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10-1-1972

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Recommended Citation

Minsky, Hyman P. Ph.D., "An Evaluation of Recent U.S. Monetary Policy - I: Can and Should the Money Supply Be Controlled?" (1972). *Hyman P. Minsky Archive.* Paper 236.
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HYMAN P. MINSKY

Reprinted from the Banker's Magazine (England)
October 1972

An Evaluation of Recent U.S. Monetary Policy

In this, and the next two issues of The Bankers' Magazine, *Professor Hyman P. Minsky of Washington University, evaluates* US *monetary policy since* 1966 *and concludes that the current debate now being waged between 'monetarists' and 'fiscalists' provides but limited help in the interpretation and understanding of Federal Reserve policy. In the first part of this analysis, Professor Minsky asks 'Can and Should the Money Supply be Controlled?'*

I Can and Should the Money Supply be Controlled?

As a result of the boring and continuing debate in America between 'monetarists' and 'fiscalists' it might appear that an evaluation of recent United States monetary policy should focus on three questions: Can the Federal Reserve control the money supply?: Would appropriate control of the money supply lead to desired levels or rates of change of economically meaningful target variables?: and Should the money supply be controlled even if such control can lead to the achievement of targets?

The above phrasing – which emphasizes what the questions might appear to be – reflects the view that the current controversy in America on monetary theory and policy centres around minor theoretical and policy problems. The controversy ignores deeper and vital differences in economic theory and the interpretation of experience. The monetarist and fiscalist positions constitute two policy postures derived from standard economic theory.

ECONOMIC THEORY *v.* REALITY?

The deeper question in monetary theory is whether standard economic theory, in either its monetarist or its fiscalist garb, yields an adequate basis for analysing the behavior of and prescribing policy for American and similar capitalisms. These essays argue that it does not and that an alternative Keynesian view – in which Keynes is interpreted within a financial and cyclical framework – yields a more satisfactory understanding of recent experience.

For use in monetary theory and policy, standard economic theory – what is called the neo-classical synthesis – takes the form of a model which combines a basically mechanical money supply function[1] with a 'post-Keynesian' version of classical economics. This synthesis is due mainly to the work of Professors Hicks, Patinkin and Modigliani[2]. In this union the money supply is endogenous though functionally related to a reserve base determined by the authorities. In the 'normal' case, for any given fiscal policy there exists a money supply that is consistent with the policy targets. Thus this model yields the standard or text-book monetary-fiscal policy rules for tuning the economy. In the 'abnormal' ('liquidity trap') case such a unique target money supply for each fiscal posture does not exist. Fiscal policy needs to carry the entire burden of policy.

INSTABILITY AND INTERVENTION

This standard model can not explain the behavior of financial markets and the economic system at those times that Federal Reserve behavior matters most, which is when the financial system is fragile and financial instability presents a clear and present danger. The American experiences of 1966 and 1970 indicate that in a strongly expanding economy – in a boom economy – Federal Reserve action operates mainly, though usually inadvertently, by affecting views as to the desired liability structure. Desired liability structures reflect the 'felt uncertainty' of asset holders and the issuers of liabilities. An adequate analysis of the responsibilities, limitations, and powers of monetary policy over a broad spectrum of economic environments requires an alternative to the static neo-classical paradigm – an alternative which emphasizes decision-making under uncertainty. In such a model, monetary policy can be an exercise in economic brinkmanship, although if the authorities are guided by standard theory the exercise is unintended.

The years since Kennedy's inauguration in 1961 are of particular interest. Only since 1966 has the stability of the financial system and the need for active intervention by the Federal Reserve to offset instability been once again at issue. During the thirty years prior to 1966 financial instability was not an 'active' issue. Prior to that, during the entire period from the founding of the American Republic to the great depression, financial instability was a regular recurrent problem in the United States. The current problem is the analysis, design, and execution of economic policy in an era in which financial instability has been experienced recently and remains a threat.

The main thrust of the argument that follows is that observed financial instability is due to characteristics that are basic to an advanced capitalist economy: that financial instability is endogenous and reveals a systemic flaw in capitalism. However, the irreducable minimum of instability can be amplified and its consequences exacerbated by non-essential institutional weaknesses and policy errors. In the light of the above, reforms and changes can be made which should lead to an improvement in performance.

CAN THE FEDERAL RESERVE CONTROL THE MONEY SUPPLY?

Before the alternative theoretical basis for monetary policy is taken up the 'can' question will be examined! 'Can the Federal Reserve control the money supply?' Presumably, by ignoring consequences the Federal Reserve can set the reserve base on target. However this will not in any economically meaningful sense control the money supply. Writing in 1936, Henry Simons, a leading scholar of the Chicago school (before it became naively monetarist), noted that:

> 'Banking is a pervasive phenomenon, not something to be dealt with merely by legislation directed at what we call banks. The experience with the control of note issue is likely to be repeated in the future; many expedients for controlling similar practices may prove ineffective and disappointing because of the reappearance of prohibited practices in new and unprohibited forms. It seems impossible to predict what forms the evasion might take or see how particular prohibitions might be designed in order that they might be more than nominally effective.'[3]

Similarly money is a pervasive instrument, not necessarily limited to those liabilities – whether demand or time – of banks against which 'reserves' are kept. One aspect of money is that it is the instrument used to consumate a purchase. Thus in the financial environment of a boom various funny monies appear: any economic unit can 'emit' money, the serious problem is to get it accepted. In the late nineteen sixties various funny monies were being coined and accepted in financial transactions. In particular the complex liabilities of aggressive conglomerates are a form of funny money.

An aspect of money is that it is a widely acceptable liability used to finance positions in assets. This characteristic of money is also possessed by instruments, not usually defined as money, such as commercial paper. The explosive growth of commercial paper in the late 1960's – leading up to the Penn-Central crisis – is an example of 'money creation' outside conventional banking channels. The non-eligible acceptance is another monetary form. The development, through the 1960's, of liability management banking and sophisticated corporate cash management shows that during booms an inverted 'Say's Law' is apparently applicable: the demand for finance draws forth a supply. The Federal Reserve in the late 1960's had to be aware that it was operating in a complex financial system and that its responsibilities cover much more than any narrowly defined money supply and chartered member banks.

THE FUNCTIONS OF THE FEDERAL RESERVE

As A. B. Cramp emphasizes, central banks have both control and support functions[4]. The control responsibilities aim at achieving a desired state of the economy – be it that the desired state is measured in terms of employment, inflation or the balance of payments. The standard neo-classical view of economic policy lays down directives as to how the Federal Reserve, given the thrust of fiscal actions, is to operate on the open market, manipulate reserve requirements, and use the discount window in order to achieve a desired state of the economy. These policy rules relate to the control functions.

The Federal Reserve also has support functions. Two types of support functions

[1] C. A. Phillips, *Bank Credit*, New York; The Macmillan Co., 1920.

[2] J. R. Hicks, 'Mr. Keynes and the Classics: A Suggested Interpretation'. *Econometrica*, Vol. 5, April 1937, pp. 56-70.
D. Patinkin, *Money Interest and Prices*, New York; Harper & Row (Second edition) 1965.
F. Modigliani, 'The Monetary Mechanism and Its Interaction with Real Phenomena' *Review of Economics and Statistics Supplement*, Vol. 45, Feb. 1963, pp. 79-107.

can be identified. In one type the Federal Reserve is concerned about how particular markets operate. The concern about housing, state and municipal bonds, and 'even keeling' during treasury debt operations are examples of these interests. The second type of support function deals with the overall viability of financial markets.

In fact, the Federal Reserve was largely created for this second, the support, purpose: to prevent monetary crises and the ensuing debt deflation process. The initial and, when the need arises, still dominant function of the Federal Reserve is to act as a lender of last resort. Therefore, the Federal Reserve can only afford the luxury of ignoring its support functions if the financial system is robust. Furthermore, in its support functions the Federal Reserve quite properly looks beyond its narrow immediate responsibilities to the member banks. Its implicit charge is to support to whatever extent necessary all dimensions of the financial system so as to prevent financial disruptions that can have serious consequences upon income and employment. From this perspective the major shortcomings of the Federal Reserve in the great debt deflation of 1929-33 was not that it allowed the money supply to decrease but that it permitted asset values to drop as sharply as they did; and that it allowed banks, building and loan societies, and other financial institutions to fail to the extent that they did.

Given the broad nature of 'money' and the need for the Federal Reserve to monetize assets whenever its 'support' responsibilities are operative it is evident that the Federal Reserve really cannot control the economically relevant money supply.

SHOULD THE MONEY SUPPLY BE CONTROLLED?

Once the dual control and support responsibilities of the Federal Reserve are acknowledged, then the possibility arises that inconsistencies, or tradeoffs, between responsibilities exist. As 'controlling the money supply' is rationalized on the basis of the 'control' functions, it is immediately evident that the money supply should *not* be a proximate policy objective if the measures necessary to achieve the desired money supply have sufficient undesirable consequences with respect to the Federal Reserve's support responsibilities.

Implicitly Simons' view, as cited earlier, is that the financial institutions and usages evolve – in particular in response to profit opportunities. In a profound sense institutional evolution implies uncertainty. It is never known to market participants and the authorities how new institutions will react in novel situations. For example, the validity of deposit insurance as a generalized protection against runs on financial institutions was not tested until the credit crunch of 1966, when the insolvent position of savings intermediaries did not trigger a run on these institutions[7].

A policy posture which emphasizes support functions needs to integrate uncertainty, as a determinant of the behavior of the economy and as an attribute that can be affected by monetary policy, into its theory. It requires a view of the world in which financial system disruption can take place and can have serious consequences. A theory or model is needed in which financial crises can occur, in which the conditions for a crisis are endogenously determined, and in which such crises, once they occur, have serious effects.

THEORY AND PRACTICE

From the perspective of the economic theory of both the monetarists and the fiscalists, the events of 1966, 1970, and 1971 – the 'crunch', the 'squeeze' culminating in the Penn-Central crisis, and the dollar crisis – are not explicable. There is no place in a world that is presumed to be adequately described by their models for the endogenous determination of a boom and the conditions conducive to crisis.

As an example of the blind spots induced by inappropriate theory, Darryl R. Francis, President of the Federal Reserve Bank of St. Louis in a defense of monetarism does not mention the crunch of 1966, the liquidity squeeze – Penn-Central fiasco of 1970, and the international monetary crisis of August, 1971[8].

The ignoring of financial traumas in econonic theory and in historical analysis, is important for it affects policy choices. After both 1966 and 1970 the Federal Reserve abandoned or modified its constraining control operations in order to abort what it interpreted as an incipient financial crisis. In doing this it effectively added to the supply of assets which protect against illiquidity and appreciably increased the effective quantity of reserve money – thus facilitating the expansion of the money supply. At this time the standard reading of the economic indicators had it that the control functions called for a continued monetary constraint. Thus the Federal Reserve has been criticized for relaxing constraint too soon and is held responsible for the ensuing inflationary pressures. This criticism is based upon a theoretical perspective which holds that the events which guided the Federal Reserve's policy actions could not occur and thus implicitly never did occur.

Theory, which ignores the existence of financial instability, can lead to rules that the authorities should control the growth of the money supply to the well nigh exclusion of other considerations. Once financial instability is recognized as being at times a significant threat, then such an unconditional posture becomes untenable. Money supply control is at best a conditionally desirable policy posture.

[5] 'Rules Versus Authorities in Monetary Policy' in Henry Simons, *Economic Policy for a Free Society*, Chicago: University of Chicago Press, 1948, p.172.
[6] A. B. Cramp, 'Does Money Matter' *Lloyds Bank Review*, October 1970, pp. 23-27.
[7] H. P. Minsky. 'The Crunch and its Aftermath' *The Bankers' Magazine* February, March 1968.
[8] Darryl F. Francis, 'Has Monetarism Failed? – The Record Examined,' *Review*, Federal Reserve Bank of St. Louis, March 1962, pp. 32-38.