MERCATUS CENTER
George Mason University

POLICY BRIEF

Why There Is a Need for a New Fed History in the Spirit of Friedman and Schwartz's *A Monetary History*

Robert L. Hetzel

March 2023

A Monetary History of the United States, 1867–1960 by Milton Friedman and Anna Schwartz was one of the most influential books of the 20th century.[1] As embodied in the Keynesian consensus at the time of its publication, the prevailing belief was that a free-market economy is inherently unstable. Maintenance of full employment requires regular intervention to manage the economy by superseding the working of the price system. Exhibit A for this contention was the length of the Great Depression with its decade-long high unemployment rate.

Friedman and Schwartz challenged the Keynesian consensus. They did so by highlighting the failure of the Federal Reserve System to prevent a one-third decline in the money stock. They demonstrated how, over the entire period of 1867 to 1967 and despite different monetary arrangements, the behavior of money determined the behavior of prices. As a scholarly work, Friedman and Schwartz's book pioneered a methodology for determining whether instability of the price level or the real economy originated in the private sector or with monetary instability.

Today, the monetary aggregates no longer adequately measure the expansionary or contractionary character of monetary policy. Nevertheless, one can generalize the methodology of Friedman and Schwartz. One can ask, "Does instability arise when the Federal Reserve System fails to provide a stable nominal anchor in the form of price stability and when it interferes with the stabilizing properties of the price system?"

As summarized briefly in this paper, the author's book, *The Federal Reserve: A New History*,[2] applies the basic Friedman and Schwartz methodology to challenge the standard Fed narrative that instability arises in the private sector. For the recent past, the book critically examines Fed

policy in the Great Recession and the COVID-19 pandemic. The book reaffirms the Friedman-Schwartz conclusion that interfering in the working of the private market by attempting to juggle the two competing goals of low unemployment and low inflation using a Phillips curve is destabilizing. The Fed should provide for price stability and give the market economy free rein to work.

A Monetary History of the United States still serves as a template for a Fed history through the way that it addresses issues that remain perennial. It is instructive to start by asking why there originally was a need for the Friedman and Schwartz book.[3]

THE GREAT DEPRESSION AND THE GREAT RECESSION

When Friedman and Schwartz submitted their book for review to the National Bureau of Economic Research (NBER), which sponsored the research, it met with strong resistance led by Geoffrey Moore, the leading expert on business cycles, and the NBER directors. Moore and the directors argued that the Great Depression was caused by the collapse of a housing boom and that Fed monetary policy was powerless to offset its depressing effects on the economy.[4]

Currently, the comparable argument is that the Great Recession of 2008–2009 was caused by a collapse of a housing boom and that the Fed encouraged it through its concentration on price stability. Along with Treasury Secretary Henry M. Paulson, then-Fed chairman Ben Bernanke lobbied Congress for the Troubled Asset Relief Program (TARP) to buy mortgage assets from banks. That is, Bernanke and Paulson believed that, unaided by fiscal policy to recapitalize the banking system, monetary policy could not mitigate the recession.

Both the Great Depression and the Great Recession of 2008–2009 discredited capitalism. One reason is that the public associates recession with the collapse of speculation by large banks and an ensuing disruption to financial intermediation. The public also associates large banks with capitalism. More generally, both downturns propagated the idea that instability is an inherent feature of a free-market economy and that financial intermediation undisciplined by heavy government supervision leads to speculative excess. In the spirit of *A Monetary History*, the author's book, *The Federal Reserve: A New History,* counters this popular narrative.[5] The book (chapter 21, "The Great Recession") makes the case that the Great Recession was caused by contractionary monetary policy just as contractionary monetary policy caused the Great Depression as well as other recessions. Accordingly, the book challenges the belief that the turmoil in financial markets in fall 2008 demonstrated the failure of capitalism just as *A Monetary History* challenged the Keynesian consensus that the Great Depression demonstrated the failure of capitalism.

Chapter 22 ("The 2008 Financial Crisis") challenges the popular narrative that the collapse of financial speculation, as evidenced by a bursting of a bubble in the housing market, caused a break-

down in the ability of banks to conduct financial intermediation by imposing losses on their balance sheets. A similar belief during the Great Depression, that a failure of financial intermediation was the cause of unemployment, led to the creation of a variety of government intermediaries, such as the Reconstruction Finance Corporation, the Federal National Mortgage Association, the Federal Home Loan Bank, and the Farm Credit Administration.

During the Great Recession, the Bernanke Fed devoted considerable effort to intervening in credit markets. It attempted to stimulate the housing market through the purchase of mortgage-backed securities (MBS). It attempted to undo the flight of short-term investors from banks heavily invested in long-term, problematic packaged subprime mortgages by means such as creating the Term Auction Facility and swap lines with other central banks, which lent dollars to their domestic banks. In response to the pandemic, the Fed, under Jerome Powell, also intervened massively in credit markets, not only through the purchase of MBS but also through programs that took on the tail risk of corporate and municipal securities. Heavy Fed involvement in the allocation of credit conveys the message that a free-market economy fails to allocate credit to socially desirable uses.

PRICE STABILITY AND A STABLE MONETARY FRAMEWORK

Also, Friedman and Schwartz's *A Monetary History* documented the relationship between inflation (deflation) and the rate of money growth. On several occasions, Powell, as chair of the Federal Open Market Committee (FOMC), has denied any relationship between money growth and inflation. That denial accords with the FOMC's belief that it controls inflation by managing slack in the economy (the level of the unemployment rate relative to a noninflationary value, the nonaccelerating inflation rate of unemployment [NAIRU]). At the same time, after March 2020, in response to the pandemic, the Fed monetized a large amount of the debt used to finance government transfer payments to households. With the lag predicted by Friedman, underlying inflation did rise. Can it really be that the United States operates with different laws of economics than countries like Zimbabwe, Venezuela, and Argentina?

Friedman famously proposed a rule that would require the Fed to grow the money supply at a steady rate. Although no longer feasible because of instability in the measured monetary aggregates, monetary policy in the Volcker-Greenspan era, as documented in *The Federal Reserve: A New History,* followed a rule in this spirit. Monetary policy followed a strategy that provided a stable nominal anchor and gave the price system free rein to determine real variables (employment and output). The concentration of policy on price stability meant that the FOMC fulfilled its mandate of maximum employment as the outcome of a healthy economy. This period came to be known as the Great Moderation.

The idea of providing a stable monetary framework in the form of price stability to support the operation of a free-market economy runs counter to the willingness of the Powell FOMC's effort to use monetary policy in an active way to deal with social problems. That effort appeared in the desire to achieve an unemployment rate low enough to ensure full employment in minority communities. It is also consequential that the Powell FOMC's policy implicitly rejects the Friedman hypothesis that inflation is a monetary phenomenon. Pursuing "low" unemployment to aid minority communities entails accepting a framework of tradeoffs between the two independent goals of low unemployment and low inflation. That framework is presumed to be made operational by the empirical relationship termed the *Phillips curve*. This policy of juggling the two goals of low unemployment and low inflation characterized the stop-go era of the 1970s, a policy abandoned during the subsequent Great Moderation. Such an activist policy is premised on an ability to forecast the amount of inflation implied by the periodic instances of pursuing an expansionary monetary policy to lower unemployment.

CAN THE FED REALLY TRADE OFF BETWEEN INFLATION AND UNEMPLOYMENT?

With its assumed structural relationship between unemployment and inflation, the Phillips curve builds on the assumption that inflation is a nonmonetary phenomenon. Unemployment is part of the real economy whereas inflation is the change in the value of a piece of paper (the dollar). The working assumption then is that to control inflation, the Fed manipulates the unemployment rate or, more generally, the amount of slack in resource utilization. Entering the decade of the 1970s, a massive consensus existed in favor of this view. In the 1970s, the Fed based monetary policy on this nonmonetary view of inflation.

Friedman was the foremost critic of monetary policy based on Phillips curve tradeoffs. He argued that the required forecasts would inevitably mislead policymakers. He was right in the 1970s and again in 2021. In the 1970s, the Keynesian consensus assumed that 4 percent equaled full employment. That consensus held that expansionary fiscal and monetary policy could push the unemployment rate down to at least 4 percent without significant inflation. Initially, the forecast appeared to be validated. Price stability characterized the first half of the 1960s (core consumer price index [CPI] inflation averaged 1.3 percent from 1960Q1 to 1966Q1). However, in the last half of the 1960s, inflation rose (core CPI inflation averaged 5.8 percent from 1967Q4 to 1970Q4). That increase coincided with a decline in the unemployment rate to a value below 4 percent. (It fell to 3.9 percent in 1966Q1 and 3.4 percent in 1968Q4.)

However, the Keynesian forecasts then went badly off track. While the unemployment rate rose well above 4 percent in 1970, going from 3.5 percent in December 1969 to 6.1 percent in December 1970, inflation remained high. (Quarterly average core CPI inflation was 6.5 percent in 1970.) Rather than abandon the socially desirable goal of 4 percent unemployment, the Keynesian consensus then rationalized that high inflation must be cost-push in nature. The result was a decade

of experiments in dealing with inflation as a nonmonetary phenomenon. Despite wage and price controls and then jawboning, inflation rose irregularly and averaged 12 percent over the interval of 1979Q2 to 1980Q4 (quarterly average of core CPI inflation). Because of Milton Friedman and his *Newsweek* columns, by the end of the 1970s, public opinion had changed, with the public blaming the Fed, rather than corporations and labor, for inflation. With that support, Paul Volcker started the long journey of restoring price stability.

The FOMC's pandemic monetary policy replayed the FOMC's 1970s policy of aggregate-demand management to balance off the independent goals of low unemployment and low inflation. When the COVID-19 pandemic surged in March 2020, by historical accident the key policymakers at the Fed were Keynesian by persuasion. With an unemployment rate of 13 percent in 2020Q2, policymakers believed that, with that amount of slack in the economy, the FOMC could pursue a highly expansionary monetary policy to restore the prepandemic low rate of unemployment in short order (3.8 percent in 2020Q1). A flat Phillips curve would ensure that inflation would remain in check. However, by 2021Q2, inflation had risen to 8.1 percent (core CPI). With an unemployment rate of 5.9 percent in 2021Q2, well above the 3.5 percent taken as the minimum goal by the FOMC, the FOMC assumed that underlying inflation had to be cost-push in nature and thus transitory. Not until the March 2022 meeting did the FOMC raise the funds rate off the zero lower bound (ZLB).

THE FED NARRATIVE AS EX POST RATIONALIZATION

The Fed narrative, especially as shaped by FOMC chairs Bernanke and Powell, is conditioned by the need for the Fed to defend its independence against populist attacks. To this end, Fed spokespersons relate a narrative with the underlying, unstated premise that a market economy and financial markets are inherently unstable. There is then a need for an independent Fed to offset this instability through its monetary policy, lender of last resort powers, and credit allocation. Also implicit in this narrative is the assumption that FOMC strategy follows the evolution of the economy and is never mistaken. Only the difficulty of forecasting given unforeseen shocks leads to mistakes like the failure to abandon a highly expansionary monetary policy in early 2021. FOMC spokespersons do not mention the underlying strategy that explicitly abandoned the Volcker-Greenspan policy of preemptive increases in the funds rate to preserve price stability.

Policymakers are human, and it is natural that they cannot admit to making mistakes, because the consequences of a destabilizing monetary policy are so serious. A problem is that if the Fed cannot admit that it makes mistakes, it cannot learn. Just as Friedman's proposal for a rule that would ensure steady money growth ran counter to the Fed narrative that instability in the economy needed to be offset by monetary and fiscal fine-tuning, there is a need to revive a debate over a rule that would restrict monetary policy to the goal of maintaining price stability and thus allowing full employment to emerge as the outcome of a healthy economy.

A METHODOLOGY FOR DETERMINING THE SOURCE OF MACROECONOMIC INSTABILITY

Finally, the simple passage of time makes another Fed history desirable as an addition to *A Monetary History*. Economists use the term *identification* to describe the problem of determining whether the source of economic instability lies with the private sector or with destabilizing monetary policy. Friedman and Schwartz used episodes of instability as semicontrolled experiments for the testing of their hypothesis that monetary stability is a sufficient prerequisite for the functioning of a free-market economy. Through the repeated association of real instability with monetary instability in combination with evidence of monetary policy disrupting the stabilizing properties of the price system, especially through creating unpredictable movements in the price level, the concatenation of these episodes then allowed a test of the robustness of their hypothesis.[6]

Similarly, they could test their hypothesis that the source of inflation (deflation) originated in the lack of monetary control by the Fed. This methodology requires as long a historical time period as possible to capture many episodes of instability. Because *A Monetary History* appeared in 1963, there is a need for a book like *The Federal Reserve: A New History* to reaffirm or deny the validity of basic monetarist hypotheses.

The following sections use recent examples to illustrate the relevance to current debate of *The Federal Reserve: A New History*.

MONETARY POLICY AND THE GREAT RECESSION

Although popular commentary attributes the Great Recession (December 2007 to June 2009) to a disruption in financial intermediation caused by the collapse of a housing boom, contractionary monetary policy offers an explanation very much consistent with past recessions. In these past recessions, during the prior economic recoveries, the FOMC raised the funds rate steadily until the economy weakened. However, earlier it had failed to raise the funds rate preemptively—that is, sufficiently early to prevent an increase in inflation. When the economy weakened, concerned that a reduction in interest rates would signal to markets that it would tolerate higher inflation, the FOMC limited interest rate reductions. In the spirit of go-stop policy, the FOMC went from implementing an expansionary monetary policy to hasten a reduction in the magnitude of a negative output gap to implementing a contractionary monetary policy to create a negative output gap. The FOMC went from tolerating an increase in inflation to attempting to reduce inflation.

Monetary policy during the Great Recession departed from this pattern only in that the prior inflation emerged from a large, prolonged inflation shock caused by an increase in commodity prices owing to the integration into the world economy of Brazil, Russia, India, and China (the BRICs). Although core inflation (personal consumption expenditures) remained just over 2 percent, headline inflation reached 4 percent in summer 2008. Until the end of 2008, the FOMC

retained inflation as its main concern. The US and world economies entered into a severe recession in summer 2008, although given the lags in data reporting, that fact became evident only in the fall.

The FOMC lowered the funds rate to near zero only at its December 2008 meeting. The reason was that, with a 2 percent funds rate and an underlying inflation rate of 2 percent, the real (realized) rate of interest was near zero. In past experience, such a low interest rate had always been associated with expansionary monetary policy. Only later did the FOMC understand that the economy's underlying "natural" rate of interest was actually significantly negative.

Under the assumption that the problem was not contractionary monetary policy but rather a disruption to financial intermediation exacerbated by the bankruptcy of Lehman Brothers on September 15, 2008, FOMC chair Bernanke focused on credit policy. That is, guided by his work on the Great Depression, Bernanke concentrated on a credit channel. The presumed problem was not contractionary monetary policy but rather an unwillingness of banks to lend because of hits to their balance sheets caused by the presence of mortgages of dubious and uncertain value. With this assumption, policy focused on a Treasury program (TARP) to strengthen bank balance sheets, a program to revive the commercial paper market, the purchase of MBS, and swap lines so that foreign central banks would have dollars to lend to their commercial banks that had taken on US subprime mortgage debt by issuing dollar liabilities. As it later turned out, in May 2009, revealed by the stress tests undertaken by the Fed to judge the adequacy of bank balance sheets to deal with a macroeconomic shock, the banking system was well capitalized.[7]

Another perspective on why monetary policy was contractionary in 2008 can be obtained by understanding how the FOMC departed from its basic procedures for stabilizing economic growth around potential output. After the 1951 Treasury-Fed Accord, then-FOMC chair William McChesney Martin developed the latter responsibility in the form of "lean-against-the-wind" (LAW). With LAW, the FOMC moves the funds rate to counter unsustainable strength or weakness in the economy, relative to growth in potential output. Because the FOMC does not know the value of potential output growth, the guiding principle is stability in the economy's rate of resource utilization.

With LAW, starting from balanced growth, if the FOMC observes a departure in the form of sustained increases in the economy's rate of resource utilization (sustained decreases in the unemployment rate), it raises the funds rate in a persistent way. Effectively, the economy is signaling that the real rate of interest must rise because it is below the natural rate of interest (the interest rate that moves aggregate demand intertemporally to maintain output equal to potential). Converse statements hold in the event of sustained weakness. As long as the FOMC does not modify LAW to pursue an assumed socially desirable "low" rate of unemployment, it tracks the economy's natural rate of interest. In doing so, it allows market forces to determine real output and the unemploy-

ment rate. The FOMC's mandate to ensure "maximum employment" emerges as the consequence of allowing the price system to maintain output growing at potential.

However, after its April 2008 FOMC meeting, because of its concentration on high headline inflation, the FOMC abandoned its basic LAW procedures. The FOMC failed to lower the funds rate despite the growth of a negative output gap as the recession proceeded. In fall 2008, when it became clear that the US economy had entered a serious recession, Bernanke responded by attributing the recession to a failure of credit markets, not to contractionary monetary policy. A breakdown in financial intermediation supposedly prevented the transfer of savings by households to firms. Bernanke's response reflected the human side of policymakers who inevitably attribute economic instability on their watch not to their own policy but rather to instability originating in the private sector. Earlier, at a 90th birthday celebration for Milton Friedman, Bernanke commented, "I would like to say to Milton and Anna: Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again."[8]

However, through the emphasis on what Bernanke called the "credit channel," policy in the Great Recession concentrated on the need to revive lending—that is, credit policy rather than monetary policy. In the Great Depression, acting on real bills principles, the Fed forced a contraction in bank credit. Friedman and Schwartz emphasized the concomitant contraction of the money stock. However, in previous research, Bernanke (in 1983) instead emphasized the disruption to financial intermediation.[9] In a lecture in London in early 2009, Bernanke reformulated Fed policy as working through the allocation of credit by altering the composition of the asset side of bank balance sheets rather than through controlling the size of the liability side of bank balance sheets (deposits and money creation).[10]

How would policy have changed if the Bernanke FOMC had pursued a stimulative monetary policy through purposeful money creation—that is, through money creation beyond the expansion of the deposits of the large banks swollen by a flight to safety to the too-big-to-fail banks after the failure of Lehman? First, rather than initiate programs to allocate credit, the Fed could have dealt with its lender of last resort responsibility in the way that it had with the disruption in the commercial paper market after the Penn Central bankruptcy in May 1970. In that episode, knowing that all corporations issuing commercial paper had lines of credit with banks, the Fed made known to banks that the discount window was wide open to provide the reserves required to make loans to meet any credit stringency suffered by corporations that could not issue commercial paper.

Second, the FOMC could have engaged in expansionary monetary policy rather than venturing into credit policy. It could have dropped the funds rate to zero at its September 16, 2008, meeting rather than waiting until the December 15, 2008, meeting. It could have undertaken large-scale quantitative easing (QE) through the purchase of long-term Treasuries, something it did not do until March 2009. Finally, it could have used forward guidance in a policy of "lower for longer"

for the funds rate. In fact, not until the August 2011 FOMC meeting did the FOMC start forward guidance in a way that committed its future actions.[11]

UNDERSTANDING THE RECOVERY FROM THE GREAT RECESSION

What Fed policymakers thought they had learned from the recovery from the Great Recession influenced the pandemic monetary policy initiated in March 2020. However, what they thought were mistakes of policy in the recovery were in fact its virtues. What lessons should they have learned?

The first characteristic to note about the Great Recession recovery is that it was a period of considerable stability in underlying inflation (measured by any of the various core measures of inflation). Actual and expected inflation reflected a culmination of the long process initiated with the Volcker disinflation of the early 1980s to restore price stability. In the recovery, that stability gave labor markets time to solve matches between employers and job seekers, and the prepandemic unemployment rate fell to 3.5 percent. Initially in the recovery, despite a funds rate at the ZLB, monetary policy was moderately contractionary rather than expansionary. The reason was that financial markets looked to the past and saw that a strong recovery had always followed a sharp recession. Consequently, markets imparted a strong upward tilt to the yield curve, which gave monetary policy its contractionary character.

Through preemptive increases in the funds rate, policy in the Volcker-Greenspan era had concentrated not only on forestalling the reemergence of inflation but also on convincing markets of the credibility of the policy of restoring price stability. Following that precedent, the Yellen FOMC began to raise the funds rate off the ZLB in December 2015, followed by consecutive increases starting in December 2016. That continuity of policy created the stability in underlying inflation in the recovery. Also, that stability would generate a flat Phillips curve as the unemployment rate declined with no change in core inflation. By the time of the pandemic, however, the FOMC had become Keynesian by temperament. In the spirit of policy in the 1970s, policymakers then rejected the practice of preemptive increases in the funds rate. They believed that they could achieve a socially desirable low rate of unemployment by moving leftward on a flat Phillips curve until the occurrence of a presumed moderate rise in inflation.

PANDEMIC MONETARY POLICY

Prompted by the increase in the unemployment rate to 14.7 percent in April 2020 and the assumed social imperative of restoring an unemployment rate low enough to provide full employment in minority communities, the FOMC set about implementing a highly expansionary monetary policy. Given that inflation had remained quiescent in the recovery from the Great Recession with the funds rate at or near the ZLB for eight years, the spirit of monetary policy became a "lower for

(even) longer" funds rate at the ZLB. Monetary policy was designed to convince the bond markets that the funds rate would not rise before restoration of full employment, taken to be 3.5 percent or lower. The term used was *Odyssean forward guidance*. The intention was to prevent the kind of increase in the bond rate that had occurred in May 2013, when Bernanke had announced a phasing out of QE.

Odyssean forward guidance led to fundamental departures from the earlier Volcker-Greenspan-Yellen policy, which incorporated the basics of Martin's LAW monetary policy. The FOMC would no longer raise the funds rate preemptively in response to signs of overheating in the labor market. Reminiscent of the 1970s, it would raise the funds rate only with an increase in inflation. That commitment appeared in statements that a flat Phillips curve would prevent an increase in inflation even with the unemployment rate pushed down to its prepandemic level of 3.5 percent. With a policy called *flexible average inflation targeting* (FAIT), the FOMC was committed to not raising the funds rate until after an overshoot of the 2 percent inflation target by an unspecified amount for some unspecified period of time. The stated idea was to make up for the previous undershoots of the target owing to an inflation rate approximating price stability. However, FAIT was part of Odyssean forward guidance to persuade bond markets not to raise rates on the basis of a rise in inflation.[12]

In a QE policy, those departures from the Volcker-Greenspan-Yellen monetary policy combined with the significant monetization by the Fed of the debt used to finance the three pandemic transfer payments authorized by Congress to create the kind of expansionary monetary policy not seen since the 1970s. By itself, QE is stimulative in that it makes the asset portfolio of the public more liquid by replacing illiquid assets (long-term Treasuries and MBS) with liquid assets (bank deposits). To give the public the incentive to hold a more liquid asset portfolio, the price of illiquid assets (equities, houses, commodities, consumer durables) must rise. The rise in their price relative to their service flows stimulates investment. There is then an increase in the natural rate of interest required to sufficiently restrain aggregate demand to keep output equal to potential output. When combined with a policy of preemptive increases in the funds rate, however, QE does not create inflation if the policy continues to cause the funds rate to track the natural rate of interest. That was the situation in the recovery from the Great Recession. However, that was not the case with the pandemic monetary policy. The portfolio balance effect of raising the price of illiquid assets combined with maintenance of a zero funds rate caused QE to mimic helicopter money.[13] Friedman would have predicted the rise in underlying inflation that occurred in 2021.

Effectively, the Powell FOMC returned to the aggregate-demand management (fine-tuning) of the 1970s. It did so as a consequence of making a low unemployment rate an independent goal in addition to low inflation. With unemployment and inflation as independent goals, there must be some way of predicting their relationship. That necessity places the Phillips curve at the center of the policy process. The Phillips curve implies that the FOMC moves inflation (a dollar variable) by controlling a real variable (slack in the economy or the unemployment rate relative to a

value consistent with stable inflation—the NAIRU). The result was go-stop monetary policy as a consequence of first concentrating on the unemployment goal and accepting a rise in inflation as a byproduct of lowering unemployment and then concentrating on the inflation goal and accepting a rise in the unemployment rate as a byproduct of lowering inflation. Thus, by January 2023, underlying inflation had risen, and the economy faced the prospect of a recession. Nothing in this stop-go (go-stop) scenario would have surprised Milton Friedman.

CONCLUDING COMMENT

The standard Fed narrative builds on the premise that a market economy is inherently unstable. That narrative implicitly ignores the stabilizing properties of the price system as irrelevant. The stabilizing force in the economy is presumed to be a monetary policy that counters the shocks that arise in the private sector. The Fed can serve this function because it exercises predictable control over the real economy. As expressed in the dual mandate, policy adjustments are based on whether those shocks reduce employment below its "maximum" level or raise inflation above a level taken as "price stability."

In the recent context, the initial shock was an increase in the unemployment rate after the COVID-19 virus erupted in March 2020. The FOMC then instituted an extraordinarily expansionary monetary policy made credible by a rejection of the Volcker-Greenspan-Yellen policy directed toward price stability and the associated rejection of preemptive increases in the funds rate at signs of overheating in labor markets. In a historic first, with FAIT the FOMC purposefully pursued an increase in inflation. The money creation resulting from significant monetization of the pandemic payments made to the public, when combined with a promise of a funds rate kept at the ZLB for an indefinite period, ensured an increase in underlying inflation. Headline inflation rose with the combined increase in underlying inflation and two inflation shocks: the disruption of supply chains from the pandemic and later the invasion of Ukraine produced an increase in the price of food and energy. The rise in underlying inflation then required a contractionary monetary policy.

The Fed narrative resuscitates the Keynesian narrative of the 1970s. At present, March 2023, the FOMC has committed to lowering inflation to 2 percent. In the 1970s, Arthur Burns also sincerely professed the belief that monetary policy should aim for price stability. The issue is whether a policy of juggling two independent goals, low inflation and low unemployment, is a feasible long-term policy consistent with economic and price stability. In the spirit of the Friedman and Schwartz book *A Monetary History*, *The Federal Reserve*: *A New History* provides an alternative to the Fed narrative in the monetarist spirit. Monetary policy should provide a stable framework for the operation of a market economy by concentrating on the maintenance of price stability.

ABOUT THE AUTHOR

Robert Hetzel received an AB degree in 1967 and a PhD in 1975, both from the University of Chicago. While at Chicago, he was in the Money and Banking Workshop and did his thesis work under Milton Friedman. He joined the Research Department at the Federal Reserve Bank of Richmond in 1975, where, as a senior economist and research adviser, he advised the bank president on matters concerning the president's participation in meetings of the Federal Open Market Committee. Hetzel retired in January 2018. His research agenda is the evolution of central banking in the modern regime of fiat money.

NOTES

1. Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States, 1867–1960* (Princeton, NJ: Princeton University Press, 1963).
2. Robert L. Hetzel, *The Federal Reserve System: A New History* (Chicago: University of Chicago Press, 2022).
3. In the early 1970s, I was a member of the Workshop in Money and Banking at the University of Chicago, which was run by Milton Friedman. In 1975, with Friedman as my thesis adviser, I earned a PhD in economics. Upon graduation in 1975, I worked as an economist at the Federal Reserve Bank of Richmond for more than 42 years. During that time, my job was to prepare the Richmond Bank president for Federal Open Market Committee meetings. I maintained regular contact with Friedman until a couple months before his death.
4. Geoffrey H. Moore, NBER, letters written to Milton Friedman, January 5, 1962, and January 25, 1962, originally in the office of Milton Friedman, Hoover Institution.
5. Hetzel, *The Federal Reserve System*.
6. See Christina D. Romer and David H. Romer, "Does Monetary Policy Matter? A New Test in the Spirit of Friedman and Schwartz," in *Macroeconomics Annual 1989*, ed. Oliver Blanchard and Stanley Fischer (Cambridge, MA: MIT Press, 1989), 121–70.
7. See Hetzel, *The Federal Reserve System*, 498.
8. Ben S. Bernanke, Remarks at the Conference to Honor Milton Friedman, University of Chicago, Chicago, IL, November 8, 2002.
9. Ben S. Bernanke, "Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression," *American Economic Review* 73 (June 1983): 257–76.
10. Ben S. Bernanke, "The Crisis and the Policy Response" (speech delivered at the Stamp Lecture, London School of Economics, London, January 13, 2009).
11. The statement issued by the FOMC meeting on August 9, 2011, said, "The Committee currently anticipates that economic conditions—including low rates of resource utilization and a subdued outlook for inflation over the medium run—are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013." Board of Governors of the Federal Reserve System, "FOMC Statement" (news release, August 9, 2011).
12. For a critique of FAIT and the case for refiguring it as a level target for nominal GDP, see David Beckworth and Patrick Horan, "The Fate of FAIT: Salvaging the Fed's Framework" (Mercatus Working Paper, Mercatus Center at George Mason University, October 18, 2022).
13. See also Joshua R. Hendrickson, "Is the Quantity Theory Dead? Lessons from the Pandemic" (Mercatus Working Paper, Mercatus Center at George Mason University, January 17, 2023).