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How Money Matters

Over the past 15 years the quantity of money has largely disappeared from policy discussions and the economic models used to provide monetary policy advice. Most central banks that were targeting money growth have stopped doing so. We no longer ask which measure of money is the "correct" indicator for monetary policy. Instead, we directly examine measures of inflation and output for guidance about setting the stance of monetary policy.

Yet, *money still matters*. It plays three fundamental roles in the economy: a medium of exchange, a store of value, and the unit of account. Traditionally, monetary policy was viewed as operating through the medium of exchange or the store of value, or both. We focused on M1 when we thought the medium of exchange role was dominant, because the funds in M1 are primarily used to make transactions. We focused on M2 when we thought that the wealth effect was important or that close substitutes for M1 would be informative.

Since 1982, however, measures of the quantity of money have provided little useful information about the near-term outlook for spending or inflation. Money growth has remained highly variable even as inflation has become less variable. As the chart shows, the variability of inflation, calculated as the standard deviation of quarterly percent changes in the CPI, declined by half between 1970-82 and 1983-2003. But the variability of the money stock, measured using either M1 or M2, actually went up a bit.

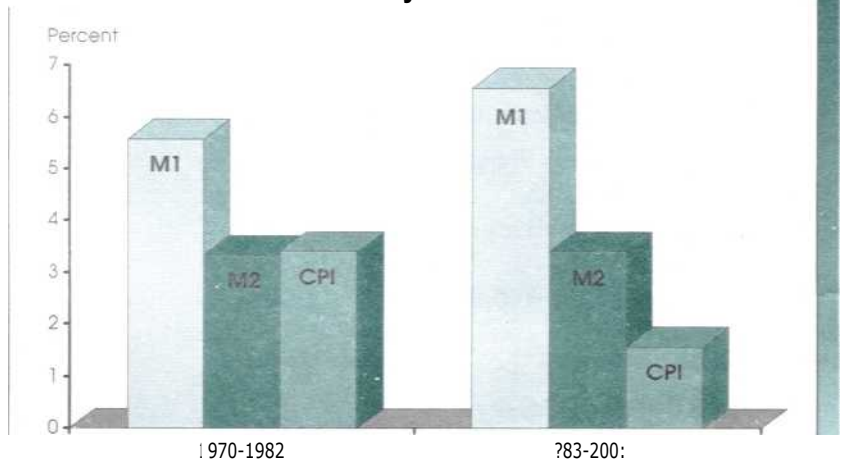
This disconnect between the variability of inflation and money growth is partly due to the success of policy in reducing inflation and causing expectations of future inflation to become more stable. In this environment, the Federal Reserve has been able to keep its federal funds target rate fixed for months at a time. When the funds rate is fixed, the short-run money supply is perfectly elastic with respect to the interest rate and all changes in money demand are perfectly accommodated.

The role of money as our unit of account, the dollar, is at center stage in monetary policy today. Our models and our discussions focus not on the quantity of money but on the purchasing power of the dollar. More uncertainty about the value of a dollar, both now and in the future, causes consumers, investors, and business managers to make mistakes that reduce economic efficiency and living standards. That is, changes in expected inflation and errors that result when actual inflation deviates from previous expectations cause economic inefficiencies. Of course, many aspects of our economy are not fully indexed for inflation. A higher inflation rate, for example, results in a higher effective tax rate on capital gains. Higher inflation also causes more uncertainty about inflation.

In fact, an important channel by which the Federal Reserve stabilizes the value of a dollar is through expectations of future inflation, the main channel through which monetary policy affects the real economy. We do not have to pay attention to the quantity of money today because policy makers are paying attention to its price, by focusing on inflation and inflation expectations.

-William T. Gavin

Standard Deviation of Money Growth and Inflation



NOTE: The standard deviations are calculated from quarterly data and reported at annual rates.