

RESEARCH SUMMARY

Making Monetarist Principles Relevant Again

How does the Federal Reserve control inflation? And why do its efforts sometimes go offtrack, creating inflation and destabilizing the economy? In “What the Fed Needs to Do to Control Inflation and Stabilize the Economy,” Robert L. Hetzel addresses these questions and explains how a consistently implemented rule-based monetary policy can bring economic stability.

Monetary Policy Needs to Be Rule Based

According to one monetarist principle, stabilizing monetary policy requires consistency in how the Federal Reserve (Fed) responds to new information about the economy. It requires a “consistent reaction function,” otherwise known as a rule, rather than a “discretionary” approach.

Why? Because a rule-based approach by the Fed can shape expectations. Financial markets are forward-looking. So to help stabilize the economy in response to shocks, the Fed must behave in a way that is predictable by financial markets.

A second monetarist principle states the following: Monetary policy should leave the determination of employment and economic output to the unfettered operation of the price system.

Bolstering the Independence of the Federal Reserve

The discretionary conduct of monetary policy can not only destabilize the economy; it can also create a problem for the perceived independence of the Federal Reserve, which may be required to make tradeoffs between price stability, full employment, and other objectives.

The issue of the Fed’s independence can be an important one, especially in an election year. Under pressure from Republicans to do one thing and from Democrats to do another, a Fed with a rule in place could defend its policy based on objective criteria.

The Fed Should Learn the Lessons of the Past

The Federal Reserve can learn by acknowledging that in the past it has implemented monetary policy by using different reaction functions.

It needs to engage in a systematic investigation of its history to determine which of these functions is stabilizing. Such a course of action will necessitate a change in culture: The Fed must admit that learning requires accepting that its monetary policy has made—and can make—mistakes. This kind of retrospective exercise would require courage by the Fed to admit that its mistakes are not just a feature of a long-gone past.