Monetarism and the Crisis in Economics

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Crisis in Economics

Allan H. Meltzer

To the economists responsible for advice and policy decisions in the 1960's, the main problems of stabilization policy seemed to have been solved. Mild recessions might have occurred because businessmen behaved erratically, or because the timing of the response to government policy actions had not been pinned down, or because politicians did not heed their economic advisers. Mild inflation might result from decisions to reduce unemployment and increase output beyond the point required by price stability. Inflation seemed manageable to the economic advisers of that period, and inflation and unemployment still seemed manageable when they wrote their memoirs.

The job of the economic adviser was to predict the future course of economic activity and to recommend economic policies that maintained the proper balance between unemployment and inflation. The policy recommendations—Keynesian policies—are familiar. When private spending declines, a responsive government substitutes its own spending by running a budget deficit, or reduces taxes to stimulate private spending. The additional spending creates jobs for idle workers. Society gets the benefit of output that would have been lost; increased output and employment raises tax revenues and finances the deficit. To reduce inflation, the government runs a bud-
get surplus. The surplus lowers economic activity, and the surplus is eliminated as inflation falls.

Changes in the federal budget deficit and changes in taxes and government spending occur all the time. Three key elements in the program offered by the economic advisers of the 1960's distinguish their advice from earlier, less activist programs. Greater use was made of short-term forecasts of economic activity, prices and interest rates. Greater reliance was placed on economists' ability to trade inflation for unemployment. Greater emphasis was given in official discussions of economic policy to planned budget deficits as a means of implementing an economic plan and achieving target rates of inflation and unemployment annually and perhaps quarterly.

No one, certainly no one in a responsible position, believed that this type of economic planning and control was infallible. To improve control, other programs supplemented budget policy. One program, known as guideposts or guidelines, restricted changes in individual prices and wages. Guidepost policies were based on the rather vague conjecture that large firms and industry-wide unions worsen the tradeoff between inflation and unemployment. Proponents of guideposts regarded their proposals as imperfect devices for slowing inflation during periods of expanding output. In the language of the time, guideposts were said to be useful against "cost-push" inflation. Another program, or series of programs, sought to reduce the United States' balance of payments deficit and sustain the international monetary system based on fixed exchange rates. Many of the steps taken to achieve balance of payments adjustment during the 1960's involved direct controls, such as the tax on interest rates or restrictions on the amount of government and private spending abroad.

Looking back to the 1960's at the start of the 1980's, one is struck by the flimsy base on which the alleged triumph of "Keynesian policies" rested. There were tax cuts in 1964, relatively large increases in government spending in 1966 and 1967, and a tax surcharge—to slow inflation—in 1968. There were numerous attempts to slow inflation by persuasion and pressure. There was a flood of words about the United States' commitment to maintain fixed exchange rates and the price of gold, and to end the deficit in the balance of payments. When the 1970's produced higher inflation, higher unemployment, and a devalued dollar, some journalists and economists who had hailed the previous decade as the age of economists interpreted the failure as a failure of economic theory.

The age of the economists, born with the tax cut of 1964, did
not survive the first signs of sustained inflation. In the words of one foreign observer, Keynesian ideas "faltered sometime in the middle Sixties and stumbled into the Seventies."

These, and many similar statements, are hyperbole. There is a connection between the scientific statements properly described as economic theory and many of the policy recommendations of the economic advisers to Presidents Kennedy and Johnson—or for that matter, Presidents Truman, Eisenhower, Nixon, Ford and Carter. It is proper to attribute part of the steady growth of the U.S. economy in the early and middle 1960's to fiscal policy decisions, including decisions to increase depreciation allowances in 1962, to reduce taxes for households and business in 1964, and to hold the growth of federal government spending near its long-term average during the first half of the decade.

Fiscal policy was not the only, and probably not the most important, factor contributing to the growth of world income in the 1950's and 1960's. Growth resulted from population growth and from institutional changes affecting the world economy that permitted the rising labor force to be absorbed at rising incomes. During those decades, the United States, the Common Market, and Japan reduced tariffs, removed barriers to trade, restored convertibility of currencies and permitted capital to move across borders in search of the highest prospective return. These changes increased efficiency, raised real incomes, and encouraged production and trade.

None of these changes depended either on careful forecasts of output and prices in the year or quarter ahead, or on carefully measured tradeoffs between inflation and unemployment. Economists from the time of Adam Smith onward believed that tariff reduction, increased capital mobility, and freer international trade, benefit both exporting and importing countries and increase the wealth of nations. More to the point, conclusions about these gains from trade are well-established principles of economics. These principles worked—and, as the post-war growth of income in the European Common Market and other market economies suggests, they worked well.

The crisis

A crisis is a decisive change of direction. I believe that the ways in which most economists think about economic policy, and the conclusions they draw, are markedly different at the beginning of
the 1980's than in the early 1960's. If the change persists, it will have a lasting effect on the conduct of economic policy.

The research economist, working to increase our understanding of some aspect of human behavior, sees little sign of crisis or decisive change. The problems he analyzes and the tools he uses differ from the tools and problems of a decade or a generation ago. With better tools and newer techniques, the subtleties that were once ignored or neglected become part of the accepted principles. There is at least some truth to the commonplace that describes research as a process of learning more and more about less and less. The startling insight that creates a crisis in theory is a rare event that becomes rarer as knowledge increases.

Economic theory is a set of principles about the allocation of scarce resources. The best established parts of the theory have been developed during the past two centuries into a formal body of knowledge that is highly abstract. In addition to these formalized abstractions, economics—and other scientific disciplines—include a number of relationships that have been observed repeatedly but are not closely tied to the formal theory. A considerable part of the research done by working economists is an effort to extend the range of economic theory to include the observed relationships within the formal structure.

Where the researcher sees gradual progress in the development of economic theory, policy makers, journalists, and legislators may see a decisive change in opinion about economic policy. Academic witnesses before congressional committees, consultants, and advisers to presidents and agencies usually do not abuse their patrons by debating subtle differences—or basic differences—in public. Policy makers want much more to know about the probable outcomes of policies, and the chances of success or failure, than about what was ignored and what was assumed to reach a conclusion. In the 1960's, consultants and economic advisers emphasized short-term, and neglected long-term, outcomes. The advisers perhaps believed that they could manage the long-term outcomes if or when they occurred. Neither they, nor their political sponsors, asked how.

Policy recommendations have undergone much more change than economic theory. One explanation of the change in policy recommendations is that the accumulation of knowledge and new research discoveries revealed the errors in the policy recommendations of the past two decades. This is a comforting idea, but it is, I believe, a very small part of the reason that changes occurred. It is true that some research in the 1950's and 1960's seemed to support the
activist policies that were proposed and implemented and that later studies cast doubt on the earlier findings. But it is closer to the truth to say that most of the policy errors resulted from the neglect of long-term implications and of principles that were well known more than a century ago.

Economists trained in the heyday of Keynesian economics were responsible for the major policy failures of the 1960's and 1970's. Their advice and recommendations proved to be wrong, not only because their forecasts were inaccurate but because they ignored long-term effects of policies and because many of their beliefs about their ability to fine tune the economy were wrong. Three examples illustrate the relation between some of the mistakes that were made and the beliefs on which policies were based.

1. The Alleged Tradeoff: Inflation and Unemployment. The Phillips curve is one of the key relations on which economic advisers relied in the 1960's. The relation, a statistical curiosity discovered by a British economist in the late 1950's, showed that for nearly a century the highest rates of unemployment occurred when wages or prices fell and lowest rates of unemployment occurred when prices rose. Phillips' work seemed to suggest that output and employment increased during periods of inflation.

Nothing in Phillips' work or in subsequent work showed that higher inflation caused lower unemployment, and nothing in economic theory gave anyone reason to believe that the relation Phillips uncovered was either a dependable basis for policy or consistent with economic theory. Nevertheless, Phillips curves jumped quickly from the scholarly journals to the Executive Office of the President. I do not know any other example in which new economic research findings, and not very strong findings at that, became the basis for official statements about public policy in so many countries in so short a time. The unusual speed with which the Phillips curve was accepted is particularly remarkable because the idea that inflation increases output and real income had been discussed for generations. The issue had not been resolved, but the presumption was that the long-term effect of inflation on output or growth was small in magnitude and uncertain in direction.

One of the oldest principles of economics makes the point that output, employment, and standards of living—real variables—do not depend on the price level. Economists recognized long ago that output and employment are no higher when prices are high than when they are low. A main point of Adam Smith's Wealth of Nations is that a country's wealth and income depend on the coun-
try's real resources and on the way in which production is organized—and not on the price level. Some short-term effects of prices on output were observed, but these effects were recognized as the transitory influence of unanticipated changes in demand. Sudden, unexpected increases in demand that raised prices and output, or sudden reductions in demand that lowered prices and output, were not expected to have any lasting effect on either prices or output.

The classical gold-standard mechanism embodied these principles. Unanticipated increases in gold flows from abroad stimulated production, but gradually raised domestic prices relative to foreign prices. The rise in domestic prices reduced exports, and raised imports, lowering domestic production and employment, and eventually lowering prices. The continuous ebb and flow of gold was anticipated, but the timing of the flows could not be predicted accurately. The inability to predict the timing of flows was recognized early as a cause of unanticipated changes in price and output.

Milton Friedman's presidential address to the American Economic Association in 1967 is a forceful statement of the role of anticipations and an important extension of established principles. Friedman showed that anticipated rates of price change (inflation) have no effect on employment and output. Once people anticipate that prices will rise, Friedman said, they demand higher wages for their labor and higher prices for their products. The increase in employment produced by higher inflation vanishes. The inflation remains. Attempts to reduce unemployment by increasing inflation work only if people are fooled by the changes. Once people learn to anticipate inflation, the tradeoff disappears. Friedman and others warned that repeated attempts to reduce unemployment by inflation would cause the rate of inflation to rise but would not lower the average rate of unemployment. A series of studies tested Friedman's argument. The results supported Friedman and other critics of the Phillips curve.

The speed with which the case for a tradeoff was accepted as a cornerstone of economic policy contrasts with the slow acceptance of the more substantial body of evidence suggesting that there was no reliable tradeoff. Friedman's reaffirmation and extension of classical principles of monetary theory was widely accepted in the economics profession long before it was accepted as a basis for policy action. As recently as 1978, high officials of the U.S. government openly promoted the notion of a tradeoff. Their German counterparts resisted, for the most part, and succeeded in keeping their rates of inflation far below ours.
2. Guideposts, Guidelines, Price and Wage Controls. Guideposts and guidelines are informal, often extra-legal, controls on the prices and wages paid by large firms. These controls, like the more formal price controls for which they substitute, neither prevent nor reduce inflation. At times, controls prevent the effects of inflationary policies from becoming apparent. But even the totalitarian regimes in Eastern Europe do not—and apparently cannot—control all prices permanently. They, too, often experience inflation following periods of relatively high demand.

Economics provides no support for the belief that controls reduce inflation. Any lasting reduction in inflation, achieved while controls are in effect, depends on government policies to reduce total spending. Unless spending is reduced, the average rate of inflation is not reduced. If spending is reduced, inflation eventually falls whether or not controls are used.

When a few selected prices of goods and services are controlled, people who are able to buy the goods and services at lower prices do not buy an unchanged amount and save the difference. Spending shifts to other goods and services. The controlled prices rise less, but other prices rise more, and a properly constructed measure of inflation is unaffected. If the prices of most domestically produced goods and services are controlled, spending shifts to imports, to used cars and second-hand markets, or to products such as fresh produce that are rarely controlled. Countries that rely on price controls face rising pressure to restrict foreign travel, imports, and other substitutes for domestic spending. Controls often lead to other restrictions: on imports, on foreign transactions, and on travel. To make controls work, ration books or waiting lines replace prices as the means of deciding who gets to buy the goods or services. Anyone who waited in line for gasoline in the spring of 1979, or who has seen the lines at stores in Eastern Europe, appreciates how these mechanisms work.

Economists—whether in the Department of Energy, the Council of Economic Advisers, or elsewhere in the government—are familiar with these basic principles. They do not rest their argument for selective or general controls on economic principles. Usually, controls are defended by appeal to non-economic considerations, to notions of equity or distributive justice, or to guesses about favorable effects on anticipations of consumers, unions, or businessmen.

Controls, guideposts, and guidelines have failed to stop inflation in every country that has used them. The failures are not failures of economic theory or evidence that economic theory is in crisis.
On the contrary, they show that political expedients, notions of equity, or guesses about anticipations are less reliable guides to successful policy than economic theory.

3. The Illusive Output Gap. The oil shocks reduced income and potential output in all non-OPEC countries by raising the amount we pay for imports and by raising the cost of using machinery relative to the cost of using labor. The higher cost of oil lowers our standard of living. The higher cost of using machinery lowers the amount of output that can be produced efficiently. We are poorer, as are all other non-OPEC countries. If we all work just as hard, we produce less because it is no longer as efficient as before to use machinery to assist labor.

Four or five years after the oil shocks, the President's Council of Economic Advisers had not incorporated the effect of the shocks into their estimates of potential output. The Council's 1978 report dwells on the amount of idle capacity, and estimates the gap between potential and actual output as two to three times greater than estimates that adjusted for the effects of the shocks on productive capacity.

The Council's view in early 1978 was that the economy was capable of achieving a substantial increase in output and a reduction of the unemployment rate to 4.8 percent without increasing the rate of inflation. In the Council's view, the best policy for 1978 was to pump up the economy by encouraging spending. This view prevailed. Monetary and fiscal policies remained expansive in 1978.

We know the result. The Council was wrong, and the critics were right. There was much less idle capacity, much less potential output, and a much smaller gap than the Council's 1978 report suggested.

Rising inflation in 1978 and 1979 was the result of error, not accident. The error was avoidable. As early as 1975, a group of economists from business and universities, known as the Shadow Open Market Committee, called attention to the “distinction between a decline attributable to real shocks and a decline attributable to cyclical forces. A cyclical decline creates an output gap. Real shocks reduce output and capacity.” By 1978, several estimates of the loss of potential output had been made. These estimates, based on careful economic analysis, showed the extent to which the Council's policies were based on illusory estimates of potential output.

There are many other examples of economic policies that have, at most, a tenuous relation to economic theory. Regulatory efforts, policies toward pollution and safety, proposals to tax wage increases
or price increases or both, most of the President's 1977 energy program, and many other proposed or actual policies have only two connections to economics. Often the policies are designed or administered by economists—people trained in economics. And many of the policies sacrifice efficiency, about which economists have expertise, for equity, a subject on which economics says nothing and economists have no special expertise.

Monetarism

The term "monetarism" was first used by Karl Brunner in 1968 to summarize three conclusions drawn from contemporary work on money and monetary policy. "First, monetary impulses are a major factor accounting for variation in output, employment and prices. Second, movements in the money stock are the most reliable measure of the thrust of monetary impulses. Third, the behavior of the monetary authorities dominates movements of the money stock over business cycles."  

Brunner compared "monetarism" to the views held by economists and officials at the Federal Reserve and in the Administration. At the time, and for the next decade, the Federal Reserve attempted to control interest rates and neglected to control the growth of money. Now, after 15 years of inflation, the Federal Reserve has recognized publicly that its procedures were faulty, that attempts to control interest rates produced higher inflation, a devalued dollar, and higher—not lower—interest rates. Each of these points was part of the monetarist critique of Federal Reserve policy. It is hard to avoid the conclusion that the current inflation is, to a considerable extent, the result of errors made by the Federal Reserve.

Many of the errors were avoidable. On March 25, 1968, Federal Reserve Chairman Martin told the Senate Banking Committee:

We know that, in the short run, expansive monetary policies tend to reduce interest rates and restrictive monetary policy to raise them. But in the long run, in a full employment economy, expansive monetary policies foster greater inflation and encourage borrowers to make even greater demands on the credit markets. Over the long run, therefore, expansive monetary policies may not lower interest rates, in fact they may raise them appreciably. This is the clear lesson of history that has been reconfirmed by the experience of the past several years.

But Chairman Martin's statement did not lead to a change in Fed-

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eral Reserve procedures. The Federal Reserve continued to use the level of interest rates to judge their policy stance and continued to control interest rates to carry out policy. Money growth continued to rise in periods of prosperity and to fall in recession.

The monetarist critique of government policy did not concentrate solely on procedures. The argument for controlling money was based on some of the oldest and most reliable propositions in economic theory. Sustained growth of money above the rates of growth of output produce inflation. Sudden, unanticipated reductions of money growth cause recessions and unemployment. Both propositions have been repeated, in one form or another, for about 200 years. Recent developments of economic theory strengthened the analytical foundation for these well-established propositions. Recent events have done nothing to undermine their factual basis.

The breakdown of the fixed-exchange-rate standard, the variability of fluctuating exchange rates, the inability of governments to control exchange rates, the flight from currencies with high anticipated rates of inflation to currencies with low anticipated rates of inflation, the inability of countries to control interest rates by monetary means, the development of substitutes for money to circumvent controls on deposit rates, the repeated failures of price and wage guidelines to have any lasting effect on inflation—these and many other propositions, tested and confirmed by experience and by economic research, show that economics is alive and remains useful—indeed, indispensable—for correct prediction and for stabilizing policies.

Why then did policies fail to reduce inflation and unemployment? Was it the result of arrogance or ignorance? I believe neither is the principal reason for policy failures, though both have played a role. Economists, no less than others, are eager to test their ideas—and impose their views—on others.

The inability of engineers, physicists, or astronomers to predict the point at which Skylab would strike the earth does not reveal some undetected, fundamental flaw in the natural sciences. It shows that some events are difficult to predict and control. Engineers and natural scientists were able to put Skylab into space and to control its path while it was in orbit, but unable to control the path on which it returned to earth.

Airplane crashes, swine flu vaccines, and problems with nuclear reactors show that technology is not flawless and that science can bring improvement, not perfection. These problems, even tragedies, do not raise doubts about the scientific bases of physics, biology,
and chemistry—or lead to the conclusion that natural science is in a crisis.

Economics is not the science that gives accurate quarterly projections of employment, prices, profits, and other variables. Economists who promised to steer the economy from quarter to quarter or year to year offered more than economics can deliver. Many may now be dispirited by the failures of the policies they advocated, initiated, and administered, and by the cost of their failures. To describe the failures of government policy as failures of economics is the very opposite of the truth.

The fact that policy makers often rely on short-run tactics that have little relation to economic theory, and fail to develop long-term strategies based on economic theory, tells us that there is a large gap between economic theory and policy. The principal failure of economics as a policy science is a failure to recognize that gap.