Monetarism Revisited

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Monetarism Revisited

by

Allan H. Meltzer

Thomas Mayer and Patrick Minford's retrospective on monetarism offers a useful summary of some of the main issues in the 1960s and 1970s debate over monetary theory and policy. I agree with much, but not all, of what they say and especially with a main conclusion that they draw: currently most of the issues then in dispute are now regarded as settled. Much of monetarist analysis now forms a central part of what is (strangely) called the neo-Keynesian model.

A counter-revolution succeeds, as in this case, when practitioners no longer distinguish competing alternatives. I accepted the editor's invitation to comment briefly on Mayer and Minford's paper, not to dispute what they say, but to extend it in three ways. First, I will briefly develop some of the reasons a counter-revolution was required. A little knowledge about Keynesian views at the time clarifies what the counter-revolution was about. Second, the discussion was not static. Issues changed. I believe the authors neglect some of the main issues in the discussion. I suggest some examples. Third, some unresolved issues remain relevant. I draw extensively on a 1997 invited lecture to the International Atlantic Economic Conference. [Meltzer, 1998]

Monetarism started as a challenge to the ruling Keynesian theory of the 1940s and 1950s. Beneath the surface lay a fundamental difference. Keynesians saw the private sector as unstable and in need of control. Monetarists believed that the central bank or government created instability and that changes in monetary policy were a main source of instability. Keynesian
models of that period had either no role, or a very modest role, for money in macroeconomic analysis. There are many examples. In Lawrence Klein's early model of the business cycle, money had no role at all. The American Economic Association's *Readings in Business Cycles* (1965) or its *Survey of Contemporary Economics* (1948) minimized the role of money. In Britain, the Radcliffe Committee did the same. Prominent economists like Nicholas Kaldor and Joan Robinson denied any role for money in inflation well into the 1980s.

In the simple Keynesian models of the time, the government used fiscal policy to control aggregate output. The central bank's role, if any, was to keep the interest rate low and to finance budget deficits and surpluses by issuing or withdrawing money. Typical workhorse models like IS-LM did not separate prices and output, did not distinguish between real and nominal interest rates and wages, did not distinguish between bonds and real capital, and excluded any international effects. Later, the appearance of A.W. Phillips' relation between changes in wages (or prices) and unemployment permitted the analyst to separate output and inflation.

For policy, two implications became important for the Great Inflation. First, monetary policymakers were expected to coordinate their actions with fiscal policymakers. In practice, they could raise interest rates, but they were expected to finance fiscal expansions without doing so. Policy coordination greatly reduced central bank independence. Second, the original Phillips curve implied that policy could trade higher employment for more inflation. The Keynesian economists who influenced or guided fiscal policy in Britain and the United States during the 1960s could not resist the temptation to coordinate policy and lower the unemployment rate. This started the Great Inflation, ended the appeal of the simple Keynesian model for most economists and supported the monetarist counter-revolution.
Discussion Moves On

Joan Robinson continued to insist that “the notion that inflation is a monetary phenomenon and that it can be prevented by refusing to allow the quantity of money to increase is to mistake a symptom for a cause.” (Robinson and Wilkinson, 1985, 90) The familiar proposition that money growth persistently in excess of output growth caused inflation was part of the monetarist canon.

Discussion moved on to the relation of inflation to market interest rates and the rediscovery of Irving Fisher’s earlier work on the distinction between real and nominal interest rates. Then it moved to the distinction between short- and long-run Phillips curves, reemphasizing the long-run neutrality of money and the so-called natural rate of unemployment. Along the way, discussion brought in international responses under the (then) fixed exchange rate system and distinguished between the real and nominal exchange rate. These propositions, once a contentious part of the monetarist-Keynesian dispute are now settled.

By 1977, differences over the role of money and most monetarist propositions had been resolved. In his address to the American Economic Association, a prominent Keynesian, Franco Modigliani (1977), shared my view that these issues were part of the controversy. He conceded that monetarists analysis was correct. The principal remaining issue that he would not concede, he said, was whether monetary policy should follow a rule, as most monetarists proposed, or proceed according to the discretionary choice of officials. Work by Finn Kydland and Edward Prescott (1977) and subsequent analysis by others, strengthened the case for systematic, predictable policy (rules) both in the economics profession and among many central bankers.
Some Unresolved Issues

Recent discussions suggest some remaining unresolved differences between the monetarist framework and the common framework used by economists. I will highlight three that seem particularly relevant currently.

First, many of the models that economists use have a single interest rate—the interest rate. The central bank sets this rate, so it is a short-term rate. By setting the rate, the central bank supplies the quantity of base money that the public wishes to hold. Money has no further role, indeed no role at all.

This confuses long- and short-run adjustment. In the short-run conditions required for a single interest rate do not hold. The expectations theory of the term structure does not hold exactly. Nor does uncovered interest parity, or the long-run relation between prices on a variety of assets and the short-term interest rate. Relative prices adjust to change in money growth; money growth retains a role in the transmission of policy impulses mainly by changing relative prices and yields until equilibrium is restored.

Second, the monetarist adjustment process highlights the role of the relative prices of assets to output. Monetary expansion promptly raises asset prices. Housing and equity prices are examples. Higher asset prices induce an increase in demand for substitutes, thereby stimulating production of new houses, and new consumer and producer capital. These substitutions do not vanish when the short-term interest reaches zero. Hence a zero short-term interest rate does not imply that monetary policy is impotent or that the economy is in a liquidity trap, as in Keynesian models. The central bank can buy other assets. A number of experiences at zero interest rates support the monetarist proposition. Most recently, the Bank of Japan, after refusing for years, began to buy long-term and foreign securities. With a lag, deflation fell
toward zero, monetary policy contributed to expansion, and a lengthy deflation and recession ended.

Third, many economists and central banks describe monetary transmission as operating by changing the volume of loans offered by banks. Monetarists have a relative price theory of transmission. When the banking system fails, as in the U.S. during the Great Depression or in Japan in the 1990s, monetary policy continues to affect output and inflation by changing relative prices.

Finally, monetarists do not dispute the importance of rational expectations. This is a significant advance of lasting importance for dynamic models. Karl Brunner and I (1993) criticized the models they use, especially the absence of costs of acquiring information. Most rational expectations models assign significant value to information but zero value to the cost of acquiring it. A main reason that price adjustment is less rapid in practice than in rational expectations models is that individuals cannot know instantly whether changes are transitory or persistent and often whether they are real or nominal changes.

Conclusion

Mayer and Minford summarize some major issues in the monetarist-Keynesian debates. They concentrate on the role of money, the supply of and demand for money, and the relation of money growth to inflation. I accept much of what they say but add some additional elements and some relevant issues that remain unresolved. My main criticism is that they, like many others, overemphasize difficulties of measuring money and especially its growth rate. Problems of measurement apply to many variables. Difficulties in forecasting the decline in inflation in the 1980s was not limited to models based on money growth.
When I extended a model of the demand for money at annual frequency in Meltzer (1963) through the 1980s, I found that when long-term interest rates returned to their 1920s values, so did the demand for money per unit of income. Further, when inflation declined in the 1980s, money per unit of income followed the same path as where inflation rose in the 1970s. This suggests considerable stability of the demand for money at annual frequency.

The proper lesson to draw from experience and economic analysis is that none of the models work very well at short frequencies. Economics is not the science that delivers consistently reliable quarterly forecasts. Experience to date suggests that such forecasts are beyond our current ability. Growth of money per unit of income remains a useful, reliable, predictor of longer-term inflation.
Bibliography


