

RESEARCHBUZZ

Money Growth Has Slowed Sharply—Should Anybody Care?

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Milton Friedman, the most influential economist of the 20th century and one of the greatest economists of all time, died on November 16, 2006 at age 94. He will be remembered as the most articulate and insightful advocate since Adam Smith of free markets and capitalism. He was the winner of the prestigious John Bates Clark award in 1951 and the Nobel Prize in 1976. He made major contributions to monetary theory and policy issues. He was famous for his conclusion that “inflation is always and everywhere a monetary phenomenon,” and for the related notion that ultimately the only thing a central bank, such as the Federal Reserve System, can control is inflation, and not output, employment, interest rates or other items that politicians and other interest groups typically urge central banks to control.

This article focuses on some of his more important ideas about money and monetary policy, both as a memorial and because his views remain controversial in their application, although not in their general acceptance. Friedman emphasized the role of the quantity of money and its growth rate in determining the pace of inflation and, when volatile, in causing business cycles. He also was a strong advocate of “rules versus discretion” in the conduct of monetary policy. In his view, the Federal Reserve has been the principal source of cyclical instability and major inflation episodes since its founding. He concluded that central banks should be given a rule to increase a measure of the nation’s money stock at a given fixed rate per year so that discretion in trying to improve economic performance would be removed.

By the 1980s, Friedman had been extremely persuasive so that economists, policymakers and

ordinary citizens had learned the lessons of the importance of money and how to properly conduct monetary policy. For example, the US Congress mandated in 1975 (House Concurrent Resolution 133) that the Fed report annual targets for the growth rates of money and credit. This directive was formalized in amendments to the Federal Reserve Act in 1977. By 1987, however, the Fed stopped reporting a target for the narrow measure of money used in transactions called M1 and by 1992 they downplayed targets for a broader measure, actually preferred by Friedman, called M2. When the relevant statute expired in 2000, the Fed ceased stating any target which might influence market expectations or be useful as a standard for performance or accountability.

The reason that US policymakers ignore monetary aggregates is that deregulation and financial innovations have distorted the measures of money so that there is no stable empirical relationship between monetary aggregate measures and nominal spending or income, or with inflation. As a result, while Friedman’s greatest contribution to monetary policy, the importance of controlling the quantity of money in the economy in order to control inflation and stabilize output and employment, has been widely accepted, it has only been implemented in highly abstract and immeasurable terms.

Friedman always argued that it did not matter which measure of money one chose in order to conduct monetary policy because they all usually moved up and down in similar patterns. The chart shows that for M1 and M2, this is generally true, as well as for a measure of M1 adjusted for retail sweep accounts that, due to a technical innovation in 1994, began to be swept into higher-interest bearing accounts that did not have reserve requirements and were not part of M1. The innovation and its effects are discussed in Anderson and Rasche (2001). There are periods when the two measures, and after 1994 the three measures, showed divergent movements, but generally their growth rates did move up and down together, as Friedman suggested.

The adjusted M1 series is the least distorted by financial innovation and bears the closest relationship to economic activity and inflation. Sharp slowings in adjusted M1 are accompanied, or soon followed, by the onset of recessions. Recently this was visible for the slowing in M1-adjusted growth in 1999-2000, which was followed by the slowing of the economy in 2000-01, and for the subsequent monetary-led rebound. The latest slowing in monetary growth occurred from mid-2004 to the end of 2005 and is presumably related, at least in

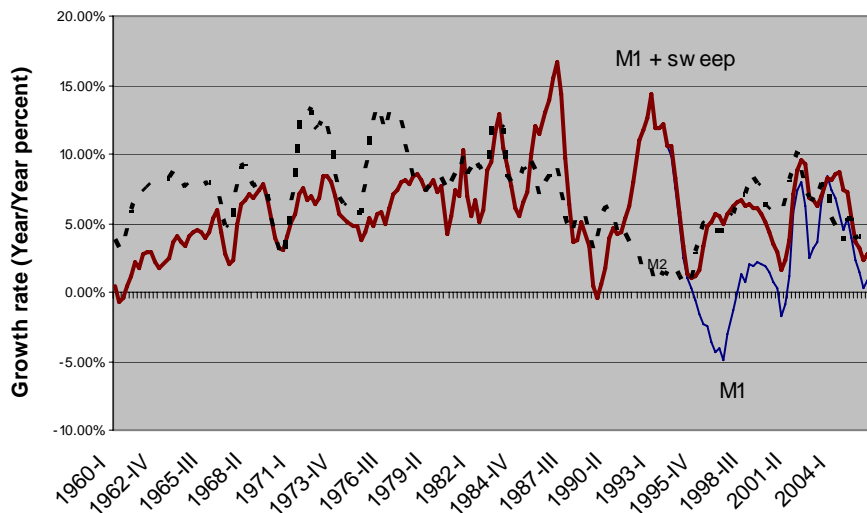
said,
 “Now that his 18-year stint as Chairman of the Fed is finished, I must confess that his performance has persuaded me that he is right – **in his own case.**” (emphasis added)

In his letter to Gregory Mankiw, a leading Harvard economist and recent Chairman of the President’s Council of Economic Advisers, Friedman reiterated his critique of central bankers, noting that:

“I have come to the conclusion that central bankers have done a wonderful job of pulling the wool over the eyes of economists. They led us all to believe that maintaining a relatively stable price level is a very difficult problem that requires the judgment of the wisest of experienced bankers and business people. ... Nothing that I have observed in recent decades has led me to change my mind about the desirability of a monetary rule which simply increased the quantity of money at a fixed rate month after month, year after year. That rule would get rid of the mis-

takes and that is probably about all you could expect to get from a monetary system.”

Growth rates of monetary aggregates often follow similar paths



part, to the slowing in real GDP growth that began earlier this year.

Why has the Fed done so well?

The economy has been spared a replay of earlier monetary policy mistakes despite the reduced focus on the quantity of money. Friedman recognized the superior job that the Fed has done since 1987 in bringing inflation down and in keeping it down during the Greenspan era. (See “He Has Set a Standard”). This was an astounding vote of approval by an economist who had built a reputation for seeing no positive benefit to having a Fed with discretionary power. But he was quick to point out that the achievements of the Fed from 1987 to 2006 were the result of the leadership of Chairman Greenspan, not to some new found institutional process or procedure. He also neglected to mention the two recession in 1990-91 and 2001. Speaking of Alan Greenspan’s support for discretion and opposition to rules, Friedman

Perhaps the deterioration of acceptance of Friedman’s insight is most evident in Gregory Mankiw’s suggestion in recent correspondence with Friedman, that the earlier poor performance of the Fed was due to bad luck, and the successes under Greenspan were simply good luck (See his response in Friedman, “Letter from Milton”)

A middle view, and perhaps the dominant view today, is that the Fed has focused on monetary aggregates and inflation control by more aggressive settings of the federal funds rate, the rate at which financial institutions borrow and lend, generally overnight, funds held on deposit at the Federal Reserve as reserves. A given change in the fed funds rate will bring about the appropriate change in the growth rate of money, even if the latter cannot be observed or measured with precision. It is reminiscent to many observers of the

story of the emperor who had no clothes. Policymakers are victims of the same cognitive dissonance as academic economists: they study and prepare policy views on monetary policy without mentioning, measuring, or being accountable for money growth.

A Focus on Money is Still Important Abroad

In the rest of the world, attention to monetary aggregates remains stronger. For example, the founding of the European Central Bank (ECB) in 1998 was premised on a continued focus on monetary aggregates, following the famous success of the German Bundesbank in targeting monetary aggregates in order to secure price stability. On November 9-10 of this year, the ECB held a conference on “The Role of Money and Monetary Policy in the Twenty-first Century.” The purpose of the meeting was fundamental. The President of the ECB, Jean-Claude Trichet, reflected the depth of the issue when he concluded that, while there is room for refinements to the intellectual framework used as a basis for monetary policy deliberations, “I remain convinced that we should not discard elements – such as monetary analysis – that have served central banks well in the past.”

President Trichet highlighted that the use of a monetary growth pillar and its associated “careful analysis of monetary developments in real time” as “helping the ECB shape its assessment of the economic situation and the associated risks to price stability,” and improved its policy decisions. Further, he noted that the importance attached to the monetary pillar has “contributed to shaping agents’ expectations in a manner which enhanced the credibility of the ECB.”

The absence of monetary targets in the US provides a vacuum, of sorts. Policymakers are aware that a policy regime change and/or poor performance in achieving low inflation could incite pressure on the Fed to restore monetary aggregate targets in order to provide a means to monitor, assess and hold accountable their behavior. The drive to implement an inflation target is part of Fed’s response to this potential problem. It is doubtful that the Fed will restore a monetary aggregate target, but at least a few policymakers will secretly be reviewing monetary developments before decisions are taken, even in America. And

a consensus of analysts and policymakers will continue to propagate the mantra that “inflation is always and everywhere a monetary phenomenon.”

Milton Friedman continued to be active right up to his death. *The Wall Street Journal* published his last article on November 17, the day following his death. In it, he compared the path of money growth surrounding the Great Depression and the end of stock price bubbles in the early 1990s in Japan and in 2000 in the US. He showed that cyclical slowdowns were predicted by slowing money growth and that the cyclical slowing was larger, the larger was the slowing in money growth.

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Sarbox Overhaul and Small Business

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Sarbanes Oxley (SOX) reform has drawn widespread attention recently, particularly eyeing the implications of SOX and the need for reform to benefit small businesses. NFI will itself visit issues pertaining to regulation and corporate governance at our November 28 Financial Forum, [In Search of Effective Corporate Governance](#). The trouble spot is Section 404, pertaining to companies' internal financial controls; small business is concerned about how Section 404 is applied to companies with \$75 million to in excess of \$700 million in market capitalization. Small businesses complain that the requirements of Section 404 are too expensive and engulfing. The Public Company Accounting Oversight Board (PCAOB), set up under SOX to police the audit industry, recently submitted a draft proposed 404 audit standard revision to the Securities and Exchange Commission (SEC), but it apparently failed, in its first draft, to meet SEC concerns where treatment of small companies is concerned. SEC Chairman Christopher Cox and PCAOB Chairman Mark W. Olson met on Sunday, November 12, 2006 to discuss the Section 404 sticking points and are now apparently in very close agreement. These proposed changes are scheduled to be adopted by the SEC commissioners on December 13 of this year.

The current impetus for change regarding Section 404 is the culmination of efforts on several fronts. An SEC advisory committee on smaller public companies, co-chaired by Henry Wander and Jasper, Indiana's James C. Thyen, President and CEO of Kimball International, Inc., released in April 2006 a report and series of 33 recommendations, whose primary recommendation was that "a new system of scaled or proportional securities regulation for smaller public companies based on stratification of smaller companies into two groups, microcap companies and smallcap companies" (Wander & Thyen 2006), a provision that SEC's Cox supports. Microcap companies are defined as having less than \$128.2 million in market capitalization, and smallcap companies as having between \$128.2 and \$787.1 mil-

lion in market capitalization. More controversially, the advisory committee recommended exemption from the SOX Section 404 internal audit provisions for microcap companies with less than \$125 million in revenues annually and to smallcap companies with annual revenues less than \$10 million, and similar categories of exemption from Section 4054, which concerns external auditing involvement. While Cox and the SEC have rejected this approach, they have proposed changes intended to guide companies of various sizes in complying with SOX provisions.

Additional governmental and regulatory inquiries into SOX effectiveness include the SEC Roundtable on Second-Year Experiences with Internal Control Reporting and Auditing Provisions, held on May 10, 2006. Their written comments are available, as is an April 2006 report from the U.S. Government Accountability Office entitled *Sarbanes-Oxley Act, Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies*.

While the national Chamber of Commerce has issued several legal challenges to SOX provisions, with some success, another independent group looking into SOX and "how to improve the competitiveness of U.S. capital markets" (Metz 2006) is the Committee on Capital Markets Regulation. Formed in September of this year, this group of business, financial, investor, corporate governance, legal, accounting and academic experts intends to issue a November 30, 2006 report of recommendations aimed at policymakers. The Capital Markets Regulation Committee is co-chaired by Columbia Business School Dean Glenn Hubbard and Brookings Institution Chairman of the Board John L. Thornton and directed by Hal S. Scott, Nomura Professor and Director of International Financial Systems at Harvard Law School.

In light of all these inputs, the SEC announced in May 2006 its intention to issue guidance for companies and to work with the PCAOB on internal control auditing standards revisions. Connecticut Senator Christopher Dodd, who will lead the Banking Committee in the Democratically-controlled Senate, and Massachusetts Representative Barney Frank, who will head the House Financial Services Committee, have both expressed interest in reviewing SOX with an eye

to easing its more onerous provisions. Incoming House Speaker Nancy Pelosi “has already identified revising the 2002 Sarbanes-Oxley law as a top priority” (Levy and Westbrook 2006). Regardless, business groups continue to pin their hopes on such administratively-imposed changes to SOX rather than on legislative mandates for change under a Democratic Congress. Business wants to reduce costs associated with Section 404 internal audits, rid themselves of the need to document “things that have nothing to do with the integrity of their financial statements” and bring back to the U.S. the large number of IPOs that are now being done through foreign exchanges, in part because of regulatory hassles (Scannell and Solomon 2006). NY Senator Charles Schumer and New York City Mayor Michael Bloomberg’s November 1, 2006 *Wall Street Journal* commentary entitled “To Save New York, Learn from London,” highlights the loss of IPOs that are no longer done in the U.S. Schumer and Bloomberg blame the perfect storm of “globalization of capital markets, overregulation, frivolous litigation and incompatible accounting standards” for the threat to New York’s pre-eminence as the world’s financial capital. SOX reform figures strongly in Schumer and Bloomberg’s proposed approach to rectifying these factors that work against the U.S. financial markets, along with curbs on securities class action lawsuits and a willingness to adopt international accounting standards.

By November 17, 2006, SEC’s Cox, PCAOB’s Olson, and U.S. Department of the Treasury Secretary Henry M. Paulson were striking unified tones regarding the forthcoming proposed changes. Cox spoke in London to the International Organization of Securities Commissioners, promising internal audit controls that are “top-down, risk-based and focused on what truly matters” (Burns and Scannell 2006). Olson, speaking to financial executives in Manhattan, said that while the internal controls genie cannot be put back in the bottle, that auditors could “dial back” their internal controls checks over financial reporting. He reported to his audience that the SEC and PCAOB are “very close” in their approaches on these issues (Reilly 2006). Paulson spoke on November 20 to the Economic Club of New York, discounting the need for legislative changes to SOX and instead focusing on reformed

implementation provisions that yield greater efficiency and cost effectiveness (Solomon 2006).

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