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How much will the balance of payments "deteriorate"?

Difficult decisions on the exchange rate ahead

Big swing into red on current account to be expected

No prizes will be awarded in 1997 for forecasting that the current account of the balance of payments will move sharply into the red. All the relevant influences are giving the same message. First, the rise in sterling since last summer will widen the deficit on trade in goods and services, and reduce the sterling value of net receipts of investment income. According to our econometric equations, the exchange rate appreciation will cut export volume growth by 2 1/2% in 1997 and (if the exchange rate stays high) by a similar amount in 1998, while import volume might be 1% or so higher in both years. The damage to the current account, in terms of value, might be over £5b. in 1997 and heading towards £10b. in 1998. The impact on investment income is also large. Because the UK's investment income receipts are much larger than its payments, and because receipts are denominated in foreign currencies to a greater degree than payments, the fall in their net value could well exceed £4b. this year.

UK domestic demand very buoyant

Secondly, domestic demand in the UK is far more buoyant at present than in the rest of Europe. As the ratios of trade to national output are so high nowadays, much of the excess growth in the UK will benefit foreign suppliers. The precise scale of this effect is partly conjecture, because no one knows exactly what will happen to demand in the UK and its trading partners over the next couple of years. But it would not be silly to propose that UK domestic demand will grow 1 1/2% faster than the OECD average in 1997, and that at least a third of this will seep abroad. That would widen the current account deficit by almost £5b. at an annual rate.

So the current account position could "deteriorate" by, say, between £10b. and £15b. this year compared with 1996. (Note that the use of the word "deterioration" is conventional, but it implies a value judgement, which may not be appropriate.) In 1996 the current account was in almost exact balance. By the end of 1997 the current account deficit will be running at over £1b. a month and increasing. The current account deficit may be highly desirable for the UK, as a counterpart of capital account inflows into this country and a symptom of high foreign investment. However, most financial comment will be alarmist. One of the most difficult decisions for the new Labour Government will be on the exchange rate. Should they fix it, perhaps as a prelude to re-joining the European exchange rate mechanism? And, if so, at what exchange rate? If the Government feels that a lower exchange rate is needed to curb the balance-of-payments "deterioration", will it be able to prevent an organized retreat becoming a disorderly rout?

Will Labour fix the exchange rate? and confront a sterling crisis?

Professor Tim Congdon 2nd May 1997

Summary of paper on

Was there a "monetarist counter-revolution"?

Purpose of the paper

The Conservative Government of 1979 to 1997 started with a different macroeconomic agenda from previous post-war governments. Rightly or wrongly, this agenda was summarized in the word "monetarism". The purpose of the paper is to consider how far the Conservatives carried out their original agenda.

Main points

* **Monetarism provided a technical prescription for the control of inflation, but it also had a wider agenda. It attacked "corporatism" and "Keynesianism", two influential patterns of thought in the Labour-dominated period from 1964 to 1979.**

* **The main practical expression of corporatism was an attempt to control inflation by incomes policies, based on cooperation between government and trades union.**

* **The Thatcher Government reduced inflation by monetary means and broke the power of the trade unions. Monetarism gave the intellectual input for this change of course.**

* **Large budget deficits and an active use of fiscal policy to boost employment are usually regarded as characteristics of Keynesianism. The Thatcher Government rejected these ideas and instead tried to restrict public sector borrowing.**

* **Despite many uncertainties inside the so-called "monetarist" school about the relationship between money and national income, inflation was much lower in the early 1990s than in the 1970s. Further, in contrast to most industrial countries, public debt did not increase relative to gross domestic product during the Conservative period.**

This paper was written by Professor Tim Congdon, with help from Mr. Stewart Robertson and Mr. Brendan Baker in the preparation of the charts. It appeared in *The Times Literary Supplement* of 18th April, as 'Election Excursion VII' under the title "Monetarism: success in practice, failure in theory".

Was there a "monetarist counter-revolution"?

An assessment of monetary policy under the Conservatives

Inflation control was Conservatives first priority in 1979

Control of inflation was the Conservatives' first priority when they were elected in 1979. In the words of *The Right Approach to the Economy*, effectively their statement of intent on economic policy, "The role of inflation as the great destroyer - of jobs, living standards and a stable order - is now much more widely recognised." What should their last end-of-term report say?

and a record of success in practice

In the five years to June 1979 the average increase in the retail price index was 15.1 per cent a year, with a peak of 26.9 per cent in August 1975; in the five years to February 1997 the average increase in the retail price index was 2.6 per cent a year, with a peak of 4.3 per cent in May 1992. The facts appear to tell their own story. On the criterion that it regards as the key measure of performance, the Conservative Government of 1979 to 1997 was successful. If the case for an "alpha" is unconvincing because it did not restore full price stability, a highly commendable "beta plus" seems fair.

But are the facts as decisive as they seem? Because inflation has fallen in all the main industrial countries since the 1970s, the Conservatives' achievement is far from unique. Critics might argue that international pressures - such as falling commodity prices and the almost universal adoption of anti-inflationary monetary policies - have been the main reasons for the decline in inflation in the UK. The British Government could then be portrayed as a bit actor in a drama jointly directed by the American Federal Reserve in Washington and the Bundesbank in Frankfurt.

But was this due to their own efforts and, in particular, to the original "monetarist" programme?

The question becomes, "to what extent was the decline in inflation due to the Government's own decisions, as it tried to fulfil a pre-determined agenda, and not the result of Britain's passive participation in the global trend?". In any answer to this question the word "monetarism" is inescapable. Back in June 1979 most members of the newly-elected Government, including Mrs. (now Lady) Thatcher herself, believed that a distinctive and valuable part of its economic programme was the pledge to combat inflation by reducing the rate of money supply growth. In that sense leading Conservative politicians were "monetarists", however much they have subsequently denied any formal affiliation to any precise set of ideas.

Monetarism more than a programme against inflation, involving

In the British political debate of the late 1970s monetarism was far more than a number of technical propositions about monetary economics. It was, self-consciously, a counter-revolution against the prevalent thought-habits of the time. Indeed, it could be characterised as a rejection of the whole post-war period trend in economic policy. (In his *Who's Who* entry Sir Keith [later Lord] Joseph, perhaps the key figure in the movement, referred to only one pamphlet he wrote for the Centre for Policy Studies, the think tank that he and Thatcher founded in 1974. It was called *Reversing the Trend*.)

1. An attack on "corporatism",

i.e. view that government-union cooperation

In particular, monetarism was targetted against two doctrines whose influence was greatest in the Labour-dominated period from 1964 to 1979. The first doctrine, often labelled "corporatism", was that the state should cooperate with the organised representatives of labour and capital (the Trades Union Congress and the Confederation of British Industry) in order to determine both macroeconomic outcomes, such as the inflation rate, and the distribution of income between wages and profits. Annual agreements between the three parties on the rate of wage and dividend increases, also known as "incomes policies", were the main practical expression of corporatist ideas.

and incomes policy necessary to defeat inflation

Incomes policies enjoyed huge support among the chattering classes, particularly in economics departments at Britain's universities. They were regarded as the correct analytical response to the problem of inflation, as they dealt with hard men like trade union leaders and hard numbers for wage increases. By contrast, monetary control was widely dismissed as a plaything of academic theoreticians. Further, incomes policies were deemed to be particularly appropriate for modern Britain, a nation assumed to suffer - indefinitely into the future - from entrenched trade union power.

Thatcher Government repudiated government-union cooperation and broke the power of the trade unions

One of the monetarists' most important messages in the late 1970s was that excessive monetary growth, not trade union power, was the cause of inflation. It followed that inflation could be controlled by a reduction in money supply growth, whereas over the long run incomes policies would fail. Moreover, the Government did not have to rely on trade union cooperation to keep inflation down. On the contrary, the monetarists believed that overmighty trade unions were responsible for serious inefficiencies in some of the most vital parts of Britain's economy, including the car and shipbuilding industries, and the energy utilities.

Monetarism gave rationale for this policy

In its battle with corporatism and the trade union movement, the Thatcher Government secured a comprehensive victory. In the summer of 1979 it scrapped the machinery of wage and price control. A few months later it re-emphasized its commitment to monetary restraint by raising interest rates to 17 per cent, a move intended to bring money supply growth back into line with the target. By the middle of 1982 inflation was under 5 per cent. The general election of 1983 was fought with an inflation rate of 4.0 per cent. Even more salient were the heavy defeats inflicted on the trade unions in a sequence of labour disputes. The failure of the coal-miners' strike of 1984 exploded the myth that Britain was ungovernable without the consent of the trade unions.

How important was monetarism in all this? Crucially, it did provide the intellectual rationale for ending the union-government dialogue over prices and incomes. By extension, it made possible the reforms to trade union law which over the last decade have restored managements' ability to manage. One result is that productivity gains in the once heavily-unionised industries of energy supply, steel and cars have been enormous, far higher than in manufacturing industry as a whole. These productivity gains have helped to curb inflation. More fundamentally, in the early 1980s, the month-by-month movements in

Inflation under different political parties

Superficially, the Conservatives have a better record

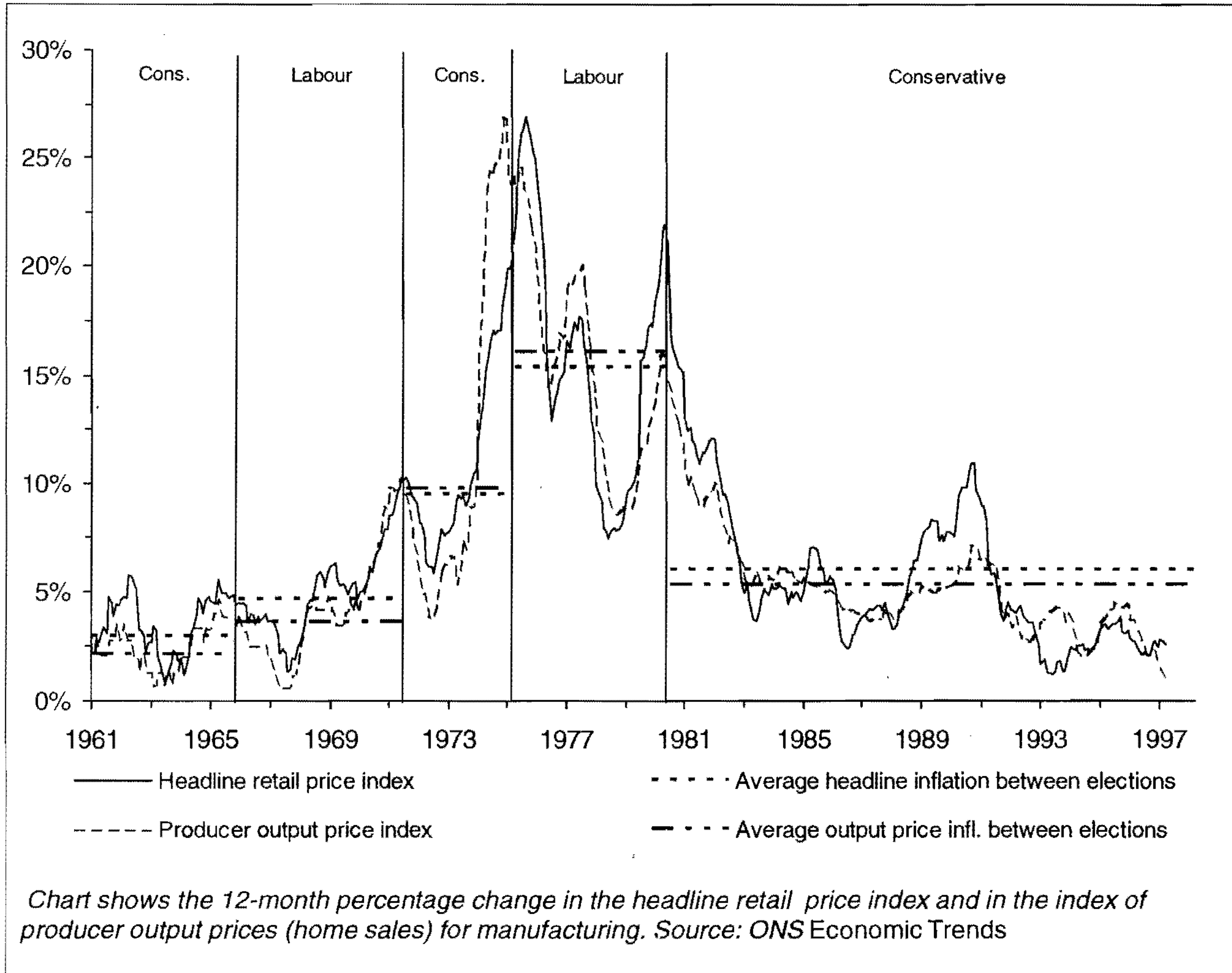

Chart shows the 12-month percentage change in the headline retail price index and in the index of producer output prices (home sales) for manufacturing. Source: ONS Economic Trends

The average annual increase in retail prices under the 1979 - 97 Conservative administration was 6.0%, sharply lower than the figure of 15.4% recorded under the last Labour Government. Indeed, in the 1990s inflation has been lower than it was in the late 1960s, when the first Wilson Government was in power. It was also much the same as it was in the early 1960s at the end of the 1951 - 64 Conservative Government. One reading of the chart is that the final years of the two long periods of Conservative rule since the war saw the best inflation performances, apparently an endorsement of the Conservatives as the party of sound money. However, that is debatable. The worst monetary mismanagement was in the early 1970s, under the Conservative Government led by Mr. Heath. The inflation peak of 1975 was the result of that mismanagement, not of the subsequent Labour Government's policies. The central ideas in British monetarism developed in the mid-1970s partly as a reaction to the disastrous inflation performance and partly as an import from the Chicago monetarism of Professor Milton Friedman. They were never embraced warmly in the Conservative Party. The technical difficulties of the early 1980s led to the abandonment of broad money targets in 1985 and was followed by another boom-bust cycle, with inflation peaking at over 10% in 1990. This was entirely the Conservatives' fault.

the money supply were monitored closely for their future inflationary message. Although this approach to macroeconomic management has been largely (but not entirely) abandoned, it was followed by exactly the decline in inflation that the monetarists wanted.

2. An attack on "Keynesianism",

where Keynesianism meant

Corporatism held sway for a relatively brief period in Britain's political economy, roughly from the mid-1960s to 1979, and had never benefited from rigorous intellectual endorsement by an acknowledged leader of thought. The second doctrine of the Labour-dominated era, Keynesianism, was a different matter. Keynes himself undoubtedly had one of the most original and powerful minds ever to have been involved in British policy-making. His thinking was widely credited with the achievement of full employment of the 1950s and 1960s, an achievement which commonly appears under the banner of "the Keynesian Revolution".

i. primacy of fiscal policy,
ii. permissiveness towards budget deficits, and
iii. focus on full employment

The ascription of full employment to Keynes depends on the claim that macroeconomic policy was transformed by the theoretical novelties in his *General Theory of Employment, Interest and Money*, published in 1936. Before this book Britain's public finances were determined by "sound finance" and, in particular, the principle that the budget should in normal circumstances be balanced or in small surplus; afterwards the Keynesian wisdom was that the budget deficit could be varied to inject or withdraw demand from the economy, in order to keep output always high enough for full employment. Keynesianism was therefore associated with the primacy of fiscal policy (i.e., variations in the budget deficit) over monetary policy in macroeconomic management, with a permissive attitude towards large budget deficits and with a focus on full employment as the Government's pre-eminent economic objective.

Monetarism argued instead for
i. primacy of monetary policy,
ii. need to restrict budget deficits, and
iii. inflation control to come ahead of full employment,

Debates about Keynes, Keynesianism and the Keynesian Revolution have been endless. Strong evidence can be presented that Keynes himself thought very differently from his disciples about large budget deficits. Moreover, a careful examination of the data shows that fiscal policy in the 20 years from 1945, the heyday of full employment, was not conducted on Keynesian lines.(1) To a large extent the Keynesian Revolution was a hoax. Nevertheless, in the late 1970s the monetarists had a hard time battling with a body of thought which was as much myth and make-believe as substance and reality. They insisted on three ideas: first, that monetary policy was more important than fiscal policy in understanding the business cycle; secondly, that over the medium term the budget deficit (known more technically as "the public sector borrowing requirement") had to be restricted to prevent excessive growth of public debt and to buttress monetary control (2); and, thirdly, that the reduction of inflation, not full employment, should be the Government's foremost macroeconomic aim.

and monetarism achieved a marked shift in both policy

The monetarists have pressed these points convincingly in the public debate of the last 20 years. Every projection of fiscal policy nowadays is framed within a medium- or long-term context, with one eye on the implications for the accumulation of public debt. Apart from Norway, the UK is the only country

and thinking about policy

in the industrial world where the ratio of public debt to national income is lower today than it was in 1979. The shift towards regarding inflation, not unemployment, as the central concern of macroeconomic policy-making has also been surprisingly complete. In part, this shift reflects a new theoretical consensus among economists, that there is no long-run trade-off between unemployment and inflation. In part, it stems from a hard-headed recognition that unemployment may be due not to a lack of demand, but to over- generous social security benefits which leave the unemployed little incentive to seek work.

So - in its contest with corporatism and Keynesianism - monetarism has notched up important victories. Even if it has not forced them into unconditional surrender, corporatism and Keynesianism have retreated to their university fastnesses, and decline pitched battle in public debate. Almost no one now proposes incomes policy as the antidote to inflation or aggressive fiscal reflation as the best way to cut unemployment. Admittedly, the number of references to all the "isms" in the newspapers has declined drastically compared with the early 1980s. Indeed, many of the residual comments on monetarism are derogatory and in the past tense.

Public debate now has parameters quite different from those in the 1970s

Mr. Will Hutton at *The Observer*, Mr. Philip Stephens at *The Financial Times* and Mr. Anatole Kaletsky at *The Times*, as well as a host of lesser commentators, poke fun at monetarism from time to time. But none of them are silly enough to suggest that the Trades Union Congress determines the inflation rate or that a PSBR of 6 or 7 per cent of national income is financially responsible. They have forgotten that in the late 1970s the majority of opinion-formers in Britain did believe that the TUC could determine inflation, while fiscal reflation - even with the PSBR at 6 or 7 per cent of national income - was routinely recommended by the National Institute and leading economists at Cambridge University, such as Professor Wynne Godley.

If monetarism was largely successful in practice, why is it now mentioned in the past tense?

The question becomes, "if monetarism in the 1980s achieved much of the agenda its supporters set in the late 1970s, why are references to it in the 1990s so rude and dismissive?". The answer is that, when confronted with real-world monetary policy, the simple messages of late-1970s monetarism were insufficient for the task. Those messages were fine in refuting incomes policies and fiscal reflation, but they were inadequate when they had to be translated into complex and technical decisions about interest rates and the exchange rate. It turned out that economists calling themselves "monetarists", far from sharing a cohesive and well-organized body of thought, had radically different views about how the economy worked and about how policy should be conducted.

Internecine debate about broad and narrow definitions in money targetry

Squabbles between the various denominations broke out early on. Initially the Thatcher Government stated its targets for monetary growth in terms of a so-called "broad aggregate" (i.e., one which includes almost any asset that might be called "money", such as virtually all bank deposits). But this was an embarrassment in the summer of 1980, when over-due measures of financial liberalisation caused the target to be exceeded by a wide margin. Professor (later

Sir) Alan Walters, who was appointed as Thatcher's economic adviser in early 1981, urged that the targets should instead be expressed in terms of "narrow money" (i.e., only notes and coin, or notes and coin plus bank deposits which could be spent without a notice period, such as current accounts).

Squabbles part of the reason for ERM advocacy,

The debate between broad and narrow monetarists has continued ever since, and undoubtedly reminds non-participants of medieval scholasticism. As a junior minister in the early 1980s Mr. Nigel (later Lord) Lawson was impatient with all the technicalities. After he became Chancellor of the Exchequer in 1983 he soon decided - with support from his predecessor, Sir Geoffrey (later Lord) Howe, who was now Foreign Secretary - that the exchange rate was superior to the money supply as a guide to interest rate decisions. In particular, membership of the European exchange rate mechanism should form the framework for monetary policy.

but a fixed exchange rate and money supply targets may be in conflict

It is an ancient principle of monetary economics that a nation cannot simultaneously pursue a money supply target and a fixed exchange rate. ERM membership, focussed on a fixed exchange rate between the pound and other European currencies, therefore meant the end of monetarism, in which money supply targets were an essential ingredient. By the late 1980s Thatcher and Walters were engaged in a long-running row with Lawson and Howe about macroeconomic policy, which in its raucousness and visibility was comparable to a high-brow Punch and Judy show.

Period of ERM membership saw large fluctuations in broad money growth,

Unhappily, none of the four key players in this wonderful piece of political theatre were much interested in what was happening to the money supply on the broad definitions, which back in the late 1970s had been the ark of the monetarist covenant. In the early 1980s broad money growth had been gradually declining and by the mid-1980s it had fallen to about 10 per cent a year. But in the late 1980s it accelerated to over 15 per cent a year. A boom followed, justly labelled "the Lawson boom" after the Chancellor who presided over it, and inflation again exceeded 10 per cent in 1990. Thatcher lost the leadership of the Conservative Party one month after the annual increase in the retail price index again went into double digits.

and boom followed by bust

The boom of the late 1980s, and the consequent rise in inflation, proved once again the underlying validity of the monetary theory of inflation. But that was not how Westminster and Whitehall saw it. Instead of re-instating the policy framework of 1979, the new administration led by Mr. John Major stood by the ERM. A severe recession ensued, wrecking thousands of small businesses and causing house prices to fall heavily for the first time in two generations. Money supply growth plunged from over 15 per cent a year to under 5 per cent a year, but - because of the ERM commitment - nothing could be done to mitigate the harshness of the monetary contraction.

Finally, in September 1992 the pound sterling was expelled from the ERM by the benign activities of foreign exchange speculators. Interest rates tumbled, with clearing bank base rates down from 10 per cent to 6 per cent by January

Real M4 and the business cycle

Small changes in real money lead to stop-go, large changes to boom-bust

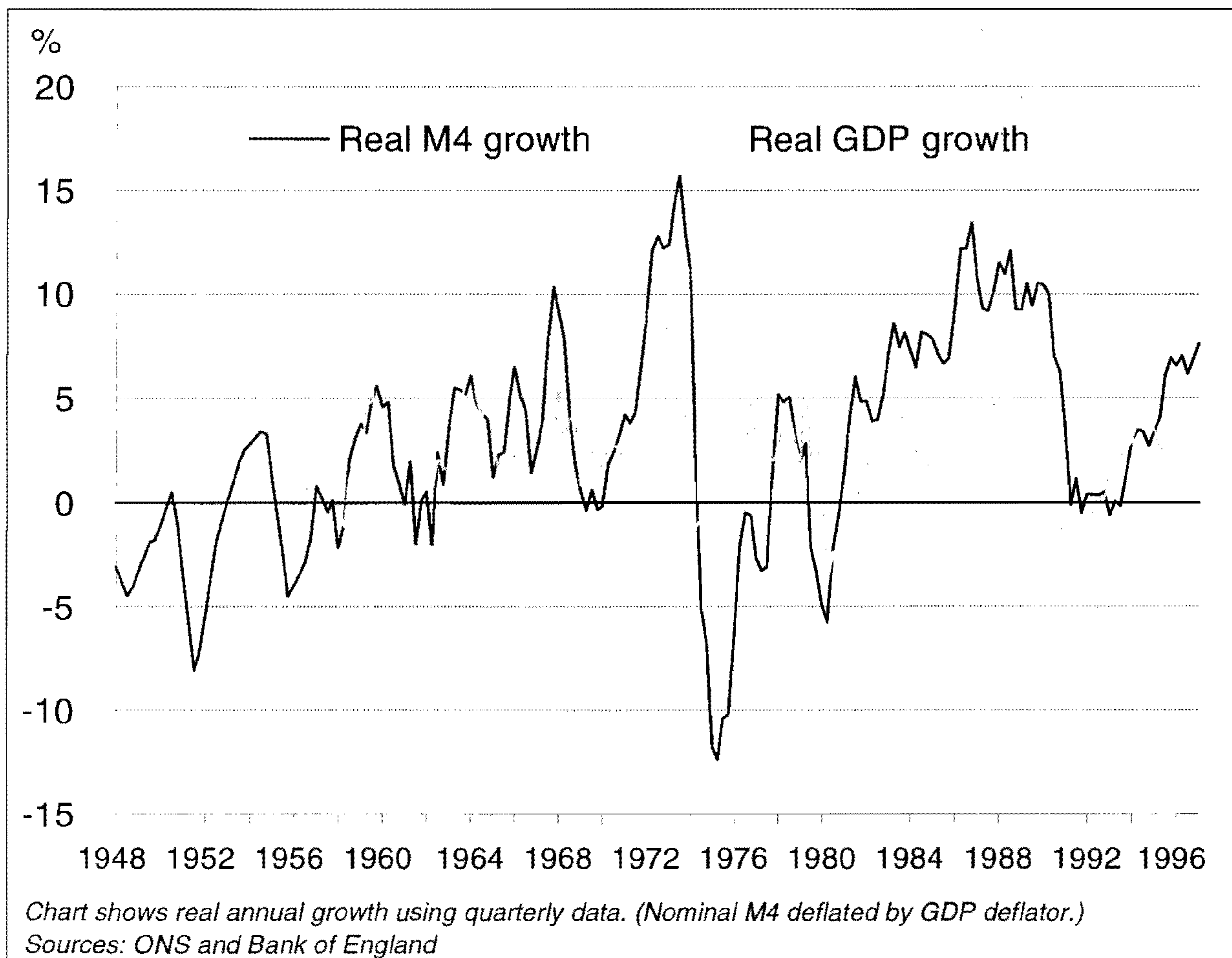

Chart shows real annual growth using quarterly data. (Nominal M4 deflated by GDP deflator.)
Sources: ONS and Bank of England

The main point of this chart is to show the contrast between the relative macroeconomic stability of the 25 years to 1972 and the instability of the following 25 years. The Heath-Barber boom of 1971 to 1973, which saw nominal broad money growth of over 20% a year, was the dividing-line between the two periods. Until then broad money growth had almost never exceeded 10% a year and gross domestic product had fallen in only one year in the post-war period. This was in 1958, which recorded a fall of 0.1% in GDP. The fall was more than explained (in accountancy terms) by a drop in stockbuilding. After the Heath-Barber boom the British economy suffered three bad recessions, all characterised by GDP falling on an annual basis. The instability of the second 25-year period undoubtedly had a heavy human cost. The 1958 recession was due to a rise in Bank rate to 7% in September 1957 and credit restrictions which virtually halted the growth of bank balance sheets and so of the money supply. Between the second quarter (Q2) of 1957 and Q2 1959 the workforce in employment went down by 3.2%. The recessions of 1974 and 1975, 1980 and 1981, and 1990 to 1992 were also the result of monetary contraction, as can be seen from the preceding sharp falls in real money growth. Both of the last two recessions saw the workforce in employment dropping by 7% or more from peak to trough.

More pragmatic policies since exit from ERM in September 1992 led - accidentally - to low and stable broad money growth

1993. A recovery began and has continued, with fits and starts, until the present. Ironically, the money supply and inflation numbers of the early 1990s were for an extended period rather close to those that might have been prescribed by a high priest of monetarism in the late 1970s. Between mid-1991 and the end of 1994 broad money growth was consistently under 5 per cent a year, and from 1993 to 1997 the annual increase in the retail price index has averaged under 3 per cent, with remarkably little variation from year to year. But - as is evident from the erratic record of official intentions, rationalizations and excuses - this outcome was a fluke.

But money growth has now accelerated again and most British economists are indifferent to this

Since the start of 1995 money supply growth has again accelerated, to almost 10 per cent a year. In general, Britain's economists are indifferent to this development, and see in the faster rate of money growth no connection with the current upturn in economic activity and no risk of a future rise in inflation. This follows a familiar and recurrent pattern. Almost without exception, Britain's economists have resolutely denied that the cyclical turmoil and high inflation of the last 50 years have any relationship with volatile and excessive money supply growth.

In terms of their ability to persuade the long-term leaders of British economic thought in the universities and day-to-day opinion-moulders in the press, the monetarists have failed almost completely. Keynes' ghost must be chuckling. The so-called "Keynesian Revolution" contained large elements of fantasy and charade, but the phrase still appears - unadorned with quotation marks - in respectable textbooks. The notion of a "monetarist counter-revolution" has vanished. Nevertheless, in the early 1980s monetarism was important in shifting the attitudes of Britain's political class towards incomes policy and fiscal activism. At the level of ideas, it defeated corporatism and refuted the more naive versions of Keynesianism. Moreover, the partial adoption and semi-abandonment of monetarist policies was followed by a sharp fall in inflation, even if this was largely an accident.

Monetarism lacks a convincing theory of the relationship between money and national income

Looking back, the monetarists' central problem was curious and unexpected. Despite the millions of words written on the subject from a monetary perspective, they did not have a generally agreed theory of the relationship between money and money national income. In jargon, they lacked an account of "the transmission mechanism". But their problem is also a problem for the Keynesians and, indeed, for any macroeconomist who thinks seriously about his subject. The sorry truth is that, over 60 years after the publication of Keynes' *General Theory*, economics does not have a definitive theory of the determination of national income. Policy-makers' failures to control the business cycle and prevent inflation over the last 20 years are due to this large vacuum in understanding.

Nominal M4 and nominal GDP growth, 1970-1997

Was low and stable money growth in the early 1990s a fluke?

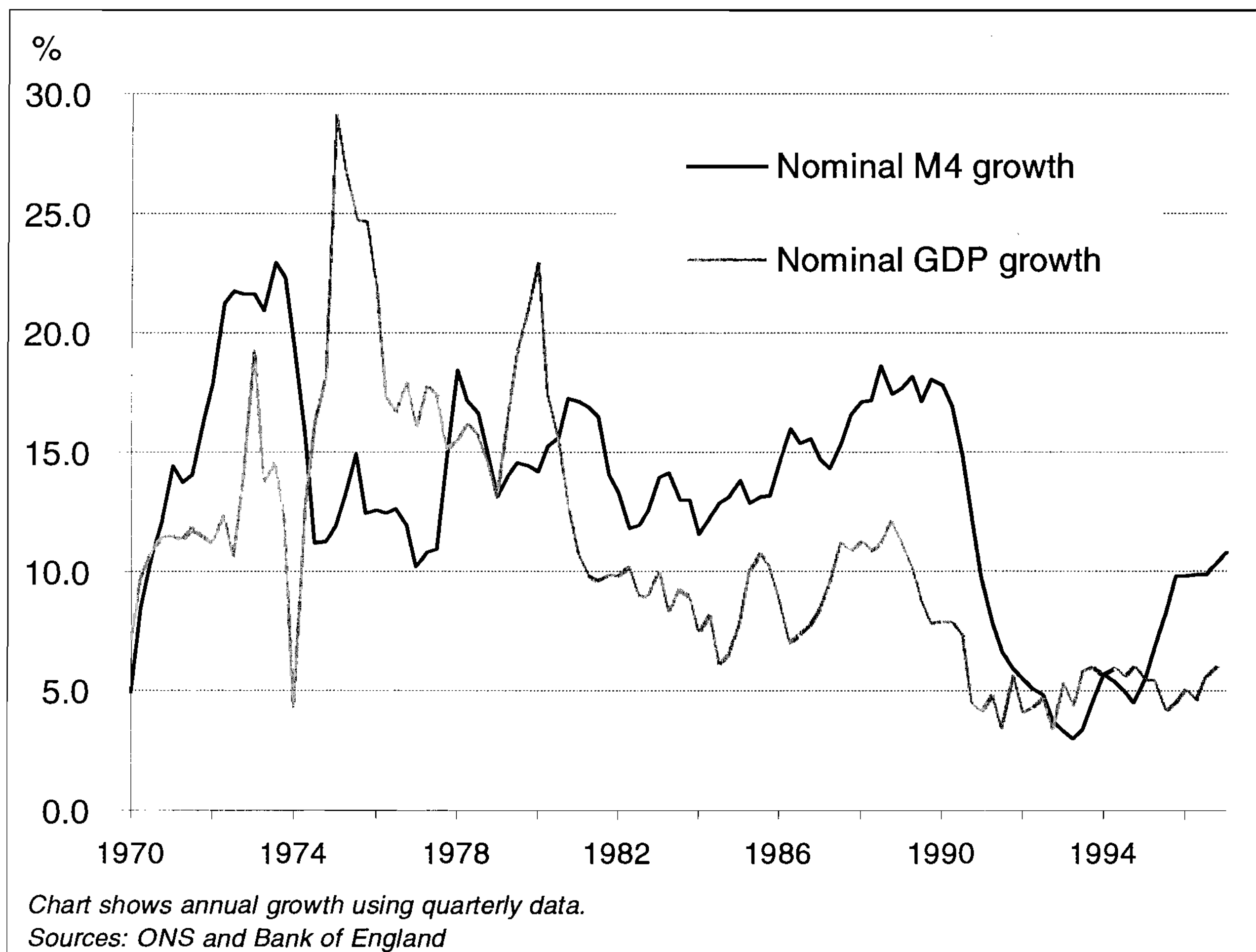

Chart shows annual growth using quarterly data.
Sources: ONS and Bank of England

Since the Heath-Barber boom of the early 1970s governments have intermittently tried to reduce money supply growth, in the belief that excessive money supply growth is the cause of inflation. However, the erratic implementation of this policy led to large fluctuations in monetary growth and considerable macroeconomic instability. In the early years of the Thatcher Government changes in real interest rates and financial regulation made it difficult to interpret monetary trends. All the same, broad money growth in 1985 was markedly lower than on average in the 1970s and inflation also was much less than before. Mr. Nigel (later Lord) Lawson then decided to abandon broad money targets and instead to base interest rates on the exchange rate, as a prelude to participation in the European exchange rate mechanism. As the chart shows, the sequel was a well-defined acceleration in money supply growth and a boom in economic activity. ERM membership followed in 1990, but it was associated with inappropriately high interest rates, a collapse in money supply growth and the most protracted recession in the post-war period. After sterling's expulsion from the ERM in September 1992, policy became far more pragmatic, but - ironically - broad money growth was stable at under 5% a year for over three years. The result was the lowest inflation over a sustained period since the late 1950s and early 1960s.

Notes

(1) See the September and October 1996 issues of this *Monthly Economic Review* on "Fiscal policy in the UK since the Second World War".

(2) The emphasis on controlling the PSBR as a key aspect of monetarism seems to have been distinctively British. Friedman denied that the large budget deficit in the USA in the early 1980s was "a major issue or cause for concern". (Letter published in *The Wall Street Journal*, 4th September, 1984). The background to British monetarists' concern about high budget deficits was set out by the author in "The analytical foundations of the Medium-Term Financial Strategy", first published in the May 1984 issue of *Fiscal Studies* and also as pp. 65-77 of Tim Congdon *Reflections on Monetarism* (Edward Elgar for the Institute of Economic Affairs: Aldershot, 1992).