RESEARCH SUMMARY

Setting Monetary Policy without Measuring the Money Supply: Why the Federal Reserve Needs to Change the Current System

During most of the period since 1959, the Federal Reserve’s operational model for monetary policy has not used measures of the money supply called monetary aggregates. Simply put, the Federal Reserve (Fed) does not focus on the size of the money stock in setting monetary policy. Instead, the Fed and other central banks rely on models with “strict” interest-rate targeting. In these models, the target rate is determined by changes in the output gap (the difference between a country’s estimated potential level of output and its actual level of output) and the inflation rate.

Hylton Hollander and Lars Christensen argue that such models result in monetary policy being less effective than it could be. In “Monetary Regimes, Money Supply, and the US Business Cycle since 1959: Implications for Monetary Policy Today,” the authors conclude the following:

- Monetary aggregates explain the cyclical variation in US output growth.
- Monetary aggregates should thus play a role in determining monetary policy.
- If the Federal Reserve had been less committed to its strict interest rate targeting, the United States would have recovered faster from the Great Recession of 2007–2009.

MONEY AND THE US BUSINESS CYCLE

Central bankers do not use monetary aggregates in their models because there is no stable relationship between monetary aggregates and interest rates (central bankers’ preferred mechanism to conduct monetary policy). However, this neglect of monetary aggregates ignores the relevance of the supply and demand for money in the economy. This is especially problematic because interest rates do not necessarily accurately demonstrate the stance of monetary policy.

For example, lowering interest rates (all else being equal) would be an expansionary monetary policy, but interest rates fall during recessions and rise with inflation. Thus, a low interest rate could actually be a sign of “tight” money rather than of expansionary monetary policy.

On the other hand, monetary aggregates do a good job of explaining the “ups and downs” of the US business cycle. If the Fed had relied on models where monetary aggregates played a role in setting monetary policy, there would have been a much larger monetary expansion during the Great Recession, which would have dramatically hastened economic recovery.
KEY TAKEAWAYS

• The money stock plays an essential role in the economy and in the determination of price levels and inflation. Central bankers should therefore incorporate changes in the money stock into their decisions about monetary policy rather than rely on strict interest targeting.

• Central banks should focus on long-term goals such as the inflation rate or the growth of nominal income (the total sum of spending in the economy) rather than focus on short-run interest rate targets.