First Trust
Weekly OUTLOOK

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Friedman vs Woodford

Milton Freidman taught us all about monetary policy…but for some reason academics and the Federal Reserve have decided to ignore him.

There appear to be two reasons for this. First, he was a "classical liberal." What today we would call a conservative. He believed in small government and freedom. Clearly there are not many academics left who believe in that.

Second, he argued it would be better to replace the humans at the Fed with a computer program to grow the money supply at a steady pace. Obviously, the humans at the Fed have a serious problem with this. So, ignore him.

Friedman told us exactly why we had the inflation of the 1970s…too much money printing. The same thing happened during COVID…the money supply soared and so did inflation. Now, we live in the aftermath of that failed experiment and the Fed is having a very hard time deciding what to do to bring it back under control.

Every day, analysts by the boatload debate whether we should move interest rates up or down. And it seems like every Fed member who speaks only gets a headline if they say they will vote to hike or cut, when, and how many times.

This was important historically, because under the monetary policy regime that existed prior to 2008 the money supply and interest rates were directly linked. The Fed operated in a "scarce reserve" system. If the Fed said it wanted interest rates lower than what it really meant was that it was going to increase the amount of reserves in the banking system. If it wanted the federal funds rate to rise, then it squeezed the amount of reserves in the system.

Back then, banks borrowed and lent reserves to each other. Banks all had Federal Funds Trading Desks; there was an actual market for reserves. In that regime, there were two ways to decide whether monetary policy was tight or loose. One, just look at money growth. If it was growing faster than the economy, then inflation would likely pick up…the classic "too much money chasing too few goods" of the Friedman era.

But the second was to compare interest rates to nominal GDP. Nominal GDP is the average growth rate of all the sectors in the economy. It includes "real" growth and "inflation." If you are lending money, you should be compensated for the loss in the value of your money due to inflation *plus* a real return for the risk of lending or the opportunity cost of not making a different investment. So, nominal GDP is a good target for interest rates.

Economists have come up with alternatives to this rule. One was invented by John Taylor. The Taylor Rule wasn't exactly targeting nominal GDP, but it was close. All of these methods attempt to use fundamental macroeconomic values to determine a real rate plus inflation that would keep interest rates in a "neutral" position. Not too tight or too loose.

All of these rules show exactly why the policies of the 1960s and 1970s caused inflation but the policies of Paul Volcker and Alan Greenspan in the 1980s and 1990s did not.

In the 1960s and 1970s interest rates were held well below nominal GDP. The way the Fed was able to hold rates this low is by adding money to the banking system. So, low interest rates and excess money growth were the same.

Volcker and Greenspan held interest rates close to nominal GDP and that meant the money supply was growing more in-line with the economy. This is why inflation was out of control in the 1970s but came back down and stayed down in the 1980s and 1990s.

All of this changed in 2008, when Ben Bernanke changed the Fed's policy regime to one of "abundant reserves." Essentially, through Quantitative Easing, the Fed flooded the banking system with reserves. Reserves were no longer scarce and banks no longer traded them. All those Federal Funds Trading desks are gone. What this means is that there is no longer a market for reserves. This de-linked interest rates and money supply growth; they are both determined independently. The Fed just sets short-term interest rates where it wants them. We have called this price fixing because there is no longer any market input. If the Fed wants to hold rates at zero, it just does it.

Why did the Fed do this? Partly because of the theoretical work done by Michael Woodford, the most recent recipient of the Nobel Prize in Economics. Many academics and members of the press are praising his work. We do not.

To Woodford, monetary policy isn't just about monetary policy itself but the public's expectations of monetary policy in the future. So, for example, he thought that in the aftermath of the Financial Crisis the Fed should commit to keeping rates low for an extended period, a policy it repeated during COVID with horribly inflationary results. In turn, Quantitative Easing – the Fed buying hundreds of billions and ultimately trillions in Treasury debt – was a tool to implement forward guidance.

But a pre-commitment to holding rates low and adding more money to help the economy grow through a crisis also signals that the Fed doesn't care as much about the actual long-term path of the economy. This means it's committing to potentially bad policy. If the Fed were omniscient about the future path of the economy, the economy wouldn't have run into certain problems in the first place. Forward guidance discounts the possibility of something unexpected happening.

Some still believe forward guidance helped the Fed deal with the Financial Crisis, but the stock market kept falling well after short-term interest rates bottomed and the Fed started Quantitative Easing. Instead, the real catalyst for recovery was ending overly strict mark-to-market accounting policies, which then gave financial firms some breathing

room. Until this is widely accepted, the Fed will continue to make mistakes.

So, to go back to our opening comments, Milton Friedman wanted to take human foibles and political pressure out of monetary policy. Bernanke, Yellen, Powell, and even Greenspan near the end of his tenure, were swayed by Woodford (and others) that the Fed could manage public expectations about future actions and actually control the economy completely.

But making a mistake in monetary policy is one of the worst things any country can do. A stable value for the purchasing power of a nation's currency is as important to an economy as a constitution. And, clearly, this recent experiment in monetary policy has been a complete failure.

The sooner we come to recognize this, the better. Unfortunately, it's hard to take power away from bureaucratic institutions once they have taken it.

To give a Nobel Prize to Woodford, a godfather of abundant reserves, puts an academic star of approval on this policy. Friedman also won a Nobel Prize for his work, but because it criticized the human management of monetary policy, the Fed wants to ignore it. Powell actually said the relationship between M2 and inflation "no longer holds" and is something we "have to unlearn."

Clearly, seeing M2 grow 42% during COVID followed by 9% inflation would suggest he was wrong. Nonetheless, many have alternative explanations for our current bout of inflation and still cling to the belief that money doesn't matter.

Clearly, we are critical of the current monetary policy regime. Our new Fed Chair, Kevin Warsh, is also critical of this regime. Nonetheless, any wholesale change in the system does not seem to be in the cards, at least anytime soon. So, for the time being, we are living in a regime where the Fed must set interest rates where it thinks they should be. How does it do that?

By keeping the funds rate close to nominal GDP. During the 1980s and 1990s this worked well, but then at the end of Greenspan's tenure he made a mistake and held rates too low in the aftermath of the dot.com crash. This helped fuel the housing bubble which led to the Great Financial Crisis, where the Fed kept rates at rock-bottom near-zero levels for several years. Yes, inflation stayed tame in spite of prolonged low rates, but that was largely because of banks having to rebuild capital after the mark-to-market meltdown and then having to meet higher capital standards.

Then, in 2021-22, nominal GDP growth far outpaced short-term rates again, and the results were far different than the tame inflation after the Financial Crisis. This time inflation soared, with the old relationship from the 1960s-70s coming back with a vengeance.

Clearly, if the Fed actually believes interest rates are more important than the money supply, it has some explaining to do. Why did seven years of near zero percent interest rates not lead to inflation, but two years of near zero rates did?

All of this brings us back to some simple truths. If the Fed is going to be setting interest rates where it wants, it should set them according to macroeconomic forces. And if interest rates are not linked to money growth, then it should not allow money growth to surge or collapse.

For interest rates, they should target nominal GDP. In the past two years (through the second quarter), nominal GDP is up at a 5.5% annual rate, which signals that a federal funds target rate of 3.875% is probably too low. It is unlikely the Fed will lift them next week because of the looming election, but we do expect a rate hike later this year. December seems most likely. For the money supply a 5.5% to 6.0% growth rate seems appropriate.

The big question for rates is how fast will nominal GDP grow. The AI investment boom, and the wars in Iran and Ukraine, are impacting all the data. Nominal GDP might be re-accelerating. Retail sales (+0.8%), industrial production (+0.7%), and producer prices (1.3%) all grew rapidly and beat consensus expectations. Consumer prices also went up fast (+0.6%), although as expected.

We get a GDP report next week and, for now, we expect real GDP growth at about a 3.3% annual rate and nominal GDP growth at about a 5.3% pace, which is in line with the past two years. The robust economic reports for September suggest momentum into the fourth quarter is picking up.

In the meantime, new Fed Chairman Kevin Warsh is trying to get the Fed out of the game it's been in for the past roughly twenty years of providing too much "forward guidance" about the future path of monetary policy, so much that he thinks the Fed has sometimes found itself in the position of implementing a monetary policy because the financial markets came to expect it rather than that policy being the most appropriate for the Fed to meet its goals.

Unfortunately, the policy of "forward guidance" still has a great deal of support in some quarters. Especially, given the recent Nobel Prize recipient. All of this makes the future more uncertain than it should be.

The bottom-line is that with the new policy regime the Fed has lost touch with the economy. It has eradicated a lot of market feedback by eliminating banks from trading federal funds. It has separated interest rates from money supply growth. It has attempted to manage public perceptions but has now lost touch with them. Friedman was right, human management of monetary policy increases the risks of making long-term mistakes.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-20 / 7:30 am	Housing Starts – Sep	1.300 Mil	**1.310 Mil**		1.275 Mil
10-22 / 7:30 am	Initial Claims – Oct 17	200K	**199K**		199K

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