Agenda, Volume 13, Number 3, 2006, pages 265-274

REVIEWS

Monetary Targeting Policy

Simon Guttmann, ***The Rise and Fall of Monetary Targeting in Australia***, *Australian Scholarly Publishing, Melbourne, 2006*

Reviewed by ***Graeme Wells***

Andy Warhol once said that 'in the future, everyone will be world-famous for 15 minutes'. He was observing that, with luck and good media management, lack of talent is no bar to temporary celebrity status.

Perhaps this also applies to economic policy prescriptions — in this interesting book Simon Guttmann makes a convincing argument that this was true of the monetary targeting episode in Australia from January 1976 to January 1985. The policy was advanced during the election campaign and adopted by the incoming Liberal-Country Party coalition at a time when, in 1975, consumer prices were almost 17 per cent higher than a year earlier and the unemployment rate was more than 8 per cent. Clearly, a strategy to control inflation was required to win the election and in 1975 Milton Friedman's widely-publicised visit to Australia prepared the ground for monetary targeting.

'Monetary targeting' refers to the policy of manipulating macroeconomic policy instruments so as to achieve a pre-announced growth rate of some monetary aggregate. In the early 1970s the basis for monetary targeting comprised several elements.

It was argued that, although there may be a short-run tradeoff between inflation and economic activity (with higher activity being obtained at a cost of higher inflation), there is no tradeoff in the long run. As people come to expect higher inflation, they adjust their behaviour in ways which offset its effects — to give one example, wage negotiations take account of expected inflation and change labour supply, shifting employment back to its original level. So higher inflation is not associated with higher output and employment in the long run. The corollary of this argument is that, if policy-makers could convince people to *expect* a fall in inflation, a cut in inflation could be obtained with only a small short term cost to activity.

The other elements were, first, that the authorities can exercise control over some monetary aggregate and, second, that inflation is closely related to it. In Australia the chosen aggregate was M3, which is the sum of currency on issue and the public's deposits at banks. So, if M3 growth has a predictable and causal relation to an ultimate policy target such as price inflation, monetary targeting

provides a framework for formulating policy which is effective and easily communicated to the public.

Guttman argues convincingly that these requirements were not met in the mid 1970s, and that this was well-understood by the Reserve Bank. Empirical studies did not suggest a tight relation between M3 growth and inflation in Australia. Nor was it likely that close control of M3 would be possible. In the early 1960s, for example, work by Robert Mundell, Marcus Fleming and Harry Johnson had established that in the absence of restrictions on international capital flows, it would be impossible to achieve monetary targets if the exchange rate were fixed, or adjusted infrequently, as was the case in Australia over most of the targeting period.

Market-determined interest rates were also required if monetary growth was to be insulated from the effects of budget imbalances. This requirement was not met either, because until the early 1980s the Treasury set the interest rates on government securities, with the Reserve Bank being the residual purchaser or seller of the imbalance between Treasury supply and private-sector demand for securities. In turn, changes in Reserve Bank holdings of government securities change the monetary base and hence the money supply.

Although the Reserve Bank and the Treasury were aware of the difficulties of successfully implementing an inflation targeting regime, they both supported it. Guttmann argues that an important reason for Treasury support was that under the system of regulated interest rates, with the Reserve being the residual purchaser of government securities, monetary targeting provided a discipline on the size of the fiscal balance. The Reserve Bank, on the other hand, hoped that adoption of monetary targeting would lead the Treasurer to adopt policies necessary for its effective implementation. Deregulation of interest rates, which would have involved an increase in the power of the Reserve Bank at the expense of the Treasury, was an important requirement.

In these circumstances it is hardly surprising that (apart from two early successes) targets were not met, or that the difficulties inherent in the targeting regime were not clearly understood by financial markets and the wider public.

Lack of transparency had its costs. Deregulation of financial markets in the early 1980s removed controls on bank interest rates, floated the exchange rate, and removed Treasury controls on government-security interest rates. This meant that banks started to win back business from nonbank financial institutions (NBFIs). Since M3 included the deposits of banks but not deposits of NBFIs, M3 growth became an increasingly unreliable guide to monetary conditions and in January 1985 targeting was abandoned by then Treasurer Keating. The newly elected Labor government had yet to establish its economic credentials and financial markets took fright, depreciating the Australian dollar and raising the international risk premium on Australian interest rates.

Although the Reserve Bank could have foreseen that financial market deregulation (which for the first time gave the Reserve the tools with which to

implement an effective monetary policy) would pose problems for M3 targeting, no alternative strategy was readily available. It would be almost a decade before the present policy of inflation targeting was put in place. Over the 1980s, average CPI inflation in Australia was substantially higher than in Japan, the United States, the Euro area and the United Kingdom. The promise of monetary targeting — that changing inflationary expectations could achieve disinflation at low cost — was not realised.

Australian macroeconomic policy is again governed by pre-announced targets — the Reserve Bank's inflation target and the government's target for the fiscal balance. The CPI targeting regime has a number of features which suggest that the Reserve Bank has learned valuable lessons from earlier experience. Control of CPI inflation is a final objective of policy rather than an intermediate target, and the Bank has operational independence from the Treasury in the use of the cash rate to achieve its target. The target applies to a longer horizon than the twelve-month time frame for monetary targets. It is defined in terms of achieving a target range of 2-3 per cent CPI inflation 'over the cycle'. While reference to the 'cycle' leaves a degree of wriggle room — it may refer to either a 'classical' or 'growth' cycle, for instance — it sensibly allows for temporary deviations outside the target range. Finally, the Reserve now goes to some length to explain its policy actions and, largely as a result of its efforts, the complexities of policy implementation are well understood by Australian financial markets and policy commentators.

On the other hand the Government's present fiscal strategy, which is to maintain the budget in balance over the course of the economic cycle, retains echoes of the monetary targeting era. Targeting was seen as an indirect mechanism to restrict the size of budget deficits. Now the fiscal target is explicit, although the precise measure of the fiscal deficit is open to manipulation by the Treasurer.

But like the monetary target, the budget balance is an intermediate target and its relationship to the ultimate objectives of policy is unclear. One suspects that the focus on the budget balance is, like monetary targeting and the equally short-lived emphasis on the current account deficit which followed it, a simple-minded device to justify other policies. It may be a useful way to constrain the expenditure claims of sectional interests, for example. Or it may be an indirect way to target the current account deficit by boosting national saving. But it is much less useful if pursuit of budget surpluses results in inaction with regard to efficiency enhancing tax reforms, or expenditures which pass cost-benefit criteria.

Guttmann has written a useful and interesting book. For observers outside the political-policy process it provides a timely reminder of the difficulties of implementing good policy. The book is enlivened by the personal recollections of a range of individuals — politicians, policy advisers, academics, officers of the Reserve Bank and the Treasury, and prominent newspaper columnists. An apposite quotation is from then Reserve Bank governor Sir Harold Knight who,

when giving an account of his appearance before the Campbell Committee, could not recall ‘just how far I permitted myself the liberties of plain speech’ (p. 144).

An important message of this book is that economic policy would have been better served if those involved had implemented monetary targeting with a clear idea of what it could achieve, and used plain language to explain the policy to the public.

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