

# Is

BY OTMAR ISSING

# Monetarism

*Has the resurgence  
of Keynesianism  
already peaked?*

# Dead?

**H**asn't the theory of monetarism been consigned to the scrap heap along with other discarded theories? Aren't monetarists an endangered species? The answer seems obvious. The name of the economist who for a time was held to be the very antithesis of monetarism is now on everyone's lips. "Keynes is back." That's the message proclaimed in one way or another by large numbers of academic papers and newspaper headlines. And all over the world, a historically unprecedented expansion of government spending programs and a veritable explosion of budget deficits are infused with the Keynesian spirit.

## KEYNES VERSUS FRIEDMAN

The Keynes renaissance comes as no surprise. Beginning in 2007, the global economy was plunged into a severe crisis comparable only to the post-1929 Great Depression. Keynes's *General Theory of Employment, Interest, and Money* of 1936 marked a turning point in economic theory and practice, offering the conviction that by managing demand, unemployment could be eliminated and full employment ensured. This view later came to dominate policy, particularly in the English-speaking countries, but its influence was also felt throughout the academic debate. John R. Hicks characterized the period 1950–1975 as the Age of Keynes.

This dominance of Keynesianism was finally undermined by two developments. The first was new theoretical and empirical research, chiefly associated with the American economist Milton Friedman. The work of those economists, who soon came to be termed "monetarists," called into question fundamental elements of both Keynesian theory and the economic policy it underpinned. Growing skepticism toward Keynesian thinking—concerning the effectiveness of fiscal policy and its multiplier effects, the

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## Big Thinkers on Money

“When we say ‘the prices of goods are determined by supply and demand’, we almost always ignore money. We only think of the supply and demand of goods. But that is only half of the story. Prices of goods are determined by the supply and demand not only of goods, but by the supply and demand of gold in terms of which, through money, all prices are expressed.”

—Irving Fisher, 1913



“In summary, the prediction that prices respond proportionally to changes in money in the long run, deduced by Hume in 1752 (and by many other theorists, by many different routes, since), has received ample—I would say decisive—confirmation, in data from many times and places.”

—Robert E. Lucas, Jr.,  
1996

“And all the fundamental flaws of metallism and of the quantity theory, which I ... have certainly not defended, cannot alter the fact that the theories so often excoriated under these headings do contain a great deal of sound sense, a great deal of practical wisdom ...”

—Joseph A. Schumpeter,  
1917



“No money—no inflation.”

—Mervyn A. King, 2002

disregard for money and monetary policy, and the hubristic attempt at fine-tuning the economy—was replaced by growing support for monetarism.

The second development, just as important, was that Keynesian policy had failed in practice. No one could have conceded this more plainly than then-British premier James Callaghan in his speech to the Labour Party Conference in Blackpool in September 1976: “We used to think that you could just spend your way out of a recession and increase employment by cutting taxes and boosting Government spending. I tell you, in all candor, that that option no longer exists, and that insofar as it ever did exist, it only worked by injecting bigger doses of inflation into the economy followed by higher levels of unemployment as the next step. That is the history of the past twenty years.”

Monetarism offered an explanation of why Keynesian policy had failed, and at the same time prescribed a superior alternative. The “Keynesian Revolution” gave way to the

“Monetarist Counter-Revolution” (Harry J. Johnson). Central banks adopted monetarist thinking: Germany’s Bundesbank was the first central bank in the world to publish a money supply target, for 1975. But in monetarist circles, the Bundesbank’s policy soon came to be criticized for not being sufficiently true to principles. The central bank itself termed its approach “pragmatic monetarism.”

That said, the two camps were by no means as diametrically opposed as this much-simplified picture suggests. Monetarists and Keynesians—especially the latter—come in many flavors. Friedman himself once said, in 1966, that “We are all Keynesians now,” although he doubtless meant it differently, since he finished the sentence: “...nobody is any longer a Keynesian.”

### MONETARISM IN RETREAT

In fact, monetarism was in retreat long before the current crisis erupted. The recent wave of financial innovations has,

to varying degrees, made monetary aggregates less meaningful as indicators. The majority of central banks pay increasingly less attention to the growth of the money supply, or even ignore it altogether. Inflation targeting, the strategy aimed at controlling inflation directly, has largely held sway from the mid-1990s onwards. It uses forecasting models that do not assign any active role to the money supply. Even recent trends in academic debate give scant attention to monetarism. Since the outbreak of the crisis, Keynesianism appears to have vanquished all opposition.

So is monetarism dead? Was it no more than a passing phase in economic theory and practice? A whole series of monetarist-influenced policy prescriptions have fallen from fashion. Take, for example, the rule whereby the stock of money should be increased at a predetermined yearly—or even monthly!—percentage rate. Even the rule's originator, Milton Friedman, had long since abandoned this extreme tenet. Yet other insights, derived at least partly from monetarist critiques of what demand-management policy could achieve, should not be forgotten. If central banks disregard the lags of one to two years and more with which monetary policy measures produce their effect, they risk underestimating the dynamics of inflationary developments and exiting too late from expansionary policy.

Maybe, then, the resurgence of Keynesianism has already peaked? There are increasing signs, for example, that the multiplier effects of government spending are being overestimated, and further that governments everywhere are at a loss as to how to deal with mushrooming public debt.

#### IS MONETARISM DUE FOR A REVIVAL?

In the 1950s, there was widespread belief in the Keynesian dictum, “Money doesn't matter,” and no worry was wasted on the growth of the money supply. This belief proved to be fundamentally wrong. The recent worldwide surge in asset prices would have been unthinkable without the huge expansion in the money supply and the volume of credit. The bursting of this bubble plunged the global economy into its worst crisis since the Great Depression, and served as an object lesson for the dangers of ignoring monetary factors. It would be a tragic irony if monetarism were in turn to experience a revival, because, in the end, the disregard for monetary growth translates into a marked rise in goods price inflation as well. Is it

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being cynical to suggest that, from this point of view, the odds of a monetarist revival are not bad? A new monetarism would not be a rehash of old recipes. Models of monetary growth would no longer be based on simple money supply concepts, and the volume of credit in all its aspects would play a greater role than in the past.

The limitations of inflation targeting have meanwhile become all too apparent. For far too long, major central banks have neglected monetary factors. With its two-pillar strategy, the European Central Bank has by no means slavishly followed monetarist dogma; rather, it has subjected the growth of the various monetary aggregates and their counterparts to careful analysis, and this has influenced its decision-making. In the recent financial market turmoil, more advanced and refined analytical methods have yielded important insights (ECB, Monthly Bulletin, November 2009).

In his monumental *A History of the Federal Reserve*, the leading monetarist Allan H. Meltzer provided numerous examples of how and why a short-term approach can lead to monetary policy errors. A monetary policy that draws inspiration from monetarist ideas, by contrast, takes a medium- to long-term view. “The Federal Reserve is in the money business. It is responsible for growth of the money stock and its consequences,” says Meltzer (p. 1228)—a position that could be described as ‘enlightened monetarism’.

The thoughts on money by distinguished economists mentioned earlier in this article show that core concepts of monetarism remain valid. Indeed, the aftermath of the current explosion of government spending and budget deficits may bring a corresponding revival in monetarist economic theory. “Inflation is always and everywhere a monetary phenomenon.” Milton Friedman's fundamental monetarist proposition will be confirmed time and again. Hopefully, it will not take a new period of inflation to remind the world of its truth. ◆