MONETARY POLICY – THE LESSONS OF HISTORY

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"MONETARY POLICY — THE LESSONS OF HISTORY"

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INTRODUCTION

I AM VERY APPRECIATIVE OF THE HONOUR THE UNIVERSITY OF WESTERN AUSTRALIA HAS EXTENDED IN INVITING ME, AS GOVERNOR OF THE CENTRAL BANK, TO DELIVER THE 1987 SHANN MEMORIAL LECTURE.

ALTHOUGH I AM NOT A WEST AUSTRALIAN, IT IS FROM THIS STATE THAT MUCH FORCE IN THE DEVELOPMENT OF ECONOMIC AND MONETARY POLICY IN AUSTRALIA HAS DERIVED. SHANN, OF COURSE, TOOK A NATIONAL POINT OF VIEW IN HIS DEVELOPMENT OF ECONOMIC THOUGHT. AND IN THE POST-WAR PERIOD TWO WEST AUSTRALIANS, NAMELY DR H.C. COOMBS AND AUSTIN HOLMES, MADE VERY CONSIDERABLE CONTRIBUTIONS TO THE DEVELOPMENT OF MONETARY POLICY.

THE THINKING OF THESE LATTER TWO WEST AUSTRALIANS ABOUT AIMS AND OBJECTIVES WAS SIMILAR BUT THEIR APPROACH TO WHAT ROLE MONETARY ACTION SHOULD PLAY DIFFERED GREATLY.

I THINK IT FAIR TO SAY THAT COOMBS BELIEVED THE MONETARY SYSTEM COULD BE HARNESSED AS AN ENGINE FOR ECONOMIC AND SOCIAL REFORM. HOLMES, ON THE OTHER HAND, WAS A NON-INTERVENTIONIST.

THE RESERVE BANK TODAY IS CLOSER TO THE LATTER VIEW – IN THOUGHT AND PREFERENCE. HOWEVER, AS I HOPE TO EXPLAIN TONIGHT, IT IS DIFFICULT FOR A CENTRAL BANK ALWAYS TO HAVE A "HANDS OFF" APPROACH.

MY GENERAL THEME IS THE LESSONS THAT WE HAVE LEARNT ABOUT MONETARY POLICY SINCE SHANN'S TIME. IN THAT PERIOD WE HAVE BEEN INFLUENCED BY BOTH VIEWS.
IN THE EARLY 'THIRTIES, ATTITUDES UNDOUBTEDLY WERE STILL STRONGLY INFLUENCED BY THE LONG PREVIOUS ATTACHMENT TO THE GOLD STANDARD AND, EVEN THOUGH AUSTRALIA AND OTHERS WERE "OFF" GOLD, THERE WAS STILL A STRONG BELIEF IN THE EFFICACY OF SOME ESTABLISHED STANDARD, IN OUR CASE THE "STERLING EXCHANGE" STANDARD. THE THOUGHT OF OPERATING WITHOUT SUCH A STANDARD - EITHER A "MANAGED" OR A "MARKET" APPROACH - CONJURED UP THOUGHTS OF RAMPANT INFLATION OF WHICH THERE WERE SOME NOTABLE RECENT EXAMPLES.

SOME WOULD PUT THE POINT IN TERMS OF WHETHER WE HAD THE KNOWLEDGE AND THE RESOLUTION - THE MATURITY - AS A NATION TO OPERATE WITHOUT THE INEXORABLE PRESSURE OF AN EXOGENOUS "RULE".

IN THAT RESPECT, SHANN WAS WELL AHEAD OF HIS TIME. ALTHOUGH IT IS AN OVER-SIMPLIFICATION TO SAY THAT THE WHEEL HAS GONE FULL CIRCLE, SINCE NOTHING IS EVER QUITE THE SAME THE SECOND TIME AROUND, WE HAVE BEEN THROUGH SEVERAL REGIMES IN WHICH SOME FINANCIAL FACTOR OR IDENTITY HAS BEEN THOUGHT TO HOLD THE KEY TO SOUND MANAGEMENT.

NOW WE ARE CLOSER TO SHANN'S PHILOSOPHY THAN AT ANY TIME IN THE PAST 50 YEARS - MORE RELIANCE ON THE FREE PLAY OF SUPPLY AND DEMAND, A LESS INTRUSIVE AND LESS AUTOMATIC ROLE FOR THE MONETARY AUTHORITIES AND, ON THE WHOLE, GENERAL ECONOMIC POLICIES WHICH ALLOW THE MONETARY SYSTEM FREER PLAY.

I WOULD LIKE TO SPEND MOST OF MY TIME TONIGHT LOOKING AT THE WAY THE WHEEL HAS TURNED AND WHAT WE HAVE LEARNT IN THE PROCESS.

THE PRE-WAR DEBATE

IN THE EARLY 1930'S WE EXPERIENCED DEPRESSION OF THE ECONOMY AND DEPARTURE FROM GOLD (AND SUBSEQUENTLY FROM PARITY WITH STERLING) IN ORDER TO ADAPT TO OUR EXTERNAL CIRCUMSTANCES.
THERE WAS WIDESPREAD DISSATISFACTION ABOUT THE ULTRA-CONSERVATISM OF MONETARY POLICY. THERE WERE VOICES, SUCH AS SHANN'S AND DAVIDSON'S, FAVOURING A MORE FLEXIBLE REGIME; OTHERS FOR A MORE REGULATED SYSTEM; AND SOME (FOR PRACTICAL REASONS) FOR SIMPLY-EXPRESSED RULES THAT HAD SOMETHING OF A "GOLD STANDARD" UNDERTONE.

THUS MR L.G. MELVILLE (LATER SIR LESLIE MELVILLE), ECONOMIC ADVISER TO THE COMMONWEALTH BANK, IN HIS EVIDENCE TO THE 1935 ROYAL COMMISSION SAID:

"THE ULTIMATE PURPOSE OF MONETARY POLICY IS TO ENABLE THE ECONOMIC SYSTEM TO ACHIEVE THE OPTIMUM USE OF AVAILABLE RESOURCES AS FAR AS THIS IS POSSIBLE BY MONETARY MEANS. IN ATTEMPTING THIS IT SEEKS —

(A) STABILITY IN GENERAL BUSINESS ACTIVITY;

(B) A MAXIMUM OUTPUT OF FINAL GOODS AND SERVICES;

(C) AS FULL EMPLOYMENT AS IS PRACTICABLE.

HE CONTINUED: "THE IDEAL COURSE WOULD BE FOR THE MONETARY AUTHORITY TO USE DIFFERENT FACTORS UNDER ITS CONTROL SUCH AS THE EXCHANGE RATE, THE SIZE OF THE CREDIT BASE, INTEREST RATES, INFLUENCE ON GOVERNMENTS, BANKS AND ENTREPRENEURS SO AS TO MAKE THE BEST CHOICE BETWEEN THESE THREE OBJECTIVES." HOWEVER, HE SAID: "THIS TASK WOULD BE SO COMPLEX AS TO BE CAPABLE OF SOLUTION ONLY BY SUPERMEN WITH ABSOLUTE POWER."

THE TASK HAD TO BE SIMPLIFIED FOR PRACTICAL PURPOSES: "WE MUST SELECT ONE FACTOR IN THE ECONOMY AND ATTEMPT TO FIX IT, AT THE SAME TIME ENDEAUVOURING, AS FAR AS POSSIBLE, TO MAKE EVERY OTHER FACTOR IN THE ECONOMY ADAPT ITSELF TO THE FIXED FACTOR."
AFTER REVIEWING OTHER POSSIBILITIES, HE OPTED FOR A FIXED (THOUGH NOT IMMUTABLE) EXCHANGE RATE AS THE DATUM POINT FOR MONETARY POLICY; AND FOR EXCHANGE CONTROLS TO CENTRALISE FOREIGN EXCHANGE BALANCES.*

THE COMMISSIONERS, AFTER CONSIDERING THE CASE FOR A STABLE EXCHANGE RATE OBJECTIVE SAID THAT, IMPORTANT THOUGH IT WAS, "IT SHOULD BE SUBORDINATE TO THE BASIC OBJECTIVE OF REDUCING FLUCTUATIONS IN GENERAL ECONOMIC ACTIVITY. SUCH A POLICY IS LESS PRECISE THAN THE POLICY OF STABILITY OF EXCHANGE, AND IS ALSO ONE THE SUCCESS OF WHICH IS MUCH MORE DIFFICULT TO TEST, BUT WE CONSIDER THE IDEA UNDERLYING IT IS OF FUNDAMENTALLY GREATER IMPORTANCE."

*IT IS INTERESTING TO NOTE THAT MELVILLE TOOK THE VIEW THAT OTHER FACTORS, INCLUDING MONEY WAGES, WERE AND HAD BEEN SHOWN TO BE, NOT RIGID BUT CAPABLE OF VARYING WITH PRICES. HENCE A FIXED EXCHANGE RATE COULD BE MAINTAINED.

IT IS ALSO INTERESTING TO RECALL A FURTHER COMMENT. "IT MAY BE HOWEVER THAT A NEW PHILOSOPHY IN REGARD TO MONEY WAGES IS IN COURSE OF DEVELOPMENT. PERHAPS IN FUTURE WAGES WILL BE INCREASED FROM TIME TO TIME BUT NEVER DECREASED. THIS MAY BE ONE OF THE ECONOMIC CONSEQUENCES OF MR KEYNES ...... DEPLORE IT AS WE MAY, IF THIS NEW ATTITUDE TOWARDS WAGES IS ESTABLISHED WE MUST, IN PURSUIT OF OUR OBJECTIVES, SEEK AS FAR AS POSSIBLE TO ADAPT OUR MONETARY POLICY TO THE NEW CIRCUMSTANCES."

SOME WOULD SAY THAT ADAPTATION EVENTUALLY WENT TOO FAR. SIR JOHN HICKS, THE 1967 SHANN MEMORIAL LECTURER, WROTE IN 1955 OF THE ONSET OF WHAT HE CALLED THE "LABOUR STANDARD" – IN WHICH MONETARY VARIABLES WERE ADAPTING TO GROWTH OF MONEY WAGES.
AS REGARDS GENERAL MONETARY POLICY, THE CENTRAL BANK "WOULD HAVE TO CHOOSE, FROM THE INFORMATION AT ITS DISPOSAL, THE FACTORS TO BE CONSIDERED IN DECIDING WHAT CREDIT POLICY TO PURSUE. IT WOULD REQUIRE TO PAY ATTENTION TO MOVEMENTS, FOR EXAMPLE, IN INTERNAL PRICES, THE VOLUME AND PRICES OF EXPORTS AND IMPORTS, THE BALANCE OF PAYMENTS, INTEREST RATES, UNEMPLOYMENT, GOVERNMENT FINANCE, WAGE RATES, PROFITS AND REAL AND MONEY INCOMES. THE BANK WOULD HAVE TO DECIDE, TAKING ALL FACTORS INTO ACCOUNT AND ALLOWING DUE WEIGHT TO EACH, HOW FAR ITS POLICY SHOULD BE ONE OF EXPANSION OR CONTRACTION."

THE COMMISSIONERS THOUGHT THAT THE EXCHANGE RATE COULD NEED TO BE CHANGED FROM TIME TO TIME IN RESPONSE TO FUNDAMENTAL CHANGES IN CONDITIONS IN AUSTRALIA VIS-A-VIS THE REST OF THE WORLD. IT IS NOT CLEAR THAT OTHERWISE THEY WERE THINKING OF MUCH FLEXIBILITY - BUT CERTAINLY OF MORE THAN HAD PREVAIL'D DURING THE PRECEDING DECADE!

ARGUABLY, A GOOD DEAL MORE RIGIDITY THAN MIGHT HAVE BEEN CONTEMPLATED SEEMS TO HAVE APPLIED THEREAFTER TO BOTH DOMESTIC AND EXTERNAL MONETARY POLICY.

SINCE I WANT TO CONCENTRATE ON DOMESTIC POLICY LET ME DEAL FIRST AND BRIEFLY WITH THE SUBSEQUENT COURSE OF EXTERNAL OR EXCHANGE RATE POLICY.

EXCHANGE RATE POLICY

ALTHOUGH THERE WERE PERIODS OF ANXIETY IN THE LATE 1930'S, IT WAS JUDGED THAT CONDITIONS DID NOT CALL FOR ANY CHANGE IN THE EXCHANGE RATE.

THE ONSET OF THE SECOND WORLD WAR AT THE END OF THE DECADE AND THE PASSAGE OF NATIONAL SECURITY REGULATIONS PRODUCED A NUMBER OF CONTROLS IN WHICH AN UNCHANGED EXCHANGE RATE WAS AN INTEGRAL PART. THIS WAS SO INTERNATIONALLY.
WARTIME EXPERIENCE AND MEMORIES OF PRE-WAR COMPETITIVE DEVALUATIONS NO DOUBT HAD THEIR INFLUENCE AT THE INTERNATIONAL FINANCIAL MEETINGS AT BRETON WOODS WHICH LED TO THE ESTABLISHMENT OF THE INTERNATIONAL MONETARY FUND. EXCHANGE RATES WERE TO BE REGARDED AS FIXED SAVE FOR THE NEED TO CORRECT A "FUNDAMENTAL DISEQUILIBRIUM". OTHERWISE, THE DOMESTIC ECONOMY WAS TO ADAPT TO MAINTAIN THE EXCHANGE RATE.

SOME WOULD SAY THAT THE RIGIDITY ON THE EXCHANGE RATE SYSTEM WAS ITS UNDOING. OTHERS WOULD SAY IT WAS UNWILLINGNESS TO ABIDE BY THE RULES REQUIRING DOMESTIC ADJUSTMENTS TO PRESERVE THE EXCHANGE RATE WHICH UNDERMINED AN OTHERWISE SOUND SYSTEM.

CERTAINLY, HOWEVER, BY 1971 IT WAS THE UNWILLINGNESS OF THE UNITED STATES TO HAVE ITS DOMESTIC POLICIES RESTRAINED BY CONCERN FOR THE EXCHANGE RATE WHICH LED TO PRESSURES ON ITS GOLD RESERVES. THE DECISION BY THE US TO OPT OUT OF CONVERTIBILITY OF GOLD AT A FIXED PRICE WAS FOLLOWED BY WIDESPREAD ABANDONMENT OF THE FIXED EXCHANGE RATE SYSTEM.

THIS USHERED IN A VERY MIXED BAG OF EXCHANGE RATE PRACTICES. FOR A NUMBER OF LEADING COUNTRIES, FLOATING RATES BECAME THE NORM. HOWEVER, "CLEAN" FLOATING PROGRESSIVELY BECAME UNTENABLE - TO AN EXTENT BECAUSE OF THE ABSENCE OF INTERNATIONALLY AGREED PRACTICES.*

TRADE IMBALANCES PRODUCED CAPITAL IMBALANCES IN THE OPPOSITE DIRECTION LEADING TO VERY SUBSTANTIAL CAPITAL FLOWS AMONG COUNTRIES.

COULD A SET OF RULES HAVE AVOIDED THE TENSION AND DISRUPTION OF RECENT YEARS? THE UNHELPFUL ANSWER MUST BE "ONLY IF THE RULES WERE UNIVERSALLY ACCEPTABLE SO THAT COUNTRIES WOULD SEE BENEFIT FROM STICKING TO THEM".

OVER TIME, A WIDE RANGE OF PROPOSALS HAVE BEEN PUT FORWARD. THESE RANGE FROM RETURN TO A VARIANT OF THE GOLD STANDARD TO COMPLETE LAISSEZ FAIRE AMONG NATIONAL MONETARY AUTHORITIES. PROPOSALS SUCH AS FORMAL "TARGET ZONES" FOR EXCHANGE RATES FALL SOMEWHERE IN BETWEEN. ONE FURTHER BOLD SUGGESTION IS TO MOVE TO THE USE OF ONE CURRENCY ONLY; OR ONE CURRENCY AMONG THE MAJOR COUNTRIES WHO WOULD THEN FOLLOW A SINGLE, UNIFIED MONETARY POLICY. ANOTHER IS THE ESTABLISHMENT OF A CURRENCY "BUFFER STOCK" BY CENTRAL BANKS WHO WOULD UNDERTAKE CO-ORDINATED INTERVENTION WHERE AND WHEN THEY DEEMED IT DESIRABLE.

WHAT CAN BE SAID TO HAVE BEEN LEARNT FROM THIS EXPERIENCE?

FIRST, THERE IS THE LESSON OF EXPERIENCE ITSELF. THIS HAS BEEN VERY EXTENSIVE; MANY PROPOSALS HAVE BEEN MADE AND A VARIETY OF EXCHANGE SYSTEMS HAVE BEEN TRIED. LACK OF AGREEMENT IS AT THE HEART OF THE PROBLEM. THE USELESSNESS OF RULES THAT WILL NOT BE OBSERVED UNDER PRESSURE HAS BEEN AMPLY DEMONSTRATED.

INTERNATIONAL FINANCIAL DeregULATION AND FINANCIAL TECHNIQUES HAVE RUN AHEAD OF INTERNATIONAL POLICY MAKING. MARKET FORCES ARE NOW VERY POWERFUL AND HAVE NOT BEEN SATISFIED WITH THE RATHER HALTING STEPS THAT THE MAJOR COUNTRIES HAVE TAKEN TO ADJUST IMBALANCES. ULTIMATELY THERE WILL HAVE TO BE POLICY CONVERGENCE OR COOPERATION AMONG THE HANDFUL OF MAJOR COUNTRIES; OR THE FINANCIAL MARKETS WILL IMPOSE THEIR OWN SOLUTIONS. OR WE SHALL LAPSE INTO PROTECTIONISM.

IDEALLY, OF COURSE, MUCH OF THE ADJUSTMENT WOULD COME FROM HIGHER IMPORTS BY THE "SURPLUS" COUNTRIES SO THAT WORLD TRADE MIGHT EXPAND. BUT GIVEN THE RELATIVE SIZE OF THE ECONOMIES, IT
SEEMS INEVITABLE THAT U.S. IMPORTS WILL NEED TO DECLINE. A "REAL" ADJUSTMENT OF THIS KIND IS MUCH TO BE PREFERRED TO A MONETARY ADJUSTMENT INITIATED BY MAJOR CHANGES IN EXCHANGE RATES.

SMALLER COUNTRIES LIKE AUSTRALIA, WITH "OPEN" ECONOMIC AND FINANCIAL SYSTEMS, HAVE LITTLE ALTERNATIVE TO ADAPTING TO THE WORLD AS WE FIND IT.

AUSTRALIA WAS DRIVEN TO THE VIEW THAT A VIRTUALLY FIXED EXCHANGE RATE IN A VOLATILE WORLD THREW AN INTOLERABLE BURDEN OF ADJUSTMENT ONTO THE DOMESTIC ECONOMY. AFTER SOME YEARS OF A "MANAGED" EXCHANGE RATE IN THE '70'S AND EARLY '80'S, THE EXCHANGE RATE WAS FLOATED IN 1983. ALTHOUGH, AS I SHALL COME TO LATER, WE HAVE MORE RECENTLY BEEN UNABLE TO REFRAIN FROM INTERVENTION IN THE MARKET, THE EXCHANGE RATE CONTINUES TO BE BASICALLY MARKET DETERMINED AND FLEXIBLE.

DOMESTIC POLICY

RETURNING TO THE DOMESTIC SCENE, IT IS WORTH REMEMBERING THAT PROBLEMS OF THE DEPRESSION LED TO A REACTION AGAINST UNREGULATED MARKETS.

AUSTRALIA, LIKE OTHER COUNTRIES, SOUGHT GROWTH WITH STABILITY THROUGH A REGIME OF CONTROLS - VIRTUALLY RATIONING. FIXED EXCHANGE RATES WERE A BACKDROP TO THE CONDUCT OF DOMESTIC POLICIES. IN THE MONETARY FIELD REGULATIONS SOUGHT TO CONTROL INTEREST RATES AND THE POWERS OF INSTITUTIONS TO LEND. OTHER REGULATIONS WERE DESIGNED TO AVOID RECURRENCE OF THE ILLS OF THE 1930'S WHEN MUCH OF THE OD IUM FOR THE DEPRESSION FELL ON THE BANKS. THESE INCLUDED POWERS TO LICENCE BANKS, TO INSPECT AND AUDIT THEM AND TO PROTECT THEIR DEPOSITORS.
EXPERIENCE DURING THE SECOND WORLD WAR DEMONSTRATED THAT THE ECONOMY COULD FUNCTION – ON SOME ACCOUNTS WELL – WITH CONSIDERABLE REGULATION. THIS LED TO A PERIOD OF GREAT OPTIMISM ABOUT THE ABILITY OF GOVERNMENTS TO DIRECT AND CONTROL ECONOMIC ACTIVITY. ALL OVER THE WORLD, GOVERNMENTS RESPONDED BY DEVELOPING EXTENSIVE NETWORKS OF ECONOMIC INTERVENTION.

THIS APPROACH WAS ACCOMPANIED BY STABILITY AND STRONG OVERALL GROWTH FOR SOME TIME. BUT PROBLEMS BEGAN TO BUILD UP AND WE FOUND THAT THERE WERE LIMITS TO THE CAPACITY OF GOVERNMENTS TO ACHIEVE ECONOMIC GOALS.

AUSTIN HOLMES USED TO SAY THAT EITHER THE (EXCHANGE) RATE ADAPTED TO THE ECONOMY OR THE ECONOMY ADAPTED TO THE RATE.

THE POST-WAR BOOM PERIODS COULD NOT BE CONTAINED BY THE FIXED EXCHANGE RATE AND RELUCTANCE TO ALTER THE RATE CONTRIBUTED TO INFLATION.

MUCH THE SAME CAN BE SAID OF CONTROLLED INTEREST RATES. IN THE POST-WAR, LOW INTEREST RATES WERE GENERALLY IN VOGUE AND IN BOOM TIMES WERE A SOURCE OF INFLATIONARY BIAS.

IN RETROSPECT, ALTHOUGH BOTH SETS OF RATES HAD PROVISION FOR ADJUSTMENT, THE PRESUMPTION WAS AGAINST FLEXIBILITY.

THERE MAY WELL ALSO HAVE BEEN A VIEW THAT THESE RATES WERE NOT BASICALLY OUT OF LINE BUT WERE REFLECTING INADEQUATE POLICIES ELSEWHERE IN THE ECONOMY, I.E. THAT THE RATES WERE "MESSENGERS" TELLING OF PROBLEMS ELSEWHERE.

WE HAVE LONG BEEN WARNED NOT TO SHOOT THE MESSENGER! BUT THERE WAS ALSO THE QUESTION OF MONETARY POLICY BEING USED TO COMPENSATE FOR DIFFICULTIES IN OTHER SECTORS. TO DO THAT CLEARLY WOULD HAVE IMPOSED ITS OWN COSTS IN THE MONETARY AREA. BUT INFLATION WAS THE GREATER THREAT.

THE PROCESSES THAT WERE OVERWHELMING FIXED RATES WERE ATTACKING THE GENERAL PHILOSOPHY OR REGULATION: DIRECT CONTROLS IN MANY AREAS WERE BEING DISCARDED, CIRCUMVENTED OR THWARTED BY GROWING INTERNATIONAL FINANCIAL INTEGRATION AND DEVELOPMENTS IN COMMUNICATIONS.
MOREOVER, MUCH OF THEIR JUSTIFICATION RESTED ON THEIR UNDERPINNING OF THE REGIMES OF FIXED EXCHANGE RATES AND CONTROLLED INTEREST RATES WHICH WERE THEMSELVES UNDER HEAVY QUESTIONING.

NEW DIRECTIONS

THE 1970'S WAS A DECADE OF REAPPRAISAL AND NEW DIRECTIONS.

WHAT LOOKED LIKE THE ONSET OF ANARCHY WAS DIRECTED INTO NEW CHANNELS BY THE SPREAD OF THE MONETARIST DOCTRINE, NAMELY THAT STEADY MONETARY GROWTH WAS THE KEY TO STABLE PRICES.

THE RISE AND DECLINE OF MONETARISM

FROM THE LATE 1970'S WITH INFLATION A PROBLEM AUSTRALIA, LIKE A NUMBER OF COUNTRIES, HAD GONE DOWN THE PATH OF PUTTING PARTICULAR EMPHASIS ON ACCEPTABLE RATES OF GROWTH OF THE MONEY SUPPLY.

THE MONETARY APPROACH DEPENDS FOR ITS SUCCESS ON A STABLE, KNOWN RELATIONSHIP BETWEEN MONEY GROWTH AND PRICE MOVEMENTS. THAT REQUIRES SOME CERTAINTY ABOUT WHAT WE CALL "MONEY". IT ALSO REQUIRES "ELBOW ROOM" IN TERMS OF FULLY FLEXIBLE INTEREST RATES. ALL OTHER POLICIES NEED TO CONFORM TO THIS.

WHilst WE HAVE LONG RECOGNISED THAT THERE IS A POSITIVE RELATIONSHIP BETWEEN THE VOLUME OF MONEY, ECONOMIC ACTIVITY AND PRICES, WE WERE NEVER CONVINCED MONETARISTS. SPECIFICALLY, WE WERE ALWAYS A BIT SCEPTICAL ABOUT THE SUITABILITY OF ANY OF THE CONVENTIONAL M'S EITHER AS TOUCHSTONE FOR THE MEASUREMENT OF MONETARY CONDITIONS OR AS A FIRM ANCHOR FOR MONETARY POLICY. BUT FOR A TIME, M3 WAS A USEFUL INDICATOR, AS WERE SIMILAR AGGREGATES IN OTHER COUNTRIES.
11.

THESE POLICIES HAD SOME SUCCESS. THE ESTABLISHMENT OF MONETARY GROWTH "TARGETS" WERE IMPORTANT IN TAMING INFLATION IN THE U.S. IN THE EARLY 1980'S AND IN SOME OTHER COUNTRIES. BUT THEY TENDED TO SET GOALS OR REQUIRE ADJUSTMENTS IN OTHER POLICIES THAT WERE REGARDED AS UNATTAINABLE IN OTHER YEARS.

OTHER COUNTRIES, AS WE HAVE DONE, HAVE COME TO PUT MUCH LESS RELIANCE ON ANY ONE MONETARY AGGREGATE AS A POLICY INDICATOR.

MOREOVER FOR US - AND OTHERS - THERE WERE INCONSISTENCIES.

INCONSISTENCIES IN TRYING TO ACHIEVE MONETARY PROJECTIONS WHILE THE EXCHANGE RATE WAS STILL RELATIVELY RIGID. BUT THAT WASN'T THE ONLY PROBLEM.

THE INCREASING IMPORTANCE OF FINANCIAL INTERMEDIARIES OTHER THAN BANKS HAD BEEN PROGRESSIVELY ERODING THE USEFULNESS OF THE M3 MEASURE. THE CHANGES WHICH OCCURRED IN THE WAKE OF DEREGULATION FINALLY PUSHED M3 BEYOND REASONABLE USEFULNESS AS A GUIDE FOR MONETARY POLICY.


DURING THIS TIME OF CHANGE, ATTEMPTS TO PRODUCE A USEABLE MONETARY AGGREGATE INCLUDED THE CONCEPT OF BROAD MONEY. THAT IS, THE M3 MEASURE WAS EXTENDED TO M3 PLUS FUNDS RAISED BY NON-BANK INTERMEDIARIES. DEVELOPMENT WAS STARTED ON AN EVEN BROADER MEASURE WHICH HAS BEEN CALLED "L" - A MEASURE WHICH INCORPORATES DIRECT FINANCING AS WELL.
BUT WE HAVE RECOGNISED THAT DEVELOPING EVEN BROADER FINANCIAL AGGREGATES WOULD NOT SOLVE OUR PROBLEM. WE HAVE – AT LEAST TEMPORARILY – LOST THE PREVIOUSLY UNDERSTOOD LINK BETWEEN MONETARY AGGREGATES, ACTIVITY AND PRICES.

WE COULD NOT PRETEND THAT COMPLEXITY DID NOT EXIST.

WE DO NOT KNOW WHETHER Deregulation HAS BROUGHT A TEMPORARY OR PERMANENT CHANGE IN PREVIOUSLY ESTABLISHED RELATIONSHIPS. OR WHETHER IN TIME SOME ACCEPTABLE NEW LINE OF THOUGHT WILL EMERGE.

THE "CHECKLIST" APPROACH


THE "CHECKLIST" - SOME GENERAL POINTS

THERE IS NOTHING MAGICAL ABOUT THE IDEA OF CONSULTING A WIDE ARRAY OF INDICATORS IN THE PROCESS OF DECIDING POLICY.

THE STRIKING ASPECT IS THAT IT IS A REJECTION OF THE IDEA PREVAILING FOR MOST OF THE LAST HALF CENTURY THAT SOME SINGLE QUANTITY CAN SERVE AS A GUIDE TO APPROPRIATE POLICY AND THAT ALL OTHER ELEMENTS SHOULD ADJUST TO IT.
13.

THE "CHECKLIST" APPROACH IS SIMILAR TO THAT PRESCRIBED BY THE ROYAL COMMISSIONERS MORE THAN HALF A CENTURY AGO.

THE "CHECKLIST" IS A USEFUL DISCIPLINE TO ENSURE THAT THERE IS NOT OVER-CONCENTRATION ON ANY ONE INDICATOR OR ON ANY ONE PARTICULAR AREA OF CURRENT CONCERN. OF COURSE, THERE WILL BE TIMES WHEN ONE ECONOMIC PROBLEM WILL HAVE PRIORITY AND ONE INDICATOR MAY BE DOMINANT. BUT IT WILL NOT ALWAYS BE THE SAME PROBLEM OR THE SAME INDICATOR.

EVEN WHEN APPROPRIATE POLICY IS DIAGNOSED, THERE IS THE QUESTION OF HOW TO PURSUE IT EFFECTIVELY.

FINANCIAL DEREGULATION HAS GIVEN MONETARY POLICY MUCH MORE FREEDOM TO OPERATE. INTEREST RATES AND THE EXCHANGE RATE HAVE MUCH MORE FLEXIBILITY THAN UNDER PREVIOUS REGIMES.

THE OTHER IMPROVEMENT IS BETTER DIRECTED OVERALL ECONOMIC POLICY.

THE PROCESS IS BY NO MEANS PERFECT:

* DIAGNOSIS OF APPROPRIATE MONETARY POLICY IS NOT A SCIENCE: IT INVOLVES JUDGMENTS. THERE CAN BE COMPLEXITIES AND CONFLICTS.

* EVEN APPROPRIATE GENERAL POLICY SETTINGS CAN BE SUBJECT TO TIME LAGS AND OTHER CONSTRAINTS. AN IMPORTANT TIME LAG CAN BE THAT BETWEEN RECOGNITION OF THE NEED FOR POLICY CHANGE, ITS IMPLEMENTATION AND ITS EFFECT.

* THE USE OF MONETARY POLICY WEAPONS, AS OUR PREDECESSORS WELL KNEW, IS NOT WITHOUT SIDE EFFECTS.

* FINALLY, OF COURSE, SOME INFLUENCES ON THE ECONOMY ARE OF EXTERNAL ORIGIN AND BEYOND LOCAL CONTROL.

SOME OF THESE QUALIFICATIONS ARE EXAMINED IN THE FOLLOWING PARAGRAPHS. BUT, ALL IN ALL, THERE CAN BE NO DOUBT THAT THE POTENTIAL FOR EFFECTIVE MONETARY POLICY MAKING IS GREATER THAN EVER TODAY.
14.

Resort to a wide range of indicators will, of course, reinforce one's confidence when there are no important conflicts between the indicators. And this is, I think, likely often to be the case.

For example, a situation commonly encountered is one of strong demand, high inflation and balance of payments difficulties. In this situation all of the general economic indicators can point to the need for tightening monetary policy. Initially, the monetary indicators might well give a consistent reading also – too accommodating.

The opposite situation is also easy to diagnose. Low economic activity is the classic indicator of the need, other things equal, for easier monetary policy. If prices are rising slowly (or in the extreme case, falling), and the balance of payments is strong, the case is reinforced. Again, the monetary indicators are likely to be giving a consistent signal – too firm.

Dilemmas can arise when indicators appear to give conflicting signals. Mostly these situations occur when a country is trying to run a monetary policy rather different from that in the rest of the world. The dilemma will be resolved in time by natural forces but we might not care for the solution! It is when conflicting signals emerge that priorities have to be assigned and "on balance" judgments made.

An example may serve to illustrate. In the late 1970's the Germans and Swiss both faced the dilemma of a rising exchange rate. Although there was a strong commitment to monetary control, the rising exchange rate threatened competitiveness. This, and a certain amount of suasion from other countries, eventually led both countries to adopt an easier monetary policy. (In the case of Germany, a dose of fiscal expansion was added too.) In January 1981 there was a "Deutschmark Crisis" which led to a severe tightening of monetary policy.
Dilemmas can also arise when the mix of domestic policies is out of balance. The question which then arises is the extent to which monetary policy should try to compensate. For example, assume fiscal or wages policy is too expansionary: if monetary policy is not tightened, inflation may quickly result. If monetary policy is tightened, too much of the burden may be borne by monetary conditions: one symptom might be an exchange rate stronger than can be justified by the economic "fundamentals" or interest rates at levels which threaten activity. Examples of this dilemma have been frequent in recent history - most prominent perhaps the USA in the mid 1980's.

Resolving the conflicts created by dilemmas of the sort discussed here are not easy. Legitimate differences of view can persist for some time, and it is impossible to propound general solutions. But whatever the precise situation, experience teaches us that disturbances in the monetary indicators almost certainly give warning of more general problems.

Recent Australian experience with the "checklist"

Our recent history provides something of a case study:

Since 1983, Australia has had a very open, deregulated financial system.

In this period, the major economic influence probably was the sharp decline in Australia's terms of trade.

The process of adjustment has shown up in the monetary indicators - money supply, interest rates and the exchange rate.

The most spectacular change has been in the exchange rate - first falling heavily in response to the terms of trade. More recently, it has been rising strongly under the influence of a better policy climate and worsening conditions for investment overseas. Interest rates tended to move in the opposite directions to the exchange rate.
THE GENERAL STANCE OF MONETARY POLICY AS FOR GENERAL ECONOMIC POLICY WAS ONE OF RESTRAINT. BUT IN BOTH THESE PHASES, THERE WAS A DILEMMA FOR MONETARY POLICY: SHOULD IT ACQUIESCE IN THE MARKETS' JUDGMENTS OR LEAN AGAINST THEM?

THERE WERE MANY CONSIDERATIONS, BUT MOST IMPORTANTLY:

* DID THE MARKET MOVEMENTS REFLECT FUNDAMENTAL FACTORS?

* WERE THERE ELEMENTS OF "OVER-SHOOTING" I.E. DID MARKETS OVER RE-ACT?

* WAS THE OVERALL SETTING OF ECONOMIC POLICY CORRECT AND WOULD FURTHER POLICY ADJUSTMENTS BE MADE IF NECESSARY?

* WAS THE PROBLEM BASICALLY ONE OF TIME LAGS, IN WHICH CASE PERCEPTIONS COULD BE IMPORTANT?

IN BOTH PERIODS, THE JUDGMENT WAS MADE THAT THE ECONOMY WOULD BE BEST SERVED BY GREATER STABILITY IN THE FOREIGN EXCHANGE MARKET THAN MARKET FORCES ALONE WERE THEN LIKELY TO PRODUCE I.E. THERE SHOULD BE SOME "LEANING INTO THE WIND" AND, THEREFORE, SOME MODIFICATION OF VOLATILITY IN THE EXCHANGE RATE.

CONSEQUENTLY, THE MONETARY INSTRUMENTS WERE PUT TO WORK TO BRING THIS ABOUT.

TO DO THIS, THE RESERVE BANK:

* BOUGHT OR SOLD FOREIGN EXCHANGE AS APPROPRIATE – DIRECTLY AFFECTING THE EXCHANGE RATE; AND

* ADJUSTED ITS DAY-TO-DAY OPERATIONS IN THE DOMESTIC MONEY AND SECURITIES MARKETS TO AFFECT LIQUIDITY CONDITIONS – AFFECTING THE EXCHANGE MARKET INDIRECTLY.

ALTHOUGH ATTENTION WAS HEAVILY ON EXCHANGE MARKET STABILITY, THERE WAS NO SIGNIFICANT CONFLICT WITH OTHER POLICY OBJECTIVES NOR CONFLICTING SIGNALS FROM THE "CHECKLIST" INDICATORS. IN THE EARLY PERIOD, A TIGHTENING OF MONETARY CONDITIONS WAS APPROPRIATE ON ALL TESTS. IN THE LATER PERIOD, WHILE SOME EASING IN MONETARY POLICY WAS IMPLIED, OTHER ELEMENTS OF ECONOMIC POLICY WERE IN THE PROCESS OF BEING TIGHTENED.
CAN WE BE MORE PRECISE AND ACCOUNTABLE?

THERE IS MUCH IN A VIEW WHICH MELVILLE PUT, NAMELY THAT MONETARY POLICY SHOULD NOT BE EXPRESSED IN VAGUE GENERALISATIONS BUT SHOULD BE CAPABLE OF BEING MEASURED AND TESTED.

THUS, SOME WILL SAY THAT MONETARY POLICY PRONOUNCEMENTS BASED ON THE "CHECKLIST" LEAVE UNSPECIFIED PRECISELY HOW AND WHY PARTICULAR DECISIONS ARE MADE, OR THAT IT CAN'T READILY DEAL WITH CONFLICTS.

AS AN EXTENSION OF THIS, CONCERN HAS SOMETIMES BEEN EXPRESSED THAT THE IMPRECISION OF THE "CHECKLIST" APPROACH COULD LEAVE THE AUTHORITIES VULNERABLE TO THE TEMPTATION TO PREFER SHORT-TERM EXPEDIENCY TO LONGER-RUN STABILITY!

IT IS, THEREFORE, IMPORTANT THAT THE AUTHORITIES EXPLAIN POLICIES, THE REASONS FOR THEM AND THEIR OUTWORKING PROMPTLY AND ADEQUATELY. WE HAVE SOUGHT TO PROVIDE MORE - AND MORE FREQUENT - STATISTICAL AND NARRATIVE INFORMATION ABOUT WHAT IS BEING DONE IN THE MARKET PLACE. BUT WE NEED CONSTANTLY TO EXAMINE WHETHER WE CANNOT DO MORE. WE ARE NOW MAINLY DEPENDENT ON THE USE OF PRIVATE FINANCIAL MARKETS TO GIVE EFFECT TO MONETARY POLICY. THAT MEANS AS FAR AS POSSIBLE AVOIDING ARBITRARY ACTIONS AND HAVING WELL-INFORMED MARKETS.
19.

TO SUM UP:

WHAT HAVE WE LEARNT ABOUT THE OPERATION OF MONETARY POLICY?

FIRST, THAT THE VARIOUS MONETARY RELATIONSHIPS STILL HOLD. THUS THERE IS A LINK BETWEEN MONEY, ACTIVITY AND PRICES, SO THAT MOVEMENTS IN THE MONEY SUPPLY ARE IMPORTANT; A STABLE EXCHANGE RATE AROUND LEVELS ACCEPTABLE TO THE MARKET IS HIGHLY IMPORTANT FOR TRADE AND INVESTMENT; INTEREST RATES DO INFLUENCE SPENDING DECISIONS; AND THERE ARE SOME AREAS WHERE MARKET FORCES CANNOT PROPERLY ADJUDICATE SO THAT SOME REGULATION MAY BE UNAVOIDABLE.

SECOND, THAT EACH OF THESE FACTORS IS IMPORTANT BUT NONE OF THEM ALONE IS A SATISFACTORY GUIDE TO POLICY AT ALL TIMES. THEY NEED TO BE OPERATED IN COMBINATION. EACH NEEDS TO BE FLEXIBLE.

WHAT HAVE WE LEARNT AS A NATION?

THE PARALLELS WHICH SOME SEE BETWEEN THE ECONOMIC OUTLOOK OF SHANN'S DAY AND TODAY GIVE POINT TO THIS QUESTION. ARE WE BETTER EQUIPPED TODAY TO HANDLE MISFORTUNE?

SIMILARITIES BETWEEN THEN AND NOW ARE FOUND PRIMARILY IN THE COMBINATION OF LOW COMMODITY PRICES, A SLOWING WORLD ECONOMY, BOOMING STOCK AND PROPERTY MARKETS AND RISING LEVELS OF OVERSEAS DEBT.

THE CENTRAL FACTOR WHICH TRIGGERED THE DEPRESSION WAS THE EFFECTIVE CLOSURE OF OVERSEAS CAPITAL MARKETS TO AUSTRALIAN BORROWERS.

TODAY, IN THE INTERNATIONAL ARENA, WE CAN OBSERVE A WORLD OF TRADE PROTECTION AND RETALIATION TOGETHER WITH AN ABSENCE OF ANY AGREED ADJUSTMENT MECHANISM. TO THIS CAN BE ADDED THE POSSIBLE FRAGILITY OF WHAT HAS BECOME A HIGHLY INTERDEPENDENT WORLD FINANCIAL SYSTEM.
THERE ARE, HOWEVER, SOME IMPORTANT DIFFERENCES NOT OFTEN NOTED -

. AT THE INTERNATIONAL LEVEL THERE IS AT LEAST A GREATER UNDERSTANDING, GAINED THROUGH BITTER EXPERIENCE, OF INTERDEPENDENCE AND THE NEED TO WORK TOGETHER. WITH ALL THEIR FAULTS THE INTERNATIONAL ECONOMIC ORGANISATIONS SET UP IN THE POST-WAR PERIOD HAVE AS THEIR OBJECTIVE WORLD GROWTH, STABILITY AND EQUITY. AT LEAST THEY ARE FORUMS WHERE NATIONS OF VARYING SIZE CAN BE HEARD.

. AT HOME, A LESSON WHICH WE HAVE HAD TO RELEARN IS THAT DIVERSIFICATION OF INDUSTRY AND EXPORTS (PROVIDED THEY ARE COMPETITIVE) IS ESSENTIAL. WHILST COMMODITIES STILL MAKE UP ABOUT 70 PER CENT OF OUR EXPORTS THERE IS NOW A WIDER SPREAD OF COMMODITIES AND MARKETS THAN IN THE 1920'S. FURTHER DIVERSIFICATION IS CRUCIAL TO THE LONGER TERM HEALTH OF THE BALANCE OF PAYMENTS.

. I HAVE MENTIONED OUR INTERNATIONAL INDEBTEDNESS. THE SPREAD OF OUR DEBT AND BORROWING CONDITIONS ARE RATHER DIFFERENT NOW COMPARED WITH 60 YEARS AGO. WE ARE AGAIN (AS IN THE LATE 1920'S) PAYING AROUND 18 PER CENT OF OUR EXPORTS IN (NET) INTEREST. BUT, AS A RATIO TO GDP, NET DEBT IS NOW AROUND ONE-THIRD, WHEREAS IT WAS OVER ONE-HALF THEN. AND NOW, A MUCH GREATER PROPORTION (AROUND 2/3) IS DEBT OF THE PRIVATE SECTOR.

. OFFICIAL POLICIES TODAY GIVE MORE ATTENTION TO SPREADING THE BURDEN OF MISFORTUNE. CURRENT ECONOMIC POLICY COULD BE DESCRIBED BRIEFLY AS BALANCING CORRECTION OF THE BALANCE OF PAYMENTS WITH AVOIDANCE OF ECONOMIC RECESSION. THERE ARE MORE FINANCIAL SAFETY NETS FOR THE VICTIMS OF FINANCIAL DISTRESS. IN THE SOCIAL WELFARE FIELD INCOME AND WELFARE SUPPORT SYSTEMS ARE MUCH MORE FULLY DEVELOPED. THERE ARE, OF COURSE, COSTS TO THIS, BUT WHERE THE NEED IS GENUINE, SOCIETY HAS INDICATED ITS WILLINGNESS TO PAY.
as I said, the banking system stood in a poor light in the depression. I hope I have indicated that monetary policy is better aligned today and potentially is much more flexible. Formal arrangements now exist for the protection of bank depositors. And fears about banking illiquidity in times of stress have been dissipated by the development of central banking. Perhaps the most important question here is whether the central bank would act more promptly and flexibly than it did in the 1930's. I would like to think that we central bankers above all have learnt the lessons of history!

in summary, it can be said that what official policy can do to ameliorate hard times is better understood today. But there are important qualifications to this:

International capital markets at present are marked by massive volumes of available funds and limited attractive outlets. While the markets today seem much deeper and more sophisticated, conditions could change quickly.

It must always be remembered that there are things official policy cannot do. Some of the policies and actions I have described above could, to an extent, counter hard times. Others simply redistribute the burden. When that burden results from adverse conditions abroad that are beyond our control then, by definition, the burden itself cannot be legislated away.

In the 1920's and 1930's the burden fell heavily on groups most directly affected by adverse international conditions. It would certainly have been more humane to spread the burden more widely over the community as was attempted later. However, this could not disguise the need for adjustment to the economic realities confronting the nation. I believe we understand this better today.
WHEN ALL THAT IS SAID, AN EFFICIENT, INTERNATIONALLY COMPETITIVE ECONOMY IS OUR BEST PROTECTION AGAINST ADVERSITY.

THAT MESSAGE HAS NOT CHANGED SINCE SHANN'S DAY.

CONCLUSION

IN THE CONDUCT OF ECONOMIC POLICY, WE HAVE SEEN, IN MANY COUNTRIES, ALMOST A COMPLETE CYCLE OF THINKING ABOUT THE ROLE AND EXTENT OF GOVERNMENT ECONOMIC INTERVENTION.

OPINION IS NOW CLEARLY ON THE SIDE OF FAITH IN THE ABILITY OF THE PRIVATE SECTOR TO DIRECT ECONOMIC ACTIVITY INTO THE MOST EFFICIENT AND CONSTRUCTIVE CHANNELS.

CONSISTENT WITH THIS GENERAL PHILOSOPHY, MONETARY POLICY NOW OPERATES MAINLY THROUGH THE FINANCIAL MARKETS.

IN DOING THIS IT SEEKS NOT TO OBSTRUCT THE EFFICIENCY THAT CAN FLOW FROM MARKET JUDGMENTS BUT TO

- NUDGE MARKETS IN THE APPROPRIATE DIRECTION; AND

- MODIFY OVER-SHOOTING AND OTHER DISTORTIONS

- AS EITHER BECOMES NECESSARY.

ONE MUST BE MODEST ABOUT WHAT THESE OPERATIONS CAN ACHIEVE IN ISOLATION. THEY HAVE GREATEST CHANCE OF SUCCESS WHEN CO-ORDINATED WITH EFFECTIVE USE OF OTHER - PARTICULARLY FISCAL AND WAGES - POLICIES.

THE ULTIMATE OBJECTIVE OF MONETARY POLICY CONTINUES TO BE NON-INFLATIONARY ECONOMIC GROWTH. INDICATORS OF GENERAL ECONOMIC PERFORMANCE ARE WELL TO THE FORE IN OUR DISCUSSION OF
MONETARY POLICY. OUR INTERMEDIATE INDICATORS ARE THE TRADITIONAL ONES OF MONEY SUPPLY, INTEREST RATES AND THE EXCHANGE RATE. BUT TODAY WE ARE WITHOUT SETTLED RULES OF CONDUCT. THERE IS NO ACCEPTED THEORY OF HOW INTERNATIONAL HARMONISATION IS TO BE RESTORED; NOR IS THERE ANY AGREED, SIMPLE RULE ABOUT THE CONDUCT OF DOMESTIC MONETARY POLICY.

WE ARE, THEREFORE, IN A PERIOD OF PRAGMATISM WHICH WILL ENDURE UNLESS AND UNTIL THE THEORETICIANS COME UP WITH SOMETHING BETTER.

BUT PRAGMATISM SHOULD IMPLY CAREFUL EXAMINATION OF ALL AVAILABLE INFORMATION AND CAREFUL JUDGMENT.

AT THE END OF THE DAY, THE TEST OF EFFECTIVE MONETARY POLICY - AS FOR ECONOMIC POLICY GENERALLY - WILL CONTINUE TO BE ITS CONTRIBUTION TO ECONOMIC WELL-BEING.

"CENTRAL BANKING", SHANN SAID, "CAN GIVE A COMMUNITY AND, INDEED, A WORLD ECONOMY, THE STABLE MONEY THAT INDIVIDUALISM POSITS IF THE POLITICIANS WILL GIVE IT FAIR SCOPE AND IF MEN OF TECHNICAL SKILL AND PROFESSIONAL MORALE ARE GIVEN CHARGE OF THE JOB......".

A TALL ORDER. I CAN GIVE A GOOD ACCOUNT OF THE POLITICIANS. I WILL HAVE TO LEAVE OTHERS TO JUDGE THE CENTRAL BANKERS!