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WHO WERE THE MONETARISTS

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In Britain and the United States tight money has been spectacularly successful in bringing down inflation, and in other nations reduced money supply growth is now at least associated with reduced inflation. In this narrow sense monetarist theory has been demonstrated, to the extent that most now accept that monetary growth and inflation are closely linked. However the broader Freidmanite/monetarist prescription really was not adopted by Britain ~~and~~ or the United States.

Milton Freidman wrote " Program for Monetary Stability " in 1960, well before the 1970s inflation. His proposals were designed to enhance or maintain price stability at a time of wild talk but of relatively stable prices. The proposals eventually earned a Nobel Prize. They also earned the ire of socialist and conservative interventionists who for one reason or another (or one vested interest or another) did not wish to see governments concentrate on one economic variable, allowing others to be set in relatively free markets.

Monetarism was originally a policy for staying out of trouble by adopting that steadily increasing quantity of money that was consistent with an "acceptable" (zero) rate of inflation. An essential element of monetarism was constancy. The on and off approach of U.S. and Britain has been a serious departure from Freidman's monetarism which has probably contributed to unemployment.

By the end of the seventies politicians turned to monetarism to extricate their countries from the mess that monetarism had been designed to prevent but adopted only part of the monetarist prescription. Although tight money has indeed proved a cure for inflation, it has not been a painless policy and it has not satisfied politicians who demand painless cures for conditions caused by their own excesses. On the other hand, countries,including Australia since 1978, where inflation was not tackled seriously, have not entirely escaped rising unemployment either; while nations, like France, which tried to cure unemployment by monetary expansion, and hence even more inflation, have the worst of all worlds - sharply rising inflation and rising unemployment. Switzerland, West Germany, and Japan since the first oil shock, whose money management has been more or less the Freidman prescription of constant predictable and modest expansion, have done better. Ralph Willis and others reputed to favour demand stimulus ought to think carefully before sending Australia down the French road.

Why has tight money apparently increased unemployment, and why have our governments and central bankers ~~have~~ been so unsteady ?

The 'rational expectations' view of money management is that if businessmen and their employees expect money to be tight, loose, or anything in between, they will adjust prices and wages accordingly; money being merely a measure of account will have no affect on the real world of production and employment. In Australia Introduction of decimal currency had no affect on real activity and employment because people correctly anticipated that twice the number of dollar units of account would replace the old pound units. We should not expect changes in the other direction to have real effects either. Why then, when the British and U.S. governments pre-announce more or less accurately, that money supply will grow more slowly does subsequent monetary policy cause unemployment ?

One explanation is that an all too rational public, made cynical by experience, did not believe Thatcher and Reagan. After all, why should they ? The story was not new, and in the past, those who believed it had seen their real incomes eroded, while those who bargained ~~for~~ to account for generous measures of inflation maintained or even enhanced their real incomes. This time when inflation really came down, unions and employers struck wage bargains that were too high, and profits and employment suffered. The public were rational cynics whose cynicism was for once, at least in the first instance, misplaced.

It seems tight money, even when pre-announced, reduces employment, while expanding the money supply is no longer capable of increasing business activity. Rational cynicism may also explain this asymmetrical real response to money supply. Governments which announce responsible but politically difficult courses tend not to be believed. But a government that says it intends to increase money supply by, say, adopting an incompletely funded budget deficit, is entirely credible; prices adjust to new expectations completely and quickly.

Prices may even over compensate, in anticipation of a government as wild as its own rhetoric.

Not only do monetary stimuli fail to stimulate but investors find high levels of inflation and corresponding high nominal interest rates frightening. They must make allowance for the inefficiency of an economy coping with a constantly changing unit of account, and they must guess tomorrow's inflation to allow for it. Managing West German, Swiss, or Japanese businesses, where governments have established records for controlling inflation, must be easier than elsewhere. Present high interest rates may well be the rational judgement that Reagan will lose some of his enthusiasm for inflation control as the election approaches.

West Germany (unemployment 9.4%), Switzerland (unemployment 0.8%) and Japan (unemployment 2.5%) not only have most nearly adopted monetarism, but on the matter of money their governments are believable. Other governments must establish a record that makes them credible. Then, and only then, can they expect to tighten money without real side effects, but by then they will have licked inflation anyway.

Either because political government has a poor grasp of monetary issues, or by a legal separation of power, most Central Banks enjoy some autonomy. At first blush it surprises that Central Banks don't do more to control inflation. A possible explanation is that central banks have been captured by the people who buy and sell government bonds - their customers. Since it is in the nature of things impossible to control both the supply and price of anything, a constant money supply requires a variable bond yield - a market in which fortunes can be made and lost. Central bankers and their customers are not by nature speculators, so banks control interest rates and hence the price of government paper on issue, rather then the money supply.

Neither governments nor Central Banks are inclined to adopt monetarism. During the seventies they didn't try very hard.