

# **The Change in the Role of Monetary Policy in Australia in the Past Fifty Years**

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## Outline

I will discuss how Australia evolved into an inflation-targeting country.

In doing so, I won't spend any time on institutional developments—like the changed degree of RBA autonomy and alterations in the process of decisions by the RBA Board.

Instead, I will talk about *doctrinal* developments—the changes in the analytical framework for the analysis of inflation and of monetary policy. Specifically, I will contrast the consensus (which corresponds to the thinking prevalent in Australia in the past 25 years), in which it is widely accepted that monetary policy has special responsibility for inflation, with the consensus of the previous 25 years (1966–1991), in which it was customary for policymakers in Australia to deny—in my view, mistakenly—that inflation in Australia was a monetary phenomenon.

## **The current consensus about inflation**

One can think of the current consensus in support of an inflation-targeting strategy as reflecting a conclusion that monetary policy actions are necessary and sufficient for securing control of the trend in the aggregate price level.

This conclusion in turn embeds two propositions:

- (1) Monetary policy can systematically influence aggregate demand.
- (2) Inflation responds systematically to the level of aggregate demand.

## **The prior (1966–1991) consensus about inflation in Australia**

In the 1960s, some countries, such as the United Kingdom, featured a policymaking establishment that rejected both components (1) and (2).

However, in Australia in the past fifty years, component (1)—the dependence of aggregate demand on monetary policy—has not come under really serious challenge from officials or from the economics profession as a whole. Episodes such as the “credit squeeze” (that is, monetary tightening) of 1960–1961 produced a strong presumption that monetary policy can powerfully influence aggregate demand (for example, because spending is sensitive to short-term interest rates and long-term interest rates).

## **The prior consensus about inflation in Australia, continued**

Furthermore, even prior to the floating-exchange-rate period (which began in 1983), the Australian monetary authorities (the Reserve Bank of Australia, in conjunction with the Treasury) had (and made use of) the wherewithal to influence important market interest rates—and to give monetary policy in Australia a large amount of independence from other countries' monetary policies.

Therefore, it has *not* been in serious doubt during the past fifty years that the monetary authorities in Australia can exert a powerful influence on aggregate demand.

## **The change in the consensus**

Why, then, is central-bank inflation targeting a practice followed only during the most recent quarter century?

The heart of the answer to this question lies in the absence, prior to the 1990s, of a wide acceptance in Australia that inflation is controllable via aggregate-demand management (and specifically via monetary policy). That is, component (2) above of the modern consensus was rejected.

This period of lack of acceptance of the link between inflation and monetary policy is what in my research I've called the era of *monetary policy neglect*.

## **Defining the monetary policy neglect hypothesis**

*Monetary view of inflation:* The output gap (that is, the percentage difference between output and potential output) is the dominant influence on inflation (both up and down); therefore, creating a negative output gap (i.e., moving output below the economy's supply potential) can put downward pressure on inflation. “Cost-push” factors—for example, changes in production costs or in particular prices—reflecting developments other than the demand/supply balance cannot be sources of ongoing inflation.

*Nonmonetary view of inflation:* Cost-push forces have a positive mean and are the dominant source of fluctuations in inflation. The output gap is unimportant for inflation when the output gap is negative (that is, inflation does not respond to economic slack).

## **Defining the monetary policy neglect hypothesis, continued**

*The monetary policy neglect hypothesis is as follows:*

The monetary view of inflation is valid. The monetary policy mistakes that produced high inflation in the 1970s in many countries—and in *both* the 1970s and 1980s in Australia—arose from policymakers' rejection of the monetary view of inflation process, in favor of the nonmonetary (that is, the strict cost-push) view of inflation.



## Monetary policy neglect in Australia

As I discussed in a 2005 article in the *International Journal of Central Banking*, it is the case that until the 1990s Australia had a nonmonetary tradition in inflation analysis that emphasized that tools—in particular, incomes policy (wage and price controls or national agreements on wage- and/or price-setting)—other than monetary policy had to be used to control inflation, and that monetary policy alone could not control inflation.<sup>1</sup>

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<sup>1</sup> See Nelson (2005a). A similar nonmonetary approach to inflation analysis and control prevailed in policy circles in the United Kingdom in the postwar period through 1979 and in the United States from 1970 to 1979. See Laidler (1979) and Nelson and Nikolov (2004) on the U.K. case and Poole (1979), Romer and Romer (2002, 2013) and Nelson (2012) on the corresponding U.S. experience, as well as DiCecio and Nelson (2013) and Nelson (2005b) for a comparison of the U.K. and U.S. records.

## Monetary policy neglect in Australia, continued

The existence of centralized wage setting in Australia was often invoked to support the view that nominal wage inflation—and so (it was claimed) price inflation—did not respond to aggregate-demand policy. In retrospect, this view seems misguided because:

- Over the medium term, it was often the case that centralized wage decisions in practice reflected market conditions.
- Slippage between wage decisions and wage outcomes, and between changes in prices and in wages, likely reflected market forces (and in particular reflected the course of the output gap).
- As a corollary of the preceding two points, the price-level path may be sensitive to aggregate demand even when wages are fixed by an authority—because prices may be set as a function of the longer-term expected pattern of costs.

## Monetary policy neglect in Australia, continued

Furthermore, econometric analyses of the historical Australian data have often found sizable responses of both nominal wage growth and price inflation to the output gap (both when the gap is positive and when it is negative). That is, Australian inflation *is* sensitive to monetary policy actions, via the demand channel associated with the monetary view of inflation.<sup>2</sup>

Nevertheless, the perception that inflation in Australia reflected autonomous cost pressure (including from import prices) prevailed in policymaking in 1966–1991.

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<sup>2</sup> See, for example, Jonson (1973), Grubb, Jackman, and Layard (1983), Dornbusch and Fischer (1984), and Debelle and Stevens (1995). In addition, although Gruen, Pagan, and Thompson (1999) referred to a tradition in which specifications of inflation equations for Australia included a wage-decision term, they ultimately opted for an empirical inflation equation that did not include such a term.

## **Evidence for the monetary policy neglect hypothesis**

Evidence of monetary policy neglect comes indirectly from macroeconomic data. But it can be obtained *directly* from:

1. Quotations from policymakers: these are important pieces of evidence for discerning the doctrine underlying monetary policy and thinking about inflation.
2. The record of policy measures: these confirm that the nonmonetary perspective was used to guide economic strategy against inflation.

## **Statements by policymakers**

Some examples of statements from members of successive Australian governments from 1966 to 1991 follow.

## 1966–1972 Liberal-Country Party governments

Inflation was about 7 percent by 1971. Although this indeed led to major alarm from policymakers, their response reflected a misdiagnosis of the cause of, and cure for, inflation.

Prime Minister John Gorton said that he did not “believe the present situation requires a lift in interest rates, already high” (*Sydney Morning Herald*, January 30, 1971). He stated that “the real problem... is cost-push inflation,” and maintained that the “biggest single influence now which can prevent inflation is a conscious and firm effort on the part of wage-fixing tribunals.” (*House of Representatives Debates*, February 18, 1971.)

## **1966–1972 Liberal-Country Party governments, continued**

Bill Snedden—cabinet minister with responsibility for industrial issues (and, subsequently, the Australian Treasurer)—stated that “the solution must be found in rational wage policies” (*Sydney Morning Herald*, October 9, 1970), as “excess demand does not presently exist” (*House of Representatives Debates*, February 18, 1971).

Malcolm Fraser (between periods as a minister in the Gorton and McMahon Governments) stated that reliance on “monetary policy in an attempt to control inflation” would “work too indirectly on many of the causes of inflation... [Monetary actions] work very indirectly on consumer demand and would have an even more remote impact on the wage/price spiral.” (Alfred Deakin Lecture, July 20, 1971.)

## Whitlam Government (1972–1975)

Gough Whitlam: “I have to be quite frank with you: inflation will not be wholly beaten until there is a worldwide solution.” (Televised address to the nation, quoted in *Daily Telegraph*, August 27, 1974.)

In addition, Whitlam placed emphasis on domestic wage-push as a source of inflation: “There should be no doubt that this severe inflation will continue if there are excessive wage claims.” (*The Australian*, October 22, 1974.)

Gough Whitlam: “In former years, the standard way to attack inflation was to bring about a recession... And of course it no longer works anywhere in the world... The question now is: What other approach can we take to hold down inflationary pressures?” (Queensland broadcast, July 27, 1975.)



# PM: WAGES TO BLAME FOR RISING COSTS



• MR McMAHON

CANBERRA. The Prime Minister, Mr McMahon, last night blamed "very large wage increases" for the rise in the cost of living.

He said the rise had proved the Federal Government's

**THE AUSTRALIAN** 10  
NUMBER 3281 TUESDAY OCTOBER 22 1974 NINE CENTS\*

## PM blames pay claims for jump in inflation

Worst figures for 20 years  
By PAUL KELLY



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## **Fraser Government (1975–1983)**

Malcolm Fraser: “A sharp rise in wage costs such as would be involved in fully carrying through the latest CPI increase into wage rates would... reinforce expectations of continuing high inflation...” (*Sydney Morning Herald*, January 31, 1976.) “...this vicious spiral of higher prices, higher money wages, higher costs, and yet more price increases.” (*Daily Telegraph*, February 14, 1976.) “We now all understand that if wages go up too much, that does add to inflation...” (Address to the nation, May 17, 1976, quoted in *Sydney Morning Herald*, May 18, 1976.) “... full wage indexation locks the economy into unacceptable levels of inflation.” (*Canberra Times*, September 6, 1976.)

## **Fraser Government (1975–1983), continued**

Malcolm Fraser: “The figures that I have just indicated make it quite plain that wages policy has not been carrying its share of the burden in the fight against inflation... That... does not depend upon a direct decision of this Government or of this Parliament; it depends upon a direct decision of the Australian Conciliation and Arbitration Commission.” (*House of Representatives Debates*, February 24, 1977.) “Wages are a key and central factor in the control of inflation.” (Electorate talk, September 17, 1978.) “Demands for higher wages and shorter working hours... cause higher inflation...” (*House of Representatives Debates*, March 9, 1982.)

## **Fraser Government (1975–1983), continued**

Phillip Lynch (Treasurer 1976–1977): “excessive wage and salary claims remain a direct impetus to more inflation.” (*Daily Mirror*, February 20, 1976.) “... the [wage] decision will result in some reduction in the growth of money wages—and therefore of inflation—compared with full indexation.” (*Sydney Morning Herald*, August 13, 1976.)

“Fundamentally, of course, inflation... will be heavily influenced by the extent of wage indexation...” (*House of Representatives Debates*, August 16, 1977.)

John Howard (Treasurer 1977–1983): “Our battle against inflation should also be helped by the national wage-case decision...” (*Sydney Morning Herald*, May 24, 1982.) “[Consider] what has happened to average weekly earnings... [It] illustrates very clearly the contribution that excessive wage increases have made to the high levels of inflation that were experienced through the early and middle years of the 1970s and to the level of inflation being experienced by Australia at present.” (*House of Representatives Debates*, October 24, 1982.)

## Hawke Government (1983–1991)

Ralph Willis (Shadow Treasury spokesman; later a member of Hawke and Keating Governments): “The failure to reduce inflation is also a marked feature of these kinds of policies [tight money]. Despite the fact that they create deepening recession and higher and higher unemployment, they fail to stop inflation... [W]e must have more direct measures to control inflation. In particular, we must have prices and incomes policies to control inflation.” (*House of Representatives Debates*, April 20, 1982.)

Paul Keating (Treasurer 1983–1991) stated that Australia’s wage-fixation system made inflation hard to control using aggregate-demand tools (*Sydney Morning Herald*, August 25, 1983). Hawke indicated that he viewed incomes policy as to be used in preference to the “traditional instruments of tighter monetary and fiscal policy to restrain inflation” (*The Australian*, September 1, 1983).

## **Actions against inflation**

These views of inflation's causes—and of monetary policy's lack of effectiveness as an anti-inflation weapon—motivated successive governments to employ nonmonetary tools against inflation.

### **Whitlam Government**

- ◆ Tariff cut (1973).
- ◆ (Defeated) referendum to give the federal government wage/price control powers (1973).
- ◆ Attempts to encourage wage/tax tradeoff (1974–1975).

### **Fraser Government**

- ◆ Attempted wage/price freeze (1977).
- ◆ Wage freeze (1982–1983).

## **Actions against inflation, continued**

### **Hawke Government**

- ◆ Successive Accords (wage agreements) with the union movement.
- ◆ Sales tax cut (1988 Budget). “The Budget’s anti-inflationary strategy hinges on lower indirect taxes, mainly for beer drinkers, and a delay in personal tax cuts... [T]he size of the [income tax] cuts will depend on the second wage/tax trade-off...” (News report on the 1988 Budget by Laura Tingle, *The Australian*, August 24, 1988.)

## **Actions against inflation: outside commentary**

“So monetary policy is not the best instrument to control inflation. The job is better done by wages policy—or, in the Hawke Government’s case, by the Accord.” (Ross Gittins, *Sydney Morning Herald*, July 28, 1984.)

By 1984, this consensus (that inflation was a nonmonetary phenomenon) in Australia contrasted with that prevailing in the U.K. and the U.S.—countries in which the monetary explanation of inflation had been accepted in academia and policymaking.

For example, Alan Budd (adviser to 1980s and 1990s U.K. governments) observed: “The hope is that Australia will be able to reduce inflation by other means [than demand restriction through monetary policy]. In spite of the goodwill extended to Mr. Hawke, that possibility seems remote.” (*The Australian*, November 2, 1983.)



## **Inflation in the 1980s**

During the second half of the 1980s, Australia frequently had notably higher inflation than leading OECD countries.

The resumption of high inflation in Australia after 1984 was attributed to import-price-push, profit-push, and wage growth.

*Reserve Bank Bulletin* (April 1987): “The acceleration in prices is not entirely due, however, to the depreciation. Increases in wages have also been larger.”

## **Inflation in the 1980s, continued**

Similarly, in outside commentary:

“The inflation rate peaked at almost 10 percent at the end of 1986, under the influence of rising import prices. But, thanks to cuts in real wages, it had fallen to 7 percent by June 1988, and [it] seems likely to fall further under the influence of the appreciation of the dollar and continuing wage moderation.” (Ross Gittins in *The Australian Economy 1988*, p. 33.)

Criticism of government policy also often took a cost-push form. For example, John Howard (Opposition Leader, 1985–1989) said: “The Accord... will merely lock Australia into a continually higher unit-labor-cost and inflation structure than our trading partners...” (*Australian Financial Review*, April 30, 1986.)

## **Role of monetary policy in the 1966–1991 consensus**

The pre-1991 consensus did see that excessive monetary *ease* could *add to* inflation if it pushed output above potential. But it posited that such pressure would be *superimposed on* nonmonetary sources of inflation; and that monetary *restriction* (of a kind that put output below potential) would *not* lower inflation.

This position prevailed across pre-1991 monetary arrangements, including that of monetary-growth targeting (1976–1985).

The position implied a very circumscribed view of what monetary policy can contribute to inflation control—one that essentially corresponded to Keynes’ view during the 1940s.

“And if price-levels are determined by money-costs, it follows that whilst an ‘appropriate’ quantity of money is a *necessary* condition of stable prices, it is not a *sufficient* condition.”

John Maynard Keynes (1943)

## **Role of monetary policy in the 1966–1991 consensus, continued**

The circumscribed view underlay statements by policymakers about monetary policy's role. For example:

Malcolm Fraser: “the various monetary and fiscal weapons... ought not to be nullified by the wage-fixation process.” (*Sydney Morning Herald*, January 31, 1976.)

Treasurer Phillip Lynch: “The [Arbitration] Commission has, in effect, asked the Government to control inflation with one hand tied behind its back.” (*Evening Post* (Wellington), November 23, 1976.)

## **Role of monetary policy in the 1966–1991 consensus, continued**

Sir John Phillips (Reserve Bank Governor, 1968–1975): “[I]ndeed, without the support of other appropriate policy measures, a tighter monetary policy could probably do no more than prevent a further marked deterioration in the inflationary process... [T]he extent to which economic stability can be restored by demand-management policies will be very limited if wage increases are not reduced.” (Letter to Treasurer, December 18, 1974; declassified 2005.)

Harold M. Knight (Reserve Bank Deputy Governor, 1968–1975; Governor, 1975–1982): “Although money, of course, is not the only thing that matters, if it is supplied in great excess, inflation is inevitable.” (Remarks at First National Bank of Chicago conference, April 1975.)

## **Role of monetary policy in the 1966–1991 consensus, continued**

Treasurer John Howard: “monetary policy has been directed at providing adequate funds for sustainable recovery in private-sector activity and employment, while bearing down steadily on inflation and inflationary expectations... We take some pride in the contribution monetary policy has made in checking inflation.”  
(*American Banker*, December 15, 1978.)

Treasurer John Howard: “If we adopt policies that are far more permissive so far as the money supply is concerned... the net effect will be to create a far more inflationary climate than exists at present... [I]f we adopt more permissive monetary and fiscal policies, the prospect of securing a greater level of wage restraint will be even further down the track.” (*House of Representatives Debates*, October 24, 1982.)

## **Role of monetary policy in the 1966–1991 consensus, continued**

Bob Hawke: “We know that we could generate short-term reductions in interest rates through temporarily promoting rapid monetary growth... But such an approach would lead to sharply increasing rates and the truncation of growth when balance-of-payments and inflationary pressures inevitably led to its reversal.” (*House of Representatives Debates*, May 24, 1983.)

This outlook taken by Australian governments was supported by Ross Gittins: “Monetary policy ought to be accommodating, but not over-accommodating. That is, it should not stifle economic activity, but neither should it add inflationary pressure over and above that provided by wage growth.” (*Sydney Morning Herald*, July 28, 1984.)

## **Misconception about role of monetary restraint in disinflation**

This perspective led policymakers to see it as possible to reduce inflation by nonmonetary means and then implement interest-rate reductions to reflect the lower expected inflation associated with that inflation reduction.

Treasurer John Howard: “The inflation path remains on a downward trajectory and is expected to approach 5 percent by mid-1979.” (*American Banker*, December 15, 1978.)

Bob Hawke: “The statistical evidence is there: we are winning the fight against inflation... [W]ith the clear evidence now [that] the fall in the inflationary rate has happened and that the expectation should be further movements in that direction, I would expect this to be a downward factor on interest rates.” (Remarks at press conference, October 25, 1984.)



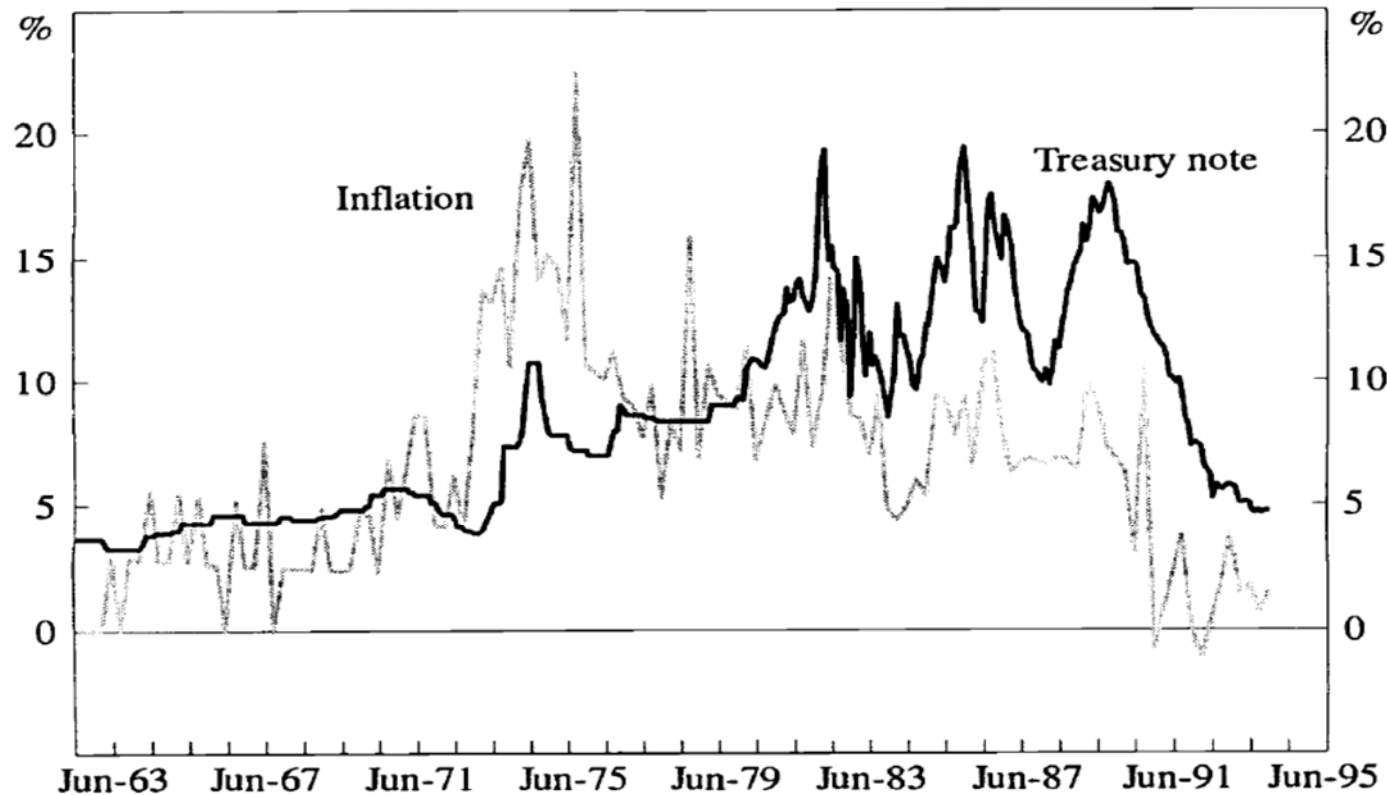
## **Misconception about role of monetary restraint in disinflation, continued**

Treasurer Paul Keating: “As we succeed now in dropping inflation, there should be scope for nominal declines in interest rates.”

(*Evening Post* (Wellington), August 30, 1988.) “Having succeeded in bringing down the inflation rate of 11 percent under the Liberal Party to 5 percent in 1985, and having watched inflation rise to 10 per cent as a result of a big depreciation of the exchange rate, we are now succeeding in bringing it back to the 5 percent area whence it came in 1985... Inflation is declining...” (*House of Representatives Debates*, November 30, 1988.)

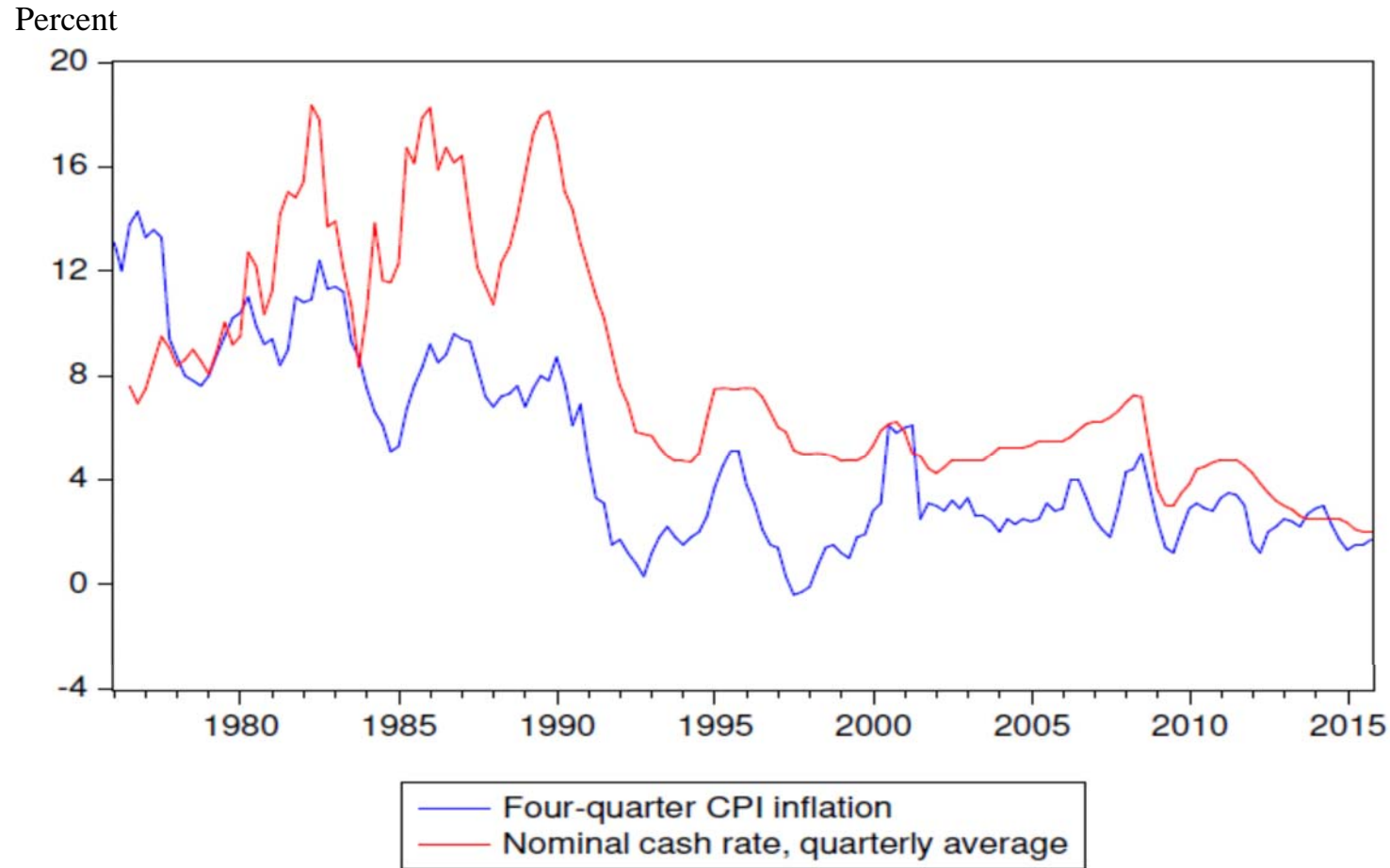
The 1978 and 1988 predictions of 5 percent inflation for the following year were not borne out. Nor were the predictions in 1978, 1984, and 1988 of imminent declines in nominal interest rates.

## Inflation and nominal interest rate (13-week Treasury note), Australia, 1963–1993



Source: Frederic S. Mishkin and John Simon, “An Empirical Examination of the Fisher Effect in Australia,” NBER Working Paper No. 5080, April 1995 (downloadable from [www.nber.org](http://www.nber.org)). The CPI series is adjusted to exclude the main effects on measured inflation of changes in national health-insurance arrangements from the mid-1970s through 1984.

# Inflation and nominal interest rate (Interbank Cash Rate), Australia, 1976–2015



Source: rba.gov.au. The CPI series is adjusted for the change in national health-insurance arrangements in 1984.

## **The change in doctrine**

In the early 1990s, a change in doctrine occurred. This change took place haphazardly, and numerous official reaffirmations of the nonmonetary view of inflation cropped up during the transitional period. For example:

Treasurer Paul Keating: “[W]orking with a tight monetary policy... doesn’t work while you’ve got the British craft union structure, which is what Australia has; you’ve got to have an incomes policy.” (On *John Laws Show*, October 24, 1989.)

## **The change in doctrine, continued**

Bernie Fraser (Reserve Bank Governor, 1989–1996): “It is not for the Bank to unilaterally announce any explicit medium-term objective for price stability.” (*Reserve Bank Bulletin*, May 1990.)

Bernie Fraser: “The Reserve Bank here can’t set an inflation target and merrily go about pursuing it. Even if we had an agreed target, that agreement would have to extend beyond monetary policy, because inflation is obviously much more than a monetary policy problem. Curbing inflation might be what monetary policy does best, but monetary policy on its own can’t be fully effective.” (*Decisions* magazine, October 1990.)

Bernie Fraser: “The task [of fighting inflation] has to be shared with other policies, and especially wages policy.” (*Australian Financial Review*, October 16, 1990.)

## **The change in doctrine, continued**

Indeed, even after the decline in inflation in the early 1990s, there was an initial tendency to explain it in good part in terms of changed wage-setting arrangements and to regard the continuation of low inflation as hinging on a successful official incomes policy.

For example, Hawke's 1994 memoirs stated (p. 182) that the "Accord agreement and the decisions made under it effectively snapped the back of inflationary expectations in Australia." Bernie Fraser contended that "Accord-type processes will help to contain inflation as recovery proceeds," while also suggesting that greater decentralization of wage-setting had eased "concerns that national wage increases would put a floor under future inflation." (*Reserve Bank Bulletin*, April 1992.)

## **The change in doctrine, continued**

In partial contrast, Chris Higgins of the Australian Treasury observed: “there is no route to lower inflation, starting from where we now are, that doesn’t go through higher real interest rates for a time.” (Remarks at Australian Graduate School of Management conference, July 1990.)

In a 2000 retrospective, David Gruen and Glenn Stevens criticized the state of inflation analysis in Australia prevailing at the end of the 1980s and remarked that, early in the 1990s, “the main insight of two centuries of monetary economics... that monetary policy ultimately determined inflation” convinced the Australian authorities that nonmonetary approaches to inflation control should be set aside in favor of central-bank inflation targeting.

## Arriving at the modern consensus

Factors likely to have led Australia to share the consensus that monetary policy has a special responsibility for inflation include:

- Greater absorption of the rest of world's academic consensus.
- Rest-of-world success (from early 1980s onward) with inflation control using monetary policy (including disinflation in U.S., and disinflation then inflation targeting in NZ).
- Corresponding disillusionment with incomes policy as an inflation-control device. (For example, the 2000 Gruen-Stevens study nominated employment and real wages—*not* inflation—as variables that the Accord affected.)
- The dramatic and lasting decline in inflation in Australia after the 1988–1989 monetary policy tightening (which had been set in motion in large part by balance-of-payments concerns rather than in response to the inflation situation).



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