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Karl Brunner, Monetarist

by Allan H. Meltzer*

An introduction to some of Karl Brunner's many papers on monetary or macroeconomic topics provides a welcome opportunity to reconsider some of his contributions to theory, research, and policy in this area. Brunner's (1968) essay, that gave monetarism its name, concentrated on the role of money in the economy and on assessing monetary policy. Later, in "The Disarray in Macroeconomics," written in 1986 and reprinted here, he referred to monetarism as a "more or less unfortunate label" (1989, p. 197). Although Brunner was alert to new developments in economics, and he changed his interpretations and beliefs when analysis or facts warranted, his dissatisfaction with the term monetarism did not represent a belated recantation of his long-standing views.

Monetarism came to be identified with either a narrow, quasi-mechanical view of the role of money or as an integral part of a conservative program to reduce the size and influence of government. Brunner (1983, p. 45) saw monetarist ideas "as an alternative to the Keynesian vision bearing on socioeconomic and socio-political issues _as a whole_." (Italics in the original) As the companion volume 1 of Brunner's papers suggests, Brunner had a very broad vision of the role of economics in clarifying the relation of man to society.

Brunner's vision of economics was greatly altered by his stay in Chicago as a Rockefeller Fellow at the Cowles Commission in 1950. Although his work at this time was entirely technical, he was stimulated intellectually by the idea that economics could be used to study a wide range of social and political phenomena. Before coming to Chicago, in his words, "I had been conditioned to consider price theory, ... as a clever but irrelevant exercise and to rely on 'sociology' when talking about the real world." (1984, p. 180) Frank Knight, Aaron Director and Milton Friedman offered

*A more extensive treatment of some of the subjects of this essay is David Laidler (1991). It is difficult for me to write about Karl Brunner's work as a third party. This essay shifts frequently from he to we.

a very different vision of price theory and of institutions. Instead of treating institutions as independent entities unrelated to people's search and effort to improve their welfare, Brunner began to think about social institutions as the result of a process in which politicians and others try to develop arrangements that benefit them.

To many, this reasoning may be right or wrong but, in either case, far from macroeconomics. For Brunner, however, issues about institutions and the role of government were central to the Keynesian - monetarist differences that dominated macroeconomic discussion during part of his professional career. Keynesians treat non-market situations from a sociological perspective. They see government as a benevolent agent working to improve social welfare. Monetarists, and certainly Brunner, regard politicians as maximizing agents pursuing their own interests. These interests may coincide with the interests of a majority but the two often differ. Keynesians favor discretionary policies because they rely on policymakers to do their best. Monetarists favor legislated rules for monetary policy and limits on the size of government and its command of resources. They see the world as highly uncertain but also regard policymakers as interested parties seeking to further their own interests not solely the public interest.

This theme returns in many of the papers reprinted here. In "Has Monetarism Failed?" (p. 24), Brunner describes the two "fundamentally different visions of the economy and substantially different views about the political economy of institutions and policymaking" characterizing the monetarist and Keynesian positions. He criticizes the late Harry Johnson's Richard T. Ely lecture as a "limited vision" of monetarist thought. Johnson's (1971) Ely lecture to the American Economic Association described monetarism as concerned mainly with inflation and monetary control. According to Johnson, Keynesian ideas had persuaded policymakers and the public at a time when unemployment was the central economic or social problem. Monetarist ideas supplanted Keynesian ideas as inflation increased. Once inflation was brought down, Johnson argued, Keynesian ideas would return.

Brunner (1983) argued that the prediction would prove wrong. He rejected not just the prediction but the limited vision of monetarist thought. He told Arjo Klamer:

> "The basic test of monetarism is the reassertion of the relevance of price theory to understand what happens in aggregate economics. Our fundamental point is that price theory is the crucial paradigm -- as a matter of fact, the only paradigm -- that economists have. You can use this paradigm to explain the whole range of social phenomena. I do not believe in a sort of 'shoe box approach' according to which you distribute problems over the different disciplines, such as political science, economics, and sociology" (1984, p. 183)

Time has shown that Brunner was right. Unemployment rates in the European Union have risen from 3% average in the 1960s to almost 10% in the early 1990s. Yet, the Keynesian policy view did not again dominate policy action, as Johnson had predicted. Even non-monetarists draw this conclusion. See Krugman (1994).

Brunner's view of the role of economics was one part of his conception. Other parts, more narrowly monetarist, concerned (1) the nature and types of impulses creating disturbances in the economy, (2) the nature of the transmission mechanism by which the shocks are transmitted to output, employment, and prices, and (3) the role of normal output and its importance for the neutrality of monetary change and for the equilibrium position to which the economy returns.

Brunner started as a history student, and he always retained his respect for history and historical data. The role of money in the great depression, at the start of the postwar inflation, in wartime inflations throughout history, in deflations after most wars, and in the 1937-38 recession gave support to the dominant role of monetary accelerations and decelerations as a source of inflationary disturbances. Later, accelerations and decelerations were replaced by unanticipated changes or shocks, but the substantive point remained.

With the passage of time, we both modified our views about the relative importance of monetary impulses. In the late 1970s, we worked with Pieter Korteweg, André Fourcans, Michele Fratianni, Dean Dutton, and Manfred J.M. Neumann on a study of inflation and output in several countries. Their papers are published, with an introduction stating the main themes, in Brunner and Meltzer (1987). Unanticipated monetary changes are "foremost" among several sources of disturbance to output and prices, but foreign influences and a net fiscal impulse are recognized also. This was not a new awareness. The same point had been recognized in our analytic models going back to the beginning of our collaboration. However, the weight given to non-monetary impulses increased.

The oil shocks of the 1970s changed our emphasis in two ways. First, it became clear that there was no reason to expect past distributions of shocks to repeat. The relative importance of monetary shocks in one period, say the depression of the 1930s, had little implication for other periods. Second, the distinction between permanent and transitory disturbances became more important in our thinking. Uncertainty about the persistence or permanence of shocks -- whether monetary or non-monetary -- was prominent in our thinking from this time on. In retrospect, it appeared that much of the criticism of Milton Friedman's monetarist dictum -- inflation is always a monetary phenomenon -- could be interpreted in this light. Those who included all price level increases as inflation could not accept Friedman's statement. The point at issue was the difference between maintained and transitory impulses. The latter raise the price level but do not permanently change the maintained rate of price change. Friedman and other monetarists found it useful to distinguish one-time changes from maintained rates of change and to reserve the term inflation for maintained changes.

When I first met Karl Brunner in 1952, he was a Keynesian. The models I studied in his class were Keynesian models. Brunner (1984) recognizes that his view of Keynesian economics changed gradually in the 1950s. In his conversation with Klamer (1984) he mentions two types of reasons for his dissatisfaction with Keynesian models. The more general came from his pursuit of analytic philosophy under the influence particularly of Hans Reichenbach who was at UCLA when Brunner arrived in the early 1950s. In Brunner's words "he helped me to understand the general nature of the cognitive endeavor." (1984, p. 182)

The other main influence was Armen Alchian who was on the faculty at UCLA when Brunner arrived. Alchian had been responsible for recruiting Brunner for the UCLA department. The two became lifelong friends who stimulated each other intellectually for many years. With Alchian, Brunner reconsidered and rejected Keynes's explanation of unemployment. Keynes had "wrestled with a serious problem [unemployment] which could not be dealt with by inherited price theory" (1984, p. 183). They concluded that Keynes failed to explain unemployment because he relied on inherited price theory. The Keynesians had resorted to sociological explanations instead of trying to reformulate price theory to include transaction and information costs. They discussed other problems including why people use money. I joined that discussion in the early 1960s. Eventually Brunner and I and Alchian separately worked out answers to parts of the problem.

Brunner's subsequent work in macroeconomics shows the influence of these discussions. In Brunner and Meltzer (1963) and all subsequent work, relative prices of assets and output are central to the macro adjustment process. The general argument is that the principal asset markets adjust relatively quickly to new information. Asset prices rise or fall relative to current reproduction cost of the assets. Changes in prices on these asset markets signal producers to change production. At first, there are general statements about transaction and information costs to explain why asset and output prices diverge. By the early 1970s, we had developed a specific hypothesis using costs of information and transactions to explain why money was used as a medium of exchange. Later emphasis was on permanent and transitory changes as a reason for information costs and for delaying adjustment of output and employment.

Because he gave much weight to information costs, Brunner saw new classical business cycle theory as both a forward and backward step. He very much approved of the skillful way in which Lucas formulated the information problem. Shocks occurred because of misperceptions about whether relative prices or the general price level had changed. Brunner believed that permanent-transitory confusion was more important quantitatively, but Lucas's formulation was the beginning of an explanation for the short-term non-neutrality of money that was consistent with long-term neutrality and with standard price theory.

When evidence rejected the Lucas hypothesis, new classical economists moved back to a Walrasian model with full information. Brunner (1989, p. 205) uses Prescott (1986) as an example of skilled analytic technique that misses central issues. In Prescott's model economy, "there is thus no trade, no division of labor ... There is no need for money -- it would serve no function -- and there is no government." Inherited price theory without transaction costs and costs of information neglects the main sources of misperception that, Brunner thought, the new classical economists had started to investigate.

Models of the real business cycle developed a part of economic analysis that, though long recognized, had remained undeveloped analytically. They combined trend and cycle in a useful way. However, these models disregarded not just monetary impulses but fiscal and regulatory changes that produced shocks to aggregate demand. Brunner thought the development useful, but he remained skeptical of the concentration on random shocks to productivity as the main cause of fluctuations. For him, the information problem of recognizing the duration of monetary (and other) shocks to aggregate demand remained important but was neglected in the real cycle models. Brunner had spent too many years, and assembled too much evidence, to be persuaded that all of the observed relation between real variables and money came from "reverse causation" -- the effect of output on money.

Brunner's work directs much attention to issues about the transmission of shocks and policy impulses. Although new classical, real business cycle models and the IS-LM model differ in many ways they share a common deficiency. Each has a single interest rate. There is no possibility for other asset prices to change relative to output prices as part of the transmission process.

In the real business cycle model, real shocks to the production function induce intertemporal substitution of labor. People work more when real wages are high than when they are low. Recessions are periods when, following negative production shocks, people choose more leisure. Brunner found the insistence on complete information in this model troublesome. In Brunner (1989, p. 214), he rejected this approach. "The costs [information and transaction costs], and most particularly the information problem, cannot be disregarded for purposes of a useful monetary analysis. The very occurrence of money solves a serious efficiency problem..."

Keynesian analysis, represented by IS-LM, made different, but no more appealing, simplifications. Transmission of monetary impulses came from (temporarily) fixed prices. The interest rate in the IS-LM model had a critical, but ambiguous, role in transmitting monetary and other shocks. On one interpretation, the only assets were money and bonds. Changes in money effect the interest rate on financial assets, but substitution is limited to a narrow range of financial assets. On the other interpretation, real assets are perfect substitutes for financial assets. This interpretation, Brunner thought, "not necessarily false" (1989, p. 210). Its application was limited to periods such as high inflation when strong impulses dominate the data. At such times, changes in risk premiums and in relative prices of real and financial assets are of secondary importance.

Brunner's view (and mine) is that the IS-LM framework omits too much of the information in relative prices. The short-term interest rate on the money market contains too much information about the current or near-term position. The longer-term evolution of the economy is more accurately reflected by long-term interest rates and the prices of real assets. Shocks that are perceived as transitory affect the short-term rate much more than the long-term rate, but shocks or changes that are perceived as permanent shift the entire yield curve and the prices of real assets.

This view of the transmission process emphasizes the role of relative prices. In the most developed form of the IS-LM paradigm, the real balance or real wealth effect has considerable importance. Changes in real balances supplement the effect of interest rate changes. Brunner never denied the existence of this effect, but he thought its empirical magnitude was too small to be of much interest. The analytic importance of the real balance effect arose in an IS-LM model to answer the question: How does monetary change affect real variables? Brunner's answer emphasized the role of relative prices. Reproduction costs change relative to the prices of existing assets; long-term interest rates change relative to short-term rates; prices of financial assets change relative to prices of real assets.

Brunner's ideas evolved as the professional discussion changed. As editor of a major journal and organizer of long-running monetary conferences in the U.S. and Germany, he was aware of the latest developments. As a policy adviser and active participant in the policy discussion, he kept up on developments in several countries. Both analytic and empirical developments altered his views. For example, he abandoned the early monetarist proposition that dominant impulses were monetary for the more eclectic proposition that "we must expect shifting combinations of nominal or real, aggregative or [relative], arrays of specific shocks." (1989, p. 220). Inflation--sustained rates of price change--remained a monetary problem.

Another, rather different, example was his changing belief about normal output. In classical analysis, the economy fluctuates around a level of output that is the maximum output that the economy can produce with full use of resources. Neo-classical economists adopted this idea. Normal output was identified with the output determined by tastes and technology in a Walrasian system.

Brunner dissented. What the neo-classicals called normal output, Brunner called maximal output. The distinction was substantive not semantic. The level of normal output around which an economy fluctuates depends not just on the technical conditions of production but on "the ranges of available organizational forms, admissible contractual arrangements and market structures... [I]nstitutional arrangements conditioning behavior on output and labor markets... [and] the prevailing political structure" also determine the position of normal output relative to maximal output. (1989, p. 222). Taxes, the variability of inflation, and the regulatory climate are subsumed in his discussion of institutions.

In the early 1980s the press wrote much about an allegedly new macroeconomic theory called supply-side economics. Many claims were made about the powerful insights, novelty, and implications of this approach. Brunner (1982) is skeptical about most of the claims about both novelty and substance.

He did not doubt that relative prices and incentives could affect the level of normal output. This was standard economics from the time of Adam Smith. But

Brunner (1982, p. 843) said, supply-side economics "is an exaggerated answer to current economic problems."

The exaggeration was found not only in the claim to novelty but in the claims that tax reduction was necessary and sufficient to increase growth and that the increased growth would be sufficient to balance the budget. The idea that tax changes affect output was a centerpiece of Keynesian economics. Keynesians emphasized the effect on output via aggregate demand. Their view had been challenged by Arnold Harberger and other writers in public finance who investigated the allocative effects of different taxes and their burdens, the program emphasized by the supply-siders. Research had found evidence of excess burden and allocative effect but the magnitudes did not support the exaggerated claims of the supply-siders. Also, Brunner argued, proponents of supply-side economics never mentioned the allocative effects of government spending. This conveyed "a faulty sense of the real burden imposed by government fiscal operations." (1982, p. 846)

From 1973 to 1988, Brunner prepared papers analyzing policy issues for the semi-annual meetings of the Shadow Open Market Committee. Some of these papers are published here for the first time.

They are characteristic of Brunner's work on policy. Each topic is given a detailed analysis. Brunner uses the analysis, his assessment of evidence, and his conception about society to draw a conclusion relevant to the discussion at that meeting. He would summarize the main point of his paper in a five minute presentation for the journalists who attended the press conference. Although the topics he addressed and his sophisticated thinking were far from the usual way that journalists thought and wrote about these issues, many looked forward to his combination of wit and substance and to the clarity with which he stated his position.

Monetarism is often portrayed as a simplistic set of ideas that does not go much beyond the notion that if money goes in at one point, nominal output comes out at the other. Readers of Brunner's papers will find no support for that view. Throughout his career he was concerned about the separation or gulf between analysis and policy. The gulf existed on both sides. Much analysis was directed at issues far removed from policy issues and often irrelevant for policy issues. In his review article, "Yale and Money" (1971, p. 174), he stated his criticism with his usual force:

> "The most serious and pervasive flaw is that the [Yale] monetary theory offers no rationale for money ... This is reinforced by a singular neglect of the development of manageable empirical theories, i.e., of constructions beyond formal manipulations or descriptive assemblies of data. ... [T]hese aspects are not confined to Yale; our profession shares quite generously in these flaws."

Policy discussion ignored most of these formulas but also ignored relevant empirical analysis. Brunner worked to change this result and narrow the gap between theory and policy. In his writing, the journals he founded, the conferences he started, this theme---bridging the gap between theory and policy---is always present.

The reader of this sample of Brunner's papers will return again and again to some central themes -- the importance of analysis for policy, the nature of relevant analysis, and the importance of basing judgments on the assessment of competing hypotheses.

The reader will also find much else. I hope these papers -- a small part of a prodigious output -- will introduce many new readers to my friend, teacher, and long-time collaborator. I know they will be stimulated and amply repaid for their effort as I was in a long and rewarding association.

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