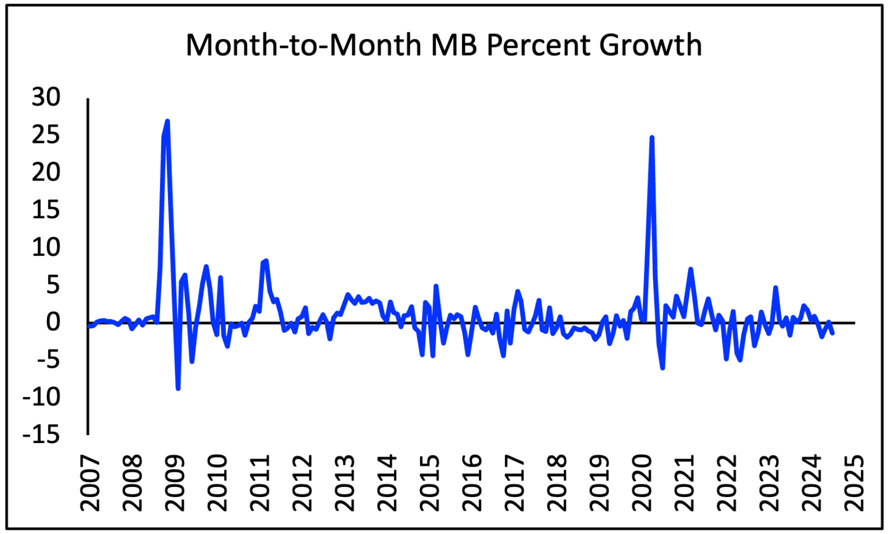
- The McCallum rule sets a target for monetary base growth using a four-year average of base velocity to adjust for shifts in currency and reserves demand.
- Unlike Meltzer's rule, McCallum's also includes a feedback term that adjusts the prescribed rate of money growth as nominal GDP rises above or falls below target.
- The McCallum rule resembles the Taylor rule, but uses the monetary base instead of the federal funds rate as the instrument.

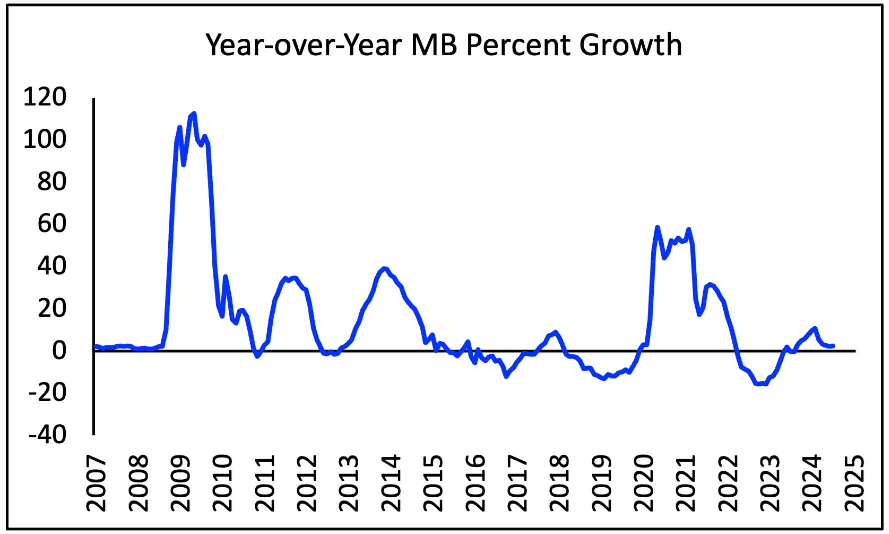
Evidence of Money's Relevance Today

- Is the SOMC's original, quantity-theoretic framework of any relevance today?

- Most economists, inside and outside the Fed, would say "no," based on the simple observation that inflation remained low, even as the monetary base grew by a factor of four during and after the 2008-09 recession.

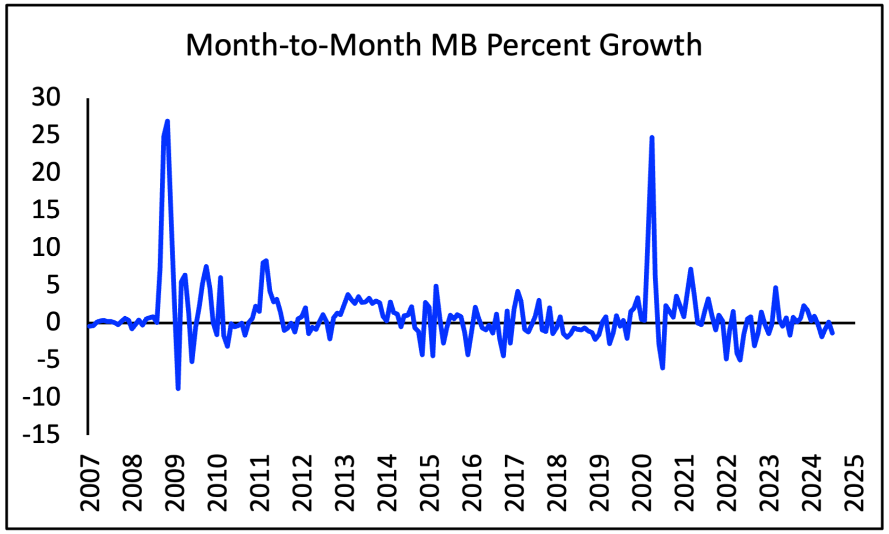
Evidence of Money's Relevance Today

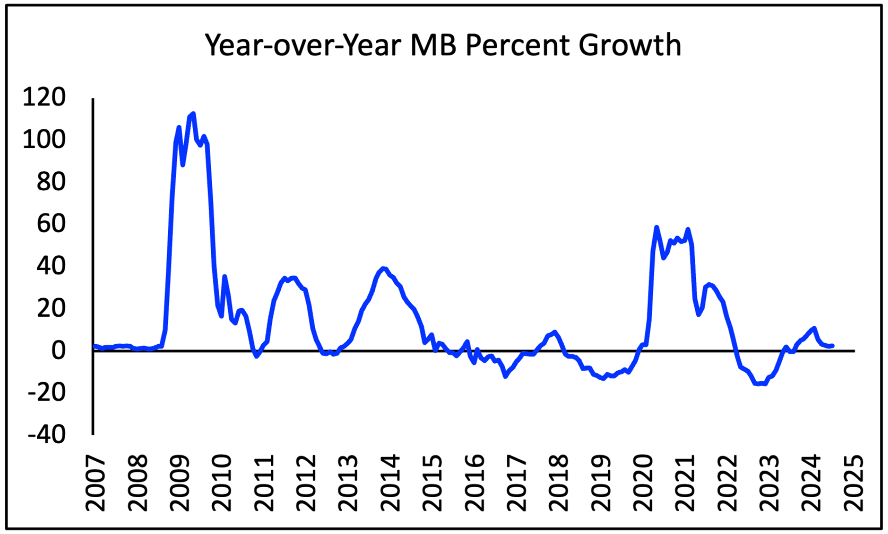




But the largest percentage-point changes in the base occurred in fall 2008, before the start of QE1 and as the Fed introduced interest on reserves.

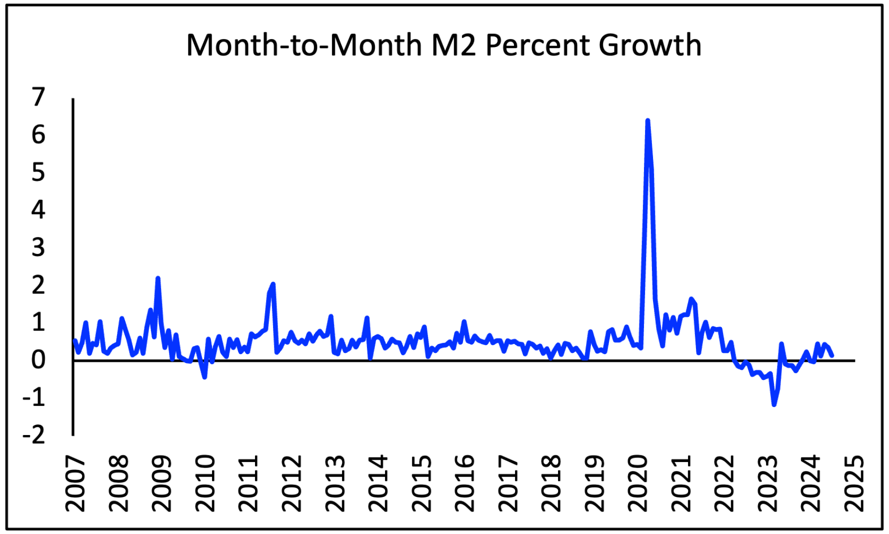
Evidence of Money's Relevance Today

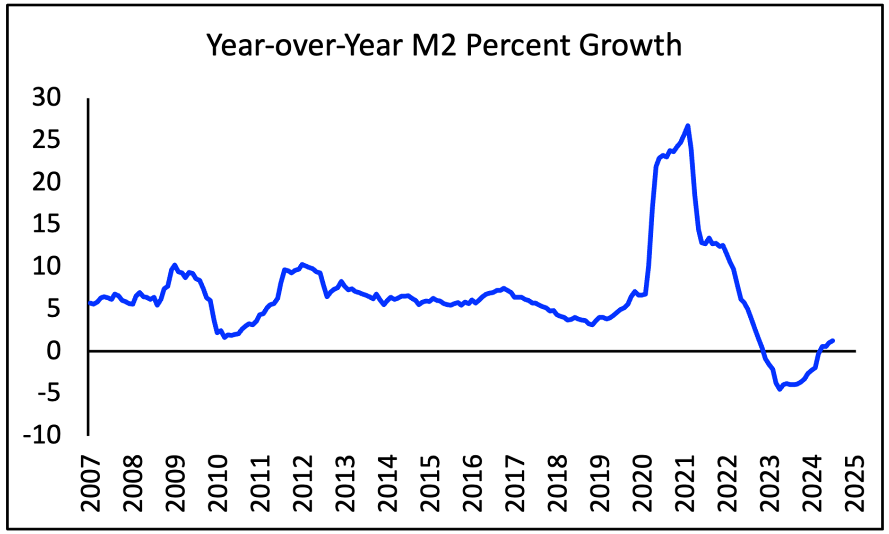




And from January 2009 through January 2019, the annualized growth rate of the monetary base was 7 percent.

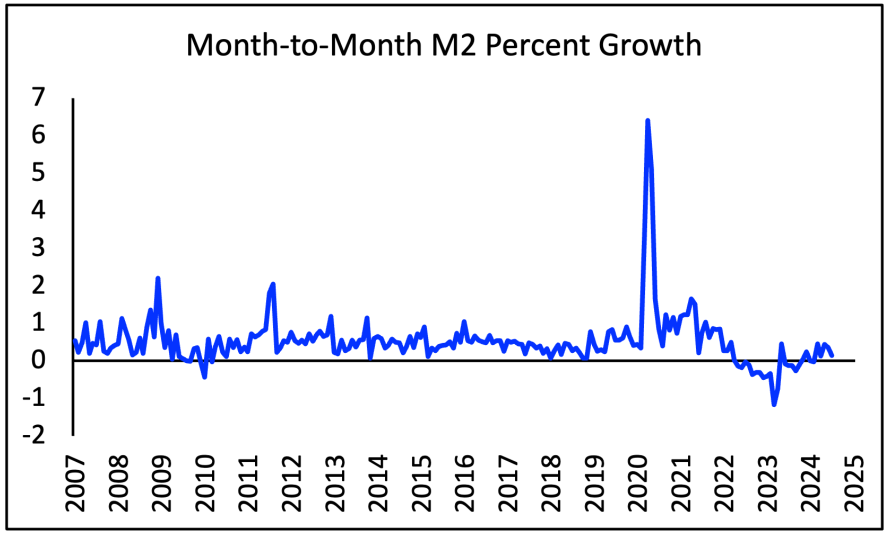
Evidence of Money's Relevance Today

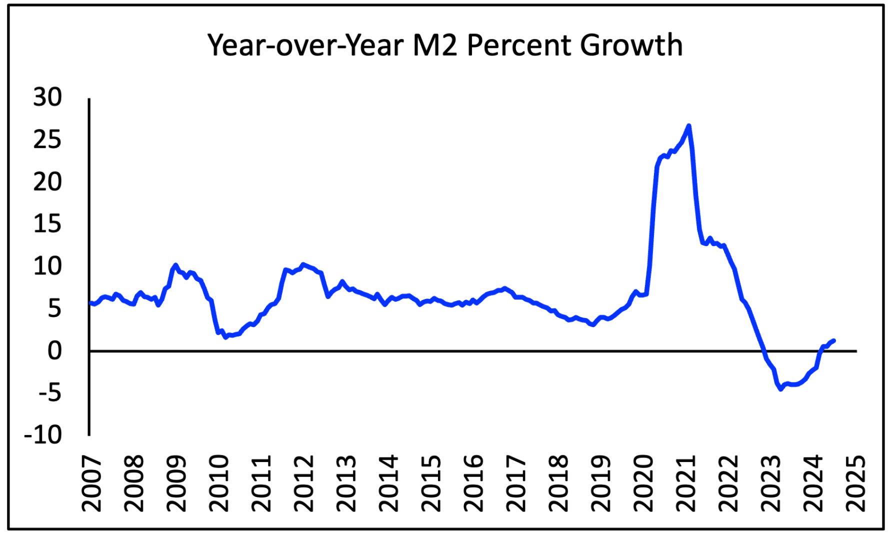




Moreover, QE1– QE3 never led to a sustained increase in M2 growth.

Evidence of Money's Relevance Today





By contrast, M2 growth did accelerate markedly post-2020, foreshadowing the unwanted inflation that followed.

Evidence of Money’s Relevance Today

- We know from Friedman and Schwartz (1963) that if you only look at the monetary base, you miss the big story behind the Great Depression: the enormous contraction in M2.

- Reynard (2023) shows that historically and across countries, large-scale central bank balance sheet expansion gets followed by rapid inflation only when broad money growth accelerates as well.

Evidence of Money's Relevance Today

- Looking at both the monetary base and M2 would have helped policymakers assess and adjust the stance of monetary policy.
- Both during 2008-2019 (slightly restrictive, despite years of very low nominal interest rates) and post-2020 (highly expansionary).