Monetarism is Alive and Well

Allan H. Meltzer

Carnegie Mellon University, am05@andrew.cmu.edu

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During the early months of 1990, inflation rates as reported by the International Monetary Fund, ranged from negative numbers to an annual rate of more than 1400 percent. Countries like Poland, Argentina, Yugoslavia and Brazil where the reported annual rate of inflation was above 1000 percent all had experienced high money growth. A few countries like Togo and Ethiopia reported falling prices. They had experienced negative rates of money growth in the recent past.

To the monetary economist, the association between money growth and inflation is simply additional evidence for one of the principal monetarist propositions: sustained money growth in excess of the growth of output produces inflation; to end inflation or produce deflation money growth must fall below the growth of output. It is noteworthy that one country with low or negative money growth, Ethiopia, reports a falling price level despite civil war and periodic famines.

What is true across countries is true across time in a particular country. Inflation will be sustained, if money growth is maintained at a rate far in excess of output. To end inflation, money growth must be reduced permanently. Countries as diverse as Chile, Israel, Brazil, Argentina, Italy, Japan, Turkey, and the United States, to name only a few, have increased or reduced inflation at different times by speeding up or reducing the rate of money growth. In some countries, the changes in money growth and inflation have ranged over hundreds or thousands of percentage points. In others, the range has been narrower.

Where inflation has been high, open market interest rates have been high and market exchange rates have depreciated. These monetarist claims have been validated also both across countries and over time. Government's efforts to hide these effects of past inflation and anticipations of future inflation may succeed for a time but...
they do not succeed permanently. Although inflation may not be reflected fully in official measures, black market or open market rates on unofficial markets tell a more correct story.

When inflation increases, output often grows for a time above its trend rate. Reductions of inflation have the opposite effect; output falls or grows at less than trend rate. These temporary changes in the growth rate of output illustrate a third monetarist proposition: the first effects of changes in money growth are on output; later the rate of inflation changes. The synchronous reduction in money growth in most of the industrial countries at the beginning of the 1980s produced a severe downturn in many of these countries. The size and duration of the downturn differed substantially from country to country. The U.S. experienced a sharp contraction of real output; Germany and much of Europe experienced a much longer recession; Japan escaped with only a modest reduction in the growth rate of output.

These monetarist propositions about inflation, interest rates, exchange rates, and output are now widely accepted by academic economists and policymakers. Many central bankers have adopted targets or guidelines for money growth. The current levels of interest rates in world markets reflect efforts by Germany, Japan, Great Britain, the United States and others to bring down the rate of money growth and to avoid a return of the high inflation of the 1970s. Conversations with central bank governors these days find them more alert to the risks of inflation, more conscious of the costs of slowing inflation once inflation has become widely anticipated, and more aware of the relation between money growth and inflation.

Contrast the responses of the United States and German governments to the oil shocks of the 1970s, or the responses of the Japanese government in 1973-74 and 1979-80 to the same shocks, or the responses of the United States to the oil shocks in 1973 and 1979 and in 1990. A lesson learned from these different approaches to the common experience, and the analyses of that experience, is that oil shocks can change the price level but, if money growth remains unchanged, the surge in prices will be temporary and short-lived. Once the oil shock passes through the economy, prices remain higher as a result of the oil shocks but rise at a rate dependent on the maintained growth of money relative to output. Monetarists have emphasized the
distinction between one-time price level changes and the sustained rates of change that are properly called inflation.

Academic and professional opinion has now accepted several of the monetarist propositions that many once regarded as wrong headed or even heretical. Central bankers in leading countries, including the United States, now describe their principal task as the maintenance of price stability. Countries like Italy, France and Britain, with a history of inflationary policy, tie their currencies to the German mark to borrow credibility from the successful, low inflation policies of the Bundesbank. And the Bundesbank sets a target for the growth rate for the money stock that it achieves much of the time. Just as importantly, market participants believe that the directors of the Bundesbank will not persistently exceed their monetary target.

**Keynesians and Monetarists**

The Keynesian tradition gave government responsibility for stabilizing an unruly economy. Keynesians developed the notion of a fiscal-monetary mix to control spending and the balance of payments simultaneously. Judicious well-timed changes in taxes and government spending were to be balanced against propitious changes in money to control the economy. The famous Phillips curve tradeoff supposedly gave economists a tool for choosing between inflation and unemployment. If the choice didn't work out as intended, Keynesians relied on informal price and wage controls, jawboning, and guideposts to improve the tradeoff. Under flexible exchange rates, they urged international policy coordination and selective exchange market intervention to manage the global economy. In these and other ways, they presented economists as engineers who adjust the controls and, when necessary, design new controls to maintain just the right mix of policies.

To know when and how much to adjust policies, Keynesian economists developed forecasting models. Some had hundreds of equations. Using large scale computers, the models could be used to simulate policy changes in advance to predict the effect of policy changes and more closely adjust the mix of policy actions.

Monetarists were critical of these models and their use in policy. They favor stable policy rules that reduce variability and uncertainty for private decisionmakers.
They argue that government served the economy best by enhancing stability and acting predictably, not by trying to engineer carefully timed changes in policy actions. Monetarists saw such efforts as frequently destabilizing.

The attempt to apply Keynesian policies, notably in the United States and Britain, produced alternating periods of rising inflation and rising unemployment, not the finely adjusted trade off that the Keynesian sought. Instead of carefully crafted adjustment of domestic output and the balance of payments, Keynesian policies brought an end to the Bretton Woods system of fixed but adjustable exchange rates. The world economy suffered from a surge of inflation, unprecedented in peacetime history. Later, increases in oil prices added to the problem of rising prices, but the oil price increases were themselves a reaction, at least in part, to the surge in the world price level and the decline in the price of oil relative to the prices of goods purchased by oil producing countries.

Forecasting proved a weak foundation for policy actions. The best forecasts of spending, output, prices and inflation proved to be unreliable. On average, forecasters have been unable to distinguish between booms and recessions a quarter or a year ahead, so they are as likely to mislead as to benefit policymakers. Federal Reserve forecasts consistently underestimated inflation during the period of rising inflation and overestimated inflation when inflation fell. A vast amount of research showed that econometric models cannot accurately forecast interest rates and exchange rates.

The Bretton Woods system of fixed exchange rates required all countries to accept the inflationary consequences of U.S. economic policy. Once the system ended, countries were free to adopt independent policies. Many did just that. Of particular interest are the policies of Japan, Germany and Switzerland. These countries undertook to lower inflation by gradual but persistent reductions in money growth. Later, several European countries adopted medium-term fiscal strategies. And, although countries did not call their actions "rules", and they did not always follow their rules, the general approach was much closer to the monetarist prescription for policies based on rules than to Keynesian activist meddling.

Nowhere was the change more apparent than in Britain in the 1980s. A medium-term fiscal plan, lower tax rates, persistent reductions in money growth, an
end to exchange controls and wage-price guidelines were part of the set of reforms that produced a revival of growth and confidence. For the first time in many decades Britain's economic performance was one of the best in the 1980s. Not all of the British reforms were monetarist prescriptions, but the shift toward rules or medium term strategies and the reduction in money growth and inflation were key parts of the policy. Later, the monetary policy was changed. Instead of controlling money growth to maintain domestic price stability, the Chancellor of the Exchequer, Nigel Lawson, told the Bank of England to control the exchange rate against the German mark and other European currencies. The result was higher money growth followed by booming demand and higher inflation, then by a disinflationary policy and a recession. The spending boom, the return of inflation and later the onset of recession show the familiar, monetarist associations of money growth with inflation, unanticipated increases in money growth with booms, and unanticipated reductions of money growth with recessions.

Why the Skepticism?

Although monetarism is as alive and well as ever, considerable skepticism and contrary opinions can be found. I think there are two factors behind the skepticism. First, the Federal Reserve's "monetarist" experiment in the early 1980s is generally described as a failure. The reasons for the alleged failure differ, but prominent among them is the shift in the demand for money in 1982. Second, the critics and the monetarists have very different policy agendas. The critics see government policy action as a way of removing instability caused by unruly private behavior. They have long advocated activist policies to control spending. When taxes and spending proved to be less flexible and their influence on output and prices less potent than Keynesians (and other activists) believed, many of the advocates of activist policy shifted attention to monetary policy. They hoped to use changes in money, credit and interest rates to fine tune the economy. Some monetarists may have encouraged this behavior by making short-term forecasts that were wide of the mark and by overstating what monetarism could deliver. Monetary relations are a basis for policy rules not short-run policy activism.