Is Monetarist Policy a Sustainable Model for The United States?

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Abstract

Monetarism is a school of economic thought put forward by American economist Milton Friedman. Friedman advocated strongly for free markets and limited government intervention in the economy. This paper proposes that America's economy can be reinvigorated by applying monetarist principles. Monetarism promotes free markets through lower inflation and financial independence from governments. Monetarism also promotes economic activity by incentivizing purchases. In the paper, I discuss some criticisms levelled against monetarism. These criticisms include claims that monetarist policy does not necessarily translate into economic growth and takes long to come into effect. In addition, some claim that monetary policy can result in hyper-inflation or liquidity traps, and that it is difficult to implement. America is the world's largest economy, and the dollar is a leading global currency. Therefore, it is important to be appraised of the nation's economic situation, and propose solutions for its strengthening.

Keywords: Monetarism, Federal Reserve, economic policy, interest rates, monetary policy, government intervention

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This paper proposes the adoption of a monetarist approach towards financial policy by the United States' government. Monetarism is an economic school of thought that was first put forward by Milton Friedman. Monetarists believe that governments can regulate the economy solely by targeting the currency supply's growth rate. This action would allow governments to avoid the inflationary effects of an excessive expansion of money into the economy. America's economy has been historically affected by negative financial policy, sometimes leading to failure of the economy. A recent example was the 2008 Financial Crash. Some of the negative effects of the meltdown included loss of income, multiplying into other problems such as forfeiture of assets, homelessness, and bankruptcy (Williamson, 2012). The government can prevent a similar occurrence in future by applying an enhanced monetarist model.

This paper is supported by five core arguments. First, I contend that monetarism allows for less government intervention. Reduced intervention is achieved by assigning the role of devising and implementing economic policy to a financial institution such as the Federal Reserve (Jahan & Papageorgiu, 2014). I also argue that monetarism leads to lower inflation rates. The reduction is characterized by better price stability, brought by predictable supply and pricing of goods and services. In addition, I contend that monetarism would allow for financial independence from government policy. Independence is maintained by keeping economic policy separate from political decisions. Monetarism also promotes buying and selling in the economy by incentivizing purchases.

My paper also considers arguments against a monetarist approach. Among the arguments is the belief that monetarist policy does not necessarily translate into economic growth. Some critics have also argued that it takes a long time to come into effect. For example, Nelson and Schwartz (2008) believe that lower interest rates do not exactly result in a uniform increase in expenditure. Arguments have also been put forward that monetary policy can result in hyper-inflation. Lower interest rates may lead to artificially lowered commodity prices preceding speculative bubbles because of a sudden shift in prices. Additionally, monetarist policy is hampered by technical limitations like liquidity traps. These instances may occur after prolonged lengths of low interest rates. Consequently, imports may be hurt where a country's interest rates are lowered until the currency is weak. These concerns are all addressed in the paper.

This paper is important because Americans need to find solutions for their excessive debt. American public debt has increased by 200%, surpassing the $27 trillion-mark last year (Palley, 2011). The entire world reacts to any shocks within its economy, evident by the effects of the 2008 housing crash. Thus, it is crucial to be well-informed about the economic system of a financial giant like America.

Arguments for Adopting a Monetarist Approach

A monetarist approach follows the teachings of renowned economist scholar, Professor Milton Friedman. Monetarism is characterized by a free market approach whereby the market is deemed inherently stable and should therefore be allowed to correct itself with minimal government intervention. The following section examines the advantages of monetarism.

Monetarism Allows for Reduced Government Intervention

A monetarist approach would return America to a free market economy. The method would be suitable because monetarists advocate for markets where supply and demand determine the uptake and prices of commodities and services. According to Mishkin (2011), monetarist theory advocates for little to no government intervention to allow the markets to operate without manipulation. This argument is evident in Friedman's work, where he criticized the Federal Reserve for unnecessarily raising interest rates, for example prior to the Great Financial Depression of the 1930s (Nelson & Schwartz, 2008). Friedman therefore believed that the Federal Reserve wrongfully constricted the flow of money into the economy when the growth needed stimulation to benefit from the post-World War 1 industrial boom.

For that reason, Friedman's attitude illustrates monetarists' general view towards government intervention in the economy.

Despite Friedman's teachings, government intervention has become the main tool used in regulating the economy. A prime example is the intervening and policy-making role played by central banks, whose creation is empowered by legislation (Williamson, 2012). Modern monetarists further suggest that rather than allow government intervention on interest rates through fiscal policy, economies can be controlled through timely expansion and contraction of the money supply. This assertion is verified by research from Palley (2011), which indicates that low interest rates before the Financial Crash of 2008 led to an oversupply of currency in the American economy. Colander (2011) notes that this increase enabled multitudes of the American population to take out cheap but unsustainable mortgages, backed by over collateralized bonds. Eventually, the housing bubble collapsed with a domino effect on the economy. This occurrence confirmed Friedman's opinion that governments should not be allowed to interfere with the normal running of the economy.

Monetarism Allows for Implementation of Lower Inflation Rates

Monetarism advocates for low interest rates on loans. To achieve growth, interest rates are lowered through applying a mix of contractionary and expansionary monetary policy. This way, central banks can dictate the flow of money into the economy, which in turn determines the central bank's lending rate (Mishkin, 2011). More specifically, monetarists argue that when central banks increase or lower the money supply at a controlled pace, there is a corresponding increase in economic growth and stability (Jahan & Papageorgiu, 2014). Stability occurs when consumers can get loans at low interest rates, since they can repay easily and expand their own ventures. A favorable interest environment thus contributes to the growth of the country's Gross Domestic Product (GDP). In addition, research by Haldane (2011) discovered that economic growth could also be measured by the ease of access to loans by citizens, evidenced by increased purchasing power. This growth is therefore achieved by implementing low interest rates on loans.

Low interest rates benefit the economy in numerous ways. First, low inflation creates an appropriate environment for investors to inject capital into their businesses (Williamson, 2012). A secure business environment increases output and productivity of the nation. Second, low inflation rates prevent systemic unpredictability in the economy. A low inflation scenario further incentivizes savings, since savers can lock in their real value from being eroded (Clarida, 2012). Countries are also able to capitalize on exports, as their currency is strengthened to compete favorably globally. Finally, low interest rates bring a reduction in mortgage repayment rates. With reduced monthly interest on repayment, consumers are left with more disposable income. Blanchard (2019) notes that this extra money can be used to expand their businesses, which translates into overall economic growth. A strong currency makes the nation more competitive in international trade. Monetarism can therefore help the economy grow by lowering interest rates.

Political and Financial Independence From Government Policy

Monetarists argue for the separation of economic policy from political decision-making. The separation is achieved by empowering central banks with the final mandate of intervening in the economy, whenever there are downturns. The premise behind this position is that central banks would avoid interference and manage interest rates wisely despite political lobbying (Mishkin, 2011). Central banks achieve impartiality by applying policy with only broad guidelines towards economic targets backed by credible research and data. The guidelines may be developed alongside legislators and other policy makers. Bernanke (2011) reports that prior to this approach, there was intense politicking with regards to setting interest rates, the interest rates would be changed arbitrarily and relied heavily on election cycles. Politically inclined interference would cause economic instability since incumbent governments would be tempted to lower interest rates close to election dates. Leaders would apply such tactics to create illusion of short term growth and boost their ratings. A specific example was the Lawson Boom in the UK in the 1980s, where manipulation of interest rates led to a short-term boom and bust (Jahan & Papageorgiu, 2014). Such instances demonstrate the need for the allocation of intervening powers to a non-partisan financial institution.

To prevent a situation like the one mentioned above, monetarists argue for the political independence of central banks. Decisions made by political official are often clouded by short-term strategy, for example influencing upcoming elections (Nelson & Schwartz, 2014). In addition, there is high temptation to cut inflation rates and consequently influence consumers to increase spending before the election. An independent central bank is likely to be more credible in the eyes of the citizenry, as its decisions will be devoid of political influence. Therefore, it is ethical to ensure the financial body tasked with economic regulation stays impartial.

Monetary Policy Is Easy to Implement

Monetary policy can be implemented easily by an appropriate financial institution. Central banks have multiple tools at their disposal that can enable them to regulate the economy, depending on the prevailing situation. In the case of the Federal Reserve, for example, there are four distinct tools that enable easy implementation of monetary policy. These are interest on reserves, open market operations, discount rates and reserve requirements (Williamson, 2009).

Interest on reserves is a new monetary tool approved by the Congress of the United States after the Financial Crash of 2008. Ideally, all banks are required to hold a certain statutory amount with the Federal Reserve or in its own vaults as a pre-condition for licensing (Christensen & Krogstrup, 2019). The amount is held as collateral in case of a crisis and the bank is forced to liquidate. This amount is officially known as a reserve requirement and it exists as an extra security measure to protect peoples' savings in case of a bank run. In this way, interest on reserves help banks protect the solvency of customers' funds. The Federal Reserve can therefore incentivize banks to lend their excess reserve by lowering interest rates.

Besides interest on reserves, open-market-operations is another instrument used to implement monetary policy. This practice refers to the buying and selling of U.S Treasury securities on the open market in a bid to regulate reserve currency supply in American banks. This policy tool is spearheaded by the Federal Open Market Committee and is designed to generate increased liquidity for commercial banks engaging in the sale and purchase of treasuries (Rocheteau et al, 2018). Buying and selling treasuries in large amounts has an impact on the money supply trickling down to various financial institutions. Robatto (2014) explains that the momentum created by the buying and selling activity in the market generates liquidity in currency flow. Therefore, depending on whether such activity reduces or increases the volume of currency circulating in an economy, open market operations allow for easy implementation of monetary policy.

Monetarism Encourages Economic Growth and Activity

Monetary policy aims to achieve economic growth through three functions. These functions are lowering inflation rates, reducing unemployment rates, and promoting reasonable long-term interest rates (Nelson & Schwartz, 2008). To achieve the economic growth, central banks implement an expansionary monetary policy. The process is explained in an article by Haldane (2018), who clarifies that expansionary monetary policy is implemented by reducing reserve demands on financial institutions, thereby increasing currency circulation. By engaging in open market operations, a central bank can also increase capital supply in the economy.

In addition to the economic growth, the implementation of this policy leads to an increase in aggregate demand growth. Mishkin (2011) observes that when monetarist policy characterized by low interest rates takes full effect, there is a resultant growth in economic activity. Low interest rates make it easier for banks to lend money to investment firms and companies. This money trickles down to the end consumer who is incentivized to spend. A study conducted by Clarida (2012) also observed that low interest rates result in reduced mortgage repayment rates. This reduction allows people to buy and speculate in real estate, leading to a property boom. Additionally, when a country's currency has a lower interest rate, it can perform favorably on the global export scene. The evidence shows that monetary policy is a useful tool in achieving economic growth.

Arguments Against the Implementation of Monetarism

Despite the various advantages of monetarism laid out in the preceding paragraphs, the theory has its fair share of criticism. Most weaknesses of monetarism are expressed in the teachings of economist John Maynard Keynes. The section below addresses some of these disadvantages.

Monetarism Is Irrelevant to Modern Economics

Critics have contended that Friedman's teachings do not hold meaning in the modern economic setup. Palley (2011) argues that monetary policy has failed to show feasible benefits during recent global recessions. An illustration is where interest rates are lowered post-recession to incentivize consumer expenditure. The reduction would result in a weakening of the currency and inadvertently reduce exports. Palley states that losses on currency exchange would therefore be greater than profits made. The second argument on the inaccuracy of monetary policy is that it cannot be used to solve distinct economic problems. According to Blanchard (2019), tools such as the management of interest rate levels cannot be narrowed down to address specific economic patterns such as boosting the economy of an underdeveloped region. In the same vein, Mishkin (2011) posits that these tools are unable to take account of crucial data sets on the correlation between stimulus and unemployment. These weaknesses render monetary policy ineffective in solving modern day economic challenges. Blanchard further posits that additional adverse effects of monetary policy may occur where a central bank applies contractionary monetary policy to increase interest rates. Research by Martin et al., (2019) verifies this idea, noting that businesses borrowing at such rates are normally forced to sell at higher prices. The result is the passing of the cost burden on to the consumer.

Although some aspects of monetarism are outdated, critics fail to acknowledge that the application of a hybrid model of monetarism could work. An example of the successful application of monetary policy is the emergence of instruments like open market operations, under the purview of the Federal Open Market Committee (FOMC), as argued by Robatto (2014). Between the end of the Financial Crash of 2008 and 2014, the FOMC embarked on an unprecedented asset purchase through open-market-operations. This action resulted in record post-crisis holdings, with the Federal Reserve's bank balance standing at $4.5 trillion (Robatto, 2014). Clearly, monetarism can still be refined to suit modern circumstances.

There Is No Guarantee of Economic Growth When Applying Monetarism

Critics of monetary policy argue that applying monetary tools results in economic uncertainty. This instability is because central banks have no control over transactions between financial players, consumers, and commercial banks. Consequently, applying controls on monetary supply in society appears to be an exercise in futility since there is no guarantee that economies will react in a predicted manner (Nelson & Schwartz, 2008). In an instance where the government institutes excessive taxation measures, increasing the monetary supply would not work. Martin et al., (2019) argue that individuals would still undergo higher inflation in the future and their cash reserves would be lowered in value, thereby hindering growth. Governments also often end up passing policy inconsistent with the targets of their central banks, for political reasons. Acemoglu and Robinson (2013) offer an example of how these issues manifest, where governments focus on the outcomes of poor policy, instead of fixing the defective economic strategies. Such actions result in stagnated economic growth, since the underlying problems go unsolved.

Despite the notion that monetarist policy does not guarantee economic growth, there exists evidence to the contrary. The critics refer to instances that suit their narrative, failing to refer to the many others where monetary policy has succeeded. Central banks do not operate in a vacuum. They align their policy in co-ordination with the relevant branches of the government and follow broad guidelines on how to set interest rates (Vayid, 2013). Further, central banks can use monetary policy tools to make significant change to the economy, for example open-market-operations. Thus, it is inaccurate to blame monetary policy solely for economic stagnation.

Monetarism Can Lead to Hyperinflation and Liquidity Traps

Another pertinent argument by critics against monetary policy is that it may lead to hyperinflation and liquidity traps. An example of the application of monetary policy is when the government prints money into circulation to prevent deflation. When the increase in circulating currency is not supported by a corresponding growth in Gross Domestic Product (GDP), there is a risk of runaway inflation (Haldane, 2018). The more currency in circulation, the more each unit of currency decreases in value where there is an unchanged demand for capital (Orphanides, 2011). Consumers end up paying more because of higher prices, since goods become more expensive while the currency is losing value. Therefore, the over circulation of currency during the application of monetary policy may have cause hyperinflation.

In addition to hyperinflation, another extreme possibility of the failure of monetary policy is the emergence of a liquidity trap in currency circulation. Liquidity traps occur in instances where interest rates are low but savings rates are high, consumers hold on to their cash savings and do not engage in open market orders. The hoarding is caused by the belief that bond prices will soon be lowered by high interest rates (Christensen, 2019). The application of monetary policy is thus rendered useless by high amounts of savings, despite prevailing low interest rates. This argument is a favorite among Keynesian economists, who believe that expansionary fiscal policy would be the solution as it is in line with their openness towards governmental intervention (Jahan et al, 2014). Evidently, the application of monetary policy can result in negative economic growth.

Despite the likelihood of hyperinflation and liquidity traps, evidence shows that such negative events occur in extreme circumstances. According to Cook and Devereux (2013), liquidity traps occur only when consumers do not purchase government bonds, despite low interest rates and high yields. The occurrence of such a scenario is usually rare. Further, central banks have different feasible ways of overcoming liquidity traps. The methods include raising interest rates, lowering prices of products to incentivize purchasing, and increased government expenditure (Cook & Devereux, 2013). These actions cause hoarders to unlock and begin spending their savings, as consumers' faith in the government's regulation of the economy is revived.

There Are Technical Limitations in the Implementation of Monetarism

The implementation of monetary policy is riddled with technical restrictions. The first limitation is evident in the lowering of interest rates. Statistically, it is only possible to nominally lower interest rates to 1%. When interest rates are already low, this situation hinders central banks from applying monetary policy effectively (Wright, 2012). During deflationary periods where the interest rate may be lowered to zero, not much can be applied to stimulate the economy. For example, some countries have attempted experimenting with Negative Interest Rate Policy (NIRP) in a bid to prevent consumers from hoarding cash. The money loses value because of negative rates, and the consumers are forced to spend to unlock the value hidden by the liquidity trap (Eggertsson, 2011). It is similarly difficult to achieve different economic outcomes by solely applying monetarist principles. An example is during instances where oil prices rise globally causing a corresponding post-surge inflation and growth. Central banks may react by increasing their interest rates to counter the inflation but such measures would only slow down economic development. These examples are compelling evidence of the difficulties encountered by policy makers in applying monetary policy.

Despite the arguments on difficulty of implementation, monetary policy remains a crucial instrument in the regulation of the economy. Monetary policy is the first line of defense available in instances of economic turmoil (Martin et al, 2019). The Federal Reserve is better placed to react compared to the President or even Congress. The Federal Reserve is also better placed to make an accurate assessment of the extent of stimulus required, such adjustments to the economy would require quick implementation. An independent institution would be best suited to implement restorative measures in a timely manner, with minimal implementation hitches. The argument on the rigidity of monetary policy is therefore laid bare.

The Effects of Monetary Policy May Take Time to Come Into Effect

There is a delay between when monetary policy is implemented and when its effects begin to take place. This delay includes instances where the changes have been made proactively; the effects may take months or years to take effect. Unlike fiscal policy that can be created and implemented quickly by the government, the required changes from monetary policy take time (Collander, 2011). Central banks' tasks would be faster if the said changes took immediate effect. The difficulty in identifying visible effects of monetary policy also lies with its forward-looking nature. For instance, policies used by central banks lack mechanisms for calculating the relationship between outputs achieved from implementing monetary policy. These encounters suggest that there is a difficulty in understanding the time in which monetary policy can be implemented successfully.

Although the effects of monetary policy may delay to come into fruition, the concerns on time can be actively mitigated by the short-term interest rate. Most economic contractions occur over a shot-term setup meanwhile fiscal policy would require conception and implementation by the relevant legislative body (Svensson, 2020). For that reason, it would take time for the stimulus effects to reach the average consumer. This delay would result in worsening of a negative economic situation. Monetary policy is therefore easier to implement for practical alleviation of economic downturns.

Conclusion

A shift in economic policy to return to monetarism would result in the stabilization of America’s economy. The current economic policy in America has resulted in economic crises, with most striking example being the Financial Crash of 2008. Monetarism has several unique advantages that can help remedy the situation. First, its implementation is devoid of political interference since it is assigned to a qualified financial institution, in most cases a central bank. Monetarism also lowers interest rates, allowing citizens to make purchases. Further, the implementation of this type of policy involves minimum bureaucracy.

To be sure, Monetarism has many critics. Some of these critics contend that monetarism has no place in modern economics, since its principles are outdated and take time to come into effect. However, other studies by reputable economists have devised numerous methods of incorporating monetarism to cure defects in existing economic policy. Other detractors have claimed that there is no guarantee that monetarism leads to a corresponding growth in the economy. Again, the critics fail to account for the weaknesses of other instruments applied in conjunction with monetarism, and pick on fringe defects. It is also often argued that monetarist policy runs a high risk of resulting in hyperinflation. This argument is incomplete, since it only accounts for extreme cases of misapplication of monetarism.

Although America has moved far from the teachings of monetarism, the current economic reality leaves policy makers with little choice but to start considering alternative solutions. It is also important to have in place a system that can protect the economy from damage of the magnitude caused by the Financial Crash of 2008. Therefore, implementation of a hybrid version of monetarist policy would be suitable for the American economy.

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