The Rise and Fall of Monetary Targeting in Australia

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Thank you Ross for those kind words. Thanks also to Scott Haslem and UBS for putting on this function. I should note that the book is based on my PhD thesis, which was completed prior to my joining the Reserve Bank, and that my comments today should not be attributed to the Bank.

The book is about the influence of one idea – that controlling the money supply means controlling inflation. It examines why this idea gained favour in Australia during the mid 1970s, how it was used to support a number of economic policies and why it lost appeal in the mid 1980s. In my comments today, I would like to raise what I think are some of the more interesting issues the book addresses to perhaps provide some pointers for questions and discussion.

From the perspective of the relatively smooth economic performance of the last decade, the turbulence of the early to mid 1970s is difficult to comprehend. The unemployment rate more than doubled, the inflation rate quadrupled, and the economy was beset by numerous shocks. As inflation came to be seen as the principal economic problem, monetarism, as rejuvenated by Milton Friedman and colleagues at the University of Chicago, offered a deceptively simple solution: reduce the growth rate of the money supply to the potential rate of real output growth in the economy and the inflation rate would fall to roughly zero.

Australia was one of the first countries to introduce monetary targeting. In March 1976 Malcolm Fraser’s Liberal and Country Party Coalition government set a projection, widely seen as a target, to reduce the rapid rate of monetary growth. The introduction of targeting is a fascinating story of politics, personalities and ideas. The implementation of a new economic policy approach is often presented as governments simply adopting the advice of bureaucrats. Michael Pusey’s 1991 account of the rise of ‘economic rationalism’ is a good example. The story of monetary targeting is, however, one of stark contrast. Targeting, essentially, was a political response to the deterioration in economic performance. Both the Commonwealth Department of the Treasury and the Reserve Bank held significant doubts about the value of the monetarist approach.

Monetary targeting was embraced by the Coalition, while in opposition, in late 1974. Previously, despite the inability of Gough Whitlam’s Labor government to come to terms with the economic dislocations experienced, the Coalition had failed to present a coherent critique of the government’s policies or a viable alternative. Understanding the rise of new policy approaches when they are embraced by a political party in opposition and later implemented in government is significantly more complicated, and also more interesting, than when policies are adopted by governments on the advice of bureaucrats. With limited expertise, the Liberal Party leadership relied heavily on their advisers and a number of monetarist-inclined academics. An important role was also played by the press, acting as the key intermediary between the solutions expounded by politicians and the public. Of particular relevance in this context is that some key economic journalists became strong supporters of monetary targeting.

The implementation of a new policy approach is rarely straightforward. Governments are likely to find that achieving the goals enunciated when the policy was first advocated is significantly harder than they envisaged and that trade-offs have to be made between competing objectives. Such factors are clearly evident with the Coalition government's implementation of monetary targeting. The initial monetary projections set by the Coalition were achieved. Yet the government was unable to demonstrate that monetary policy had been successful, since economic developments often contrasted with the rhetoric that underpinned its policy approach. A lower rate of monetary growth, for example, did not always lead to a lower inflation rate. The government's difficulties were compounded as monetary growth exceeded each projection set by the Coalition from August 1978 to the end of its period in government in 1983. Inflation and unemployment also remained intractably high. Those outcomes raise a crucial question: why did the Coalition government persist with an approach that had essentially failed? The government remained committed to targeting, I would suggest, for three broad reasons:

- First, targeting provided a justification, if not a cover, for slowing government expenditure and wages growth.
- Second, abandoning targeting would have amounted to an effective repudiation of the government's overall economic approach, with its focus on reducing the inflation rate.
- And third, abandoning targeting threatened an adverse reaction from financial markets, for whom targeting had become an article of faith.

In these circumstances, it is perhaps not surprising to find that the government's discussion of the monetary targeting policy was often misleading and gave selective attention to empirical evidence. It might well be asked, what of Treasury and the Reserve Bank? Sections of both organisations were well aware of the difficulties with monetary targeting. But the considered discussion of the issues that might have been expected from Treasury and the Reserve was largely absent.

Despite the fact that continuing with the monetary targeting policy served a number of its interests, the Coalition government did seriously consider abandoning the policy. In his 1982-83 Budget speech, Treasurer Howard suggested that the government had considered abandoning projections, but it had decided against this, because the financial markets remained committed to the policy. The markets' support for targeting was also a pertinent consideration for the Labor government, elected in March 1983. Despite its criticisms of the targeting policy in opposition, a projection was retained by the Labor government. However, it should be noted that the strategy behind monetary targeting differed considerably under the Labor government.

The reason why projections were eventually abandoned is well known. The monetary projection had always been set for M3. But financial deregulation led to an increase in the market share of banks vis-à-vis non-bank financial institutions. Given this, and the effects of financial innovation more broadly, discerning the implications of a given rate of M3 growth, or any monetary aggregate for that matter, for economic activity and inflation, became even more difficult, if not virtually impossible. What is less well known, I think, and is perhaps an issue worthy of some discussion, are the challenges the government faced abandoning targeting, and the aftermath of that decision. The key challenge came from the financial markets, which seemingly remained committed to targeting to the very end. Indeed, one commentator termed the projection the markets' 'teddy'. Communication with the markets regarding economic and financial developments by both the Labor government and the authorities was thus crucial. The significant depreciation of the dollar that followed the suspension of the monetary projection in January 1985 showed that the limited communication undertaken had been unsuccessful.

Close analysis of this period, and the targeting period more generally, provides an opportunity to examine whether governments and bureaucracies incorporate past experiences when facing new challenges. An examination of that point in the context of monetary policy in the late 1980s and beyond concludes the book, and is perhaps an issue worthy of some discussion today.

Thank you.

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