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Contents **Page**

Contents	Page
Commentary on the economic situation	1
Research paper: Keynesianism, monetarism and corporatism	3

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Money trends must still be watched

UK money growth worryingly high, US money growth puzzlingly low

UK's annual M4 growth rate hits double digits

In the year to August the UK's M4 money measure climbed by 10%, the highest figure since early 1998. While it is wrong to draw mechanical conclusions from this number for the macroeconomic outlook, past experience has shown quite a good medium-term relationship between money and nominal gross domestic product. For example, research work at Lombard Street Research has found a statistically interesting link between companies' liquidity position (their M4 money balances divided by their M4 bank borrowings) and the growth of private sector domestic demand. Roughly speaking, over the long run the corporate liquidity ratio has averaged between 55% and 60%. When the ratio is in the 60% - 70% band, demand grows at an above-trend rate; when it is over 70%, it booms. At present its value is 63% - 64%. Along with several other items of evidence, the message is that above-trend growth of demand is likely until at least the spring of next year.

Consumer price index to rise in short term because of cost pressures and later because of excess demand

The increase in the consumer price index - only 1.3% in the year to August - will remain beneath the 2% target for a few months, but higher energy and petrol bills are likely to take it above target in early 2005. Thereafter much will depend on the degree of over-heating in the economy. Companies have not been vociferous about labour shortages, but the labour market is undoubtedly rather tight. With further above trend growth, the tightness will intensify. Pay growth has been edging up, although not dramatically. A reasonable verdict is that base rates will have to be raised further and will peak nearer to 6% than 5%. Meanwhile the annual rate of M4 growth needs to moderate towards the 5% - 6% area.

Low US money growth helps to explain muted nature of the recovery

Whereas UK money growth has been worryingly high, US money growth has been puzzlingly low. The numbers wobble up and down from month to month, but since the middle of 2003 the broad money measures - M2 and M3, in the American context - has advanced at annual rates of only 3% - 4%. As Fed funds rates has been a mere 1% for most of the period, and as American banks are profitable and well-capitalised (and therefore presumably keen to expand), much higher growth rates were to have been expected. Of course the US economy has recovered from the Iraq-related weakness in early 2003, but the money numbers have correctly warned that the recovery would not be of the runaway, rip-roaring kind seen, for example, in 1983 and 1984. The American and world economies will probably continue to see above-trend growth until mid-2005, but it is remarkable that the year of 1% Fed funds rate (from July 2003 to July 2004) did not stimulate a more powerful boom. (The explanation for the low US money growth seems to be that companies have been repaying bank loans, which were artificially inflated in the bubble years.)

Professor Tim Congdon **30th September, 2004**

Summary of paper on

'What has monetarism achieved?'

Purpose of the paper

This research paper - which was originally written as a response to an article by Professors Thomas Mayer and Patrick Minford (MM) in *World Economics* - contrasts the monetarist approach to economic policy with the Keynesian and corporatist approaches which were dominant in the 1960s and 1970s. It argues that the rather critical MM assessment of monetarism is unjustified.

Main points

- Although monetarism can be viewed through the lens of technical macroeconomics, it is better seen in the UK context as part of political reaction to the crisis of the 1970s, when several influential commentators doubted the durability of British democracy.

- Monetarism challenged "corporatism" (the idea that the state should influence economic outcomes - and particularly the setting of prices and incomes - by cooperation with "the peak organizations" of labour and capital) and "Keynesianism" (the idea that the state can and should manage demand, output and employment by varying its fiscal stance), with the proposition that inflation is caused by excessive money supply growth.

- The Conservative government under Mrs. (now Lady) Thatcher implemented much of the monetarist agenda in the early 1980s by
  - ending prices and incomes policies,
  - subordinating fiscal policy to money supply targets (in a Medium-Term Financial Strategy, announced in the 1980 Budget), and
  - directing monetary policy towards the reduction of inflation rather than the maximisation of employment.

- MM claim that monetarism is "in decline". But in the UK
  i. prices and incomes policies, on corporatist lines, have not returned,
  ii. demand management by means of fiscal policy, on Keynesian lines, has not been operated for almost a generation, and
  iii. monetary policy is directed, almost exclusively, to meeting an official inflation target.

- A vast improvement in the stability of macroeconomic policy has been achieved over the last decade. This improvement has been greater than in the so-called "Keynesian revolution" in the first 25 years after 1945. It owes much to the success of monetarist ideas in their debate with the corporatist and Keynesian alternatives.

This paper was written by Professor Tim Congdon. For the background, see first paragraph opposite.

What has monetarism achieved?

Monetarism vs Keynesianism and corporatism

Background to the paper

[The following research paper is the first half of a paper that has recently been published in the World Economics *journal. The original paper – called 'Monetarism: a rejoinder' – was a reply to an earlier paper on 'Monetarism: a retrospective' in* World Economics *by Thomas Mayer and Patrick Minford. The second half of 'Monetarism: a rejoinder' is more technical than the first half and is hardly meaningful without an earlier reading of the Mayer and Minford paper; the first half – which is largely about the political context of British monetarism – stands on its own two feet. If readers are interested, copies of the Mayer and Minford paper, and the full 'Monetarism: a rejoinder', are available from either Lombard Street Research or* World Economics, *c/o NTC Economic & Financial Publishing, Farm Road, Henley-on-Thames, Oxfordshire RG9 1EJ. Until the concluding three paragraphs only small changes have been made to the version that appeared in* World Economics. *The concluding three paragraphs are new, but synthesise the points in the second half of 'Monetarism: a rejoinder'. Lombard Street Research is grateful to the Editor of World Economics and NTC Economic & Financial Publishing for permission to reproduce the piece.]*

Monetarist challenge to Keynesian and corporatist styles of policy making

Seen from a British standpoint, Mayer and Minford's 'Monetarism: a retrospective' (MM) seriously understates the achievement of monetarism. They are of course correct to describe it as a set of theoretical ideas revived by (mostly) American economists in the 1950s and 1960s, and translated into policy across the industrial world to combat the high inflation of the 1970s; they are also right to recognise the strong influence that monetarism had on UK policy-making in the early years of the Thatcher Government from 1979. But they mislead by underestimating the success of the monetarist challenge to the Keynesian and corporatist styles of policy-making which prevailed (especially in the UK) before the 1970s. The following discussion will concentrate on the UK, although the remarks will have wider relevance.

Mayer and Minford's paper focuses on technical differences between monetarism and Keynesianism, and overlooks the political dimension

In their opening remarks and in a section on 'Basic ideas and history' MM compare monetarism with other schools of macroeconomic thought, particularly Keynesianism. In their view the differences are hardly fundamental. Whereas the monetarists believe in the importance of money to national income determination in the short and long runs, the Keynesians accept the role of money of national income determination in the long run, but question it in the short and medium terms; monetarists such as Milton Friedman regard the proposition that money and national income have similar rates of changes as a reasonable working hypothesis (but acknowledge that the theory of money is an aspect of the theory of portfolio selection), while Keynesians emphasize that desired money holdings may change relative to other types of wealth and income, put questions of portfolio selection first and repudiate a mechanical one-to-one relationship between money and national income; and so on. In this ball of economic theory the dancers change their partners

from time to time, but they all know the sequence of steps in the Cambridge cash balances equation, the routines of the IS-LM model, and other familiar tunes and rhythms. Everyone enjoys everyone else's company, and the gap between monetarism and other schools of thought arises from differences of nuance and emphasis. There is no clash of worldview and ideology, and no need for polemics.

In the 1970s the role of money in the economy was highly controversial

But that was not how matters stood in Britain in the mid-1970s or for many years afterwards. The study of monetary economics in British universities had declined in the 1950s and 1960s, and most university teachers rejected both a monetary theory of inflation and a role for money in the determination of national income. (1) Inflation was widely attributed to trade union greed or "pushfulness", with one commentator remarking that "pulp forests have been consumed" in discussing the role of the trade unions in the inflationary process. (2) The standard view about the national income was that both output and income were equal to expenditure, and that expenditure was determined by past income plus or minus demand withdrawals by the state (i.e., by the use of fiscal policy) or from overseas (as the world economy waxed and waned, or because the exchange rate changed). (3) As a consequence of these beliefs, mainstream professional opinion favoured two policy approaches. First, incomes policy (or "wages and prices policy") should be used to control inflation, with high-level bargaining between the government, the trade unions and industry on dividend freezes, pay norms and such like. Secondly, fiscal policy should be used to manage demand, with the annual "Budget judgement" (i.e., the net injection or withdrawal of demand by the state, approximated by the cyclically-adjusted change in the budget deficit) being critical. The purpose of demand management was to achieve full employment, in line with an agenda widely attributed the 1944 White Paper on *Employment Policy.*

Widespread preference for fiscal policy to manage demand and incomes policy to control inflation

Monetary policy equated with interest-rate setting

Monetary policy – often defined only in terms of interest rates (i.e., the price of money) rather than in terms of the quantity of money – was widely considered to be peripheral to the economy, even though interest rates were recognised as influencing the exchange rate. According to Goodhart,

> Throughout most of the 1960s...interest rates varied mainly in response to external conditions, being raised whenever there was a need to support the fixed exchange rate, which was often under pressure, and lowered – in a spirit of general benevolence towards investment – as each balance-of-payments crisis temporarily receded. With interest rate policy mainly determined by external considerations, the money supply was allowed to vary passively. (4)

Support for incomes policy and active fiscal management, and disdain for monetary policy, had huge political significance. They did not reflect merely technical differences of opinion about the effectiveness of the various economic instruments,

Corporatism implied political power for trade unions

but were instead motivated by deeper ideological commitments in British society. The high-level bargaining associated with incomes policy gave the trade unions considerable political power. Comparisons were made between the style of British economic government in the two decades from 1960, as politicians sought economy-wide deals with senior figures in the trade unions and large companies, and the state capitalism or "corporatism" of several European nations earlier in the 20th century. (5) Clearly, the greater the reliance on incomes policy to curb inflation, the stronger was the position of the trade unions in key policy debates.

Keynesianism implied large public sector

The pre-eminence of fiscal policy also had implications for the UK's social and political structure. In his *General Theory*, published in 1936, Keynes had said that fiscal policy would work best in a nation with "a somewhat comprehensive socialisation of investment". He thereby established a persuasive argument for a mixed economy with an extensive state-owned sector. To quote Keynes' words, "The central controls necessary to ensure full employment will, of course, involve a large extension of the traditional functions of government." (6) In short, both corporatism and Keynesianism accorded with the interventionist bias of most British writers and thinkers, including most British economists, in the early post-war decades. (7)

Boom of the early 1970s driven by Keynesian and corporatist doctrines

A fair comment is that by the early 1970s the macroeconomic thinking of many British economists, and the often rather pugilistic espousal of such thinking as "Keynesianism", had become idiosyncratic by international standards. (8) Nevertheless, a blend of Keynesian and corporatist doctrines conditioned economic policy-making. Taken to extremes, it prescribed a policy mix in which incomes policy set a politically determined and administratively enforced limit on inflation, and fiscal expansionism – justified by rhetoric about full employment – drove output to its employment-maximising level. A policy mix of this kind was indeed favoured by the National Institute of Economic and Social Research in the 1960s and 1970s, but could not be freely pursued in the 1960s because a fixed exchange rate constrained UK policy-making. (9) After the breakdown of the Bretton Woods fixed-exchange-rate system in 1971, the British government was able for the first time in the post-war period to combine incomes policy with aggressive fiscal reflation. The external barrier to high money supply growth was removed, while the increased budget deficit was financed to a large extent form the banking system. In the two years to the end of 1973 the sterling M3 money supply measure – which consisted mostly of sterling bank deposits – increased by over 25% a year. A wild boom in 1972 and 1973 was followed by rising inflation in 1974 and a peak inflation rate (as measured by the annual change in the retail price index) of 26.9% in August 1975. (10) Well-respected commentators warned of the possible collapse of British democracy. (11)

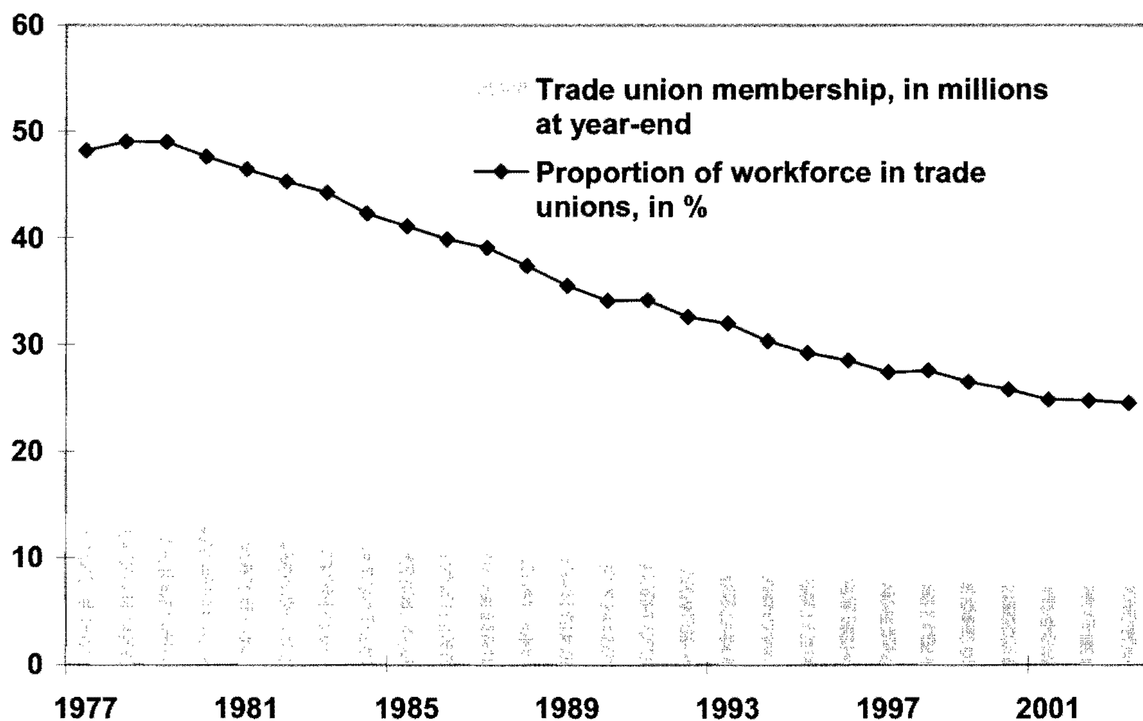
and led to 25% money supply growth and soaring inflation

The decline of the trade unions

Who has lost from this process?

Chart shows fall in union membership, both as a proportion of workforce and in absolute numbers. Source is Annual Abstract of Statistics.

Millions and % of workforce



Trade union influence peaked in the mid-1970s, when the government regularly consulted the Trades Union Congress on every important item of domestic legislation. A sequence of changes to trade union law under the Conservative government from 1979 undermined this influence and led to a large decline in trade union membership. Nowadays – with fewer than a sixth of private sector employees belonging to a trade union – membership of a trade union has become characteristic of public sector employment. Ironically, the original purpose of trade unions was to strengthen the bargaining power of workers in disputes with profit-seeking private employers. Instead the purpose of trade unions today is to represent public sector workers in pay negotiations with the government. The share of the gross operating surplus of non-financial corporations in GDP was in fact somewhat higher in 2003 (at 18.3%) than in 1979 (15.4%).

Monetarism in the UK a response to the crisis of the mid-1970s

Monetarism in the UK developed partly under the influence of academic ideas from the USA (such as the quantity theory of money associated with Milton Friedman and the Chicago school), but mostly it was a response to the economic and political crisis of the mid-1970s. Its central tenet was that inflation is a monetary phenomenon, in the sense that inflation is caused by the quantity of money rising too rapidly relative to the quantity of goods and services. To monetarist participants in the British public debates at that time the facts supporting this proposition were compelling. But Friedman's thinking supplemented the education by events in one very important way. In his presidential address to the American Economic Association in 1967 he had argued that there is no long-run trade-off between unemployment and inflation, and that the pursuit of "full employment" (meaning a low level of unemployment with an excess demand for labour) would be accompanied not by a stable high rate of inflation, but by ever-accelerating inflation. As economists examined the data, evidence for this "accelerationist hypothesis" could be found in the UK and many other countries.

Monetarist agenda was
i. to drop incomes policy,
ii. to subordinate fiscal policy to monetary policy, and
iii. to target falls in money supply growth to reduce inflation

Three vital implications followed. The first was that income policy was an ineffective answer to inflation and should be dropped; the second was that fiscal policy should be subordinated to monetary control; and the third was that policy-making should not try to achieve full employment, but should instead be focussed on the reduction of inflation (and eventual price stability) by lowering the rate of money supply growth. Heavy emphasis must be placed on one point. While the agenda could be presented as largely technical, its wider social and political consequences were drastic. Keynesianism and corporatism were ideas that fitted the post-war so-called "Butskellite" consensus, with a large public sector, extensive state ownership of the nation's capital assets, and close relations (or, at any rate, attempted close relations) between the trade unions and the government. (12) Even into the 1960s many leading figures in British public life saw the mixed economy as a half-way house between the *laissez-faire* capitalism of the 19th century and a communist end-state that was certain to arrive at some future date. (13) Despite bitter controversy the first post-war generation of Labour politicians kept Clause Four (in favour of government ownership of all the means of production) in their party's constitution.

Monetarism had radically different political and social implications from Keynesianism and corporatism

Monetarism is best interpreted not just as an alternative to Keynesianism and corporatism in technical macroeconomics, but also as an expression of an utterly different worldview. Without incomes policy, Cabinet ministers did not need to negotiate with the trade union movement; without an activist fiscal policy, the Keynesian case for a large state sector collapsed; without a full employment commitment, the government could concentrate on the provision of a sound currency to promote the efficiency of a market economy. Monetarism welcomed the liberation of market forces to collect the nation's savings, and their management

by private sector companies and institutions ("the City", in the UK context) according to profitability. By rejecting the traditional arguments for the state ownership of the so-called "commanding heights of the economy" (steel mills, nuclear reactors, state-subsidized aluminium smelters and such like), it laid the intellectual groundwork for the privatisations of the 1980s. Hundreds of thousands of British people – in the trade unions, in the media, in the universities, and indeed in positions of trust and responsibility as civil servants in government departments – had believed from the 1930s onwards that the inevitable long-run drift in UK policy-making was towards increased state ownership, more planning and intervention, and ever-growing public sector supply of services. It came as a shock to such people to find that in the mid- and late 1970s there were advocates of a diametrically opposite point of view. This clash of worldviews – about which Mayer and Minford say almost nothing – must be mentioned if monetarism is to be understood in a British setting. (14)

Election of Thatcher government in 1979 led to implementation of much of the monetarist agenda

In May 1979 the intellectual shock to Britain's left-leaning chattering classes became a real-world political trauma. The Conservative Party led by Mrs. Margaret (later Lady) Thatcher was elected with a comfortable majority in the House of Commons. It quickly set about implementing an agenda quite different from its Labour predecessor's. Within a few weeks prices and incomes policies, and the accompanying institutional machinery, were scrapped. In October exchange controls – which had been in force for 40 years – were also abolished. The task of inflation control was to fall exclusively on monetary policy. Thatcher and her ministers were prepared to test the theory that inflation has only monetary causes, and pledged themselves not to commit a U-turn ("the lady's not for turning") and restore incomes policy. In the March 1980 Budget Sir Geoffrey (later Lord) Howe announced a medium-term financial strategy, with year-by-year targets for reductions in the rate of money supply growth and in the ratio of the budget deficit (as measured by the "public sector borrowing requirement") to gross domestic product.

Debate about 1981 Budget split UK economics profession

Unhappily, the attempt to curb money supply growth involved very high interest rates and led to a deep recession in 1980 and early 1981. The severity of the recession undermined tax revenues and increased social security costs, endangering the MTFS target for a lower PSBR/GDP ratio in 1981/2 than in 1980/81. In the 1981 Budget Howe raised taxes sharply in order to keep the budgetary position under control. This was a direct challenge to Keynesianism, as the cyclically-adjusted budget deficit was being cut despite high unemployment and weak demand. The budget deficit was not being varied contra-cyclically (as the textbooks recommended), but in order to facilitate a reduction in money supply growth over the medium term. 364 economists – undoubtedly representative of mainstream academic opinion in the UK – wrote a letter to *The Times* in protest. It was

categorical in its repudiation of "monetarist policies", and warned that "present policies will deepen the depression, erode the industrial base of our economy, and threaten its social and political stability". The 364 threw down the gauntlet and invited the monetarists (who were far fewer in number) to a duel of ideas.

MM claim that monetarism was difficult to apply in practice and is now "in decline"

Implicitly, the duel was to be decided by the future passage of events. This is not the place to provide a narrative account, even in a potted version, of the main policy decisions and outcomes of the following 20 years. However, in any meaningful assessment of monetarism the main features of policy-making after the 1981 letter to *The Times* must be discussed. Mayer and Minford fail to provide such a discussion. Instead their pages on 'Monetarism in the United Kingdom' contain an outline of events between the mid-1970s and 1982, implying that – although monetary policy was rather disorganized – "shock tactics" did get inflation down and eventually "restored the fortunes of Mrs. Thatcher and her supporters". Almost nothing is said about events after 1982, as if the second Thatcher election victory marked the end of "the monetarist experiment". In their final sentence MM say that monetarism "as a distinct school is in decline", but "monetarist ideas are flourishing and form a major part of the modern synthesis". The next few paragraphs will argue that, at the level of real-world policy-making, this conclusion is almost wholly wrong. Far from slipping into decline, monetarism demolished Keynesianism and corporatism.

But that is not so, because
i. incomes policy is dead,

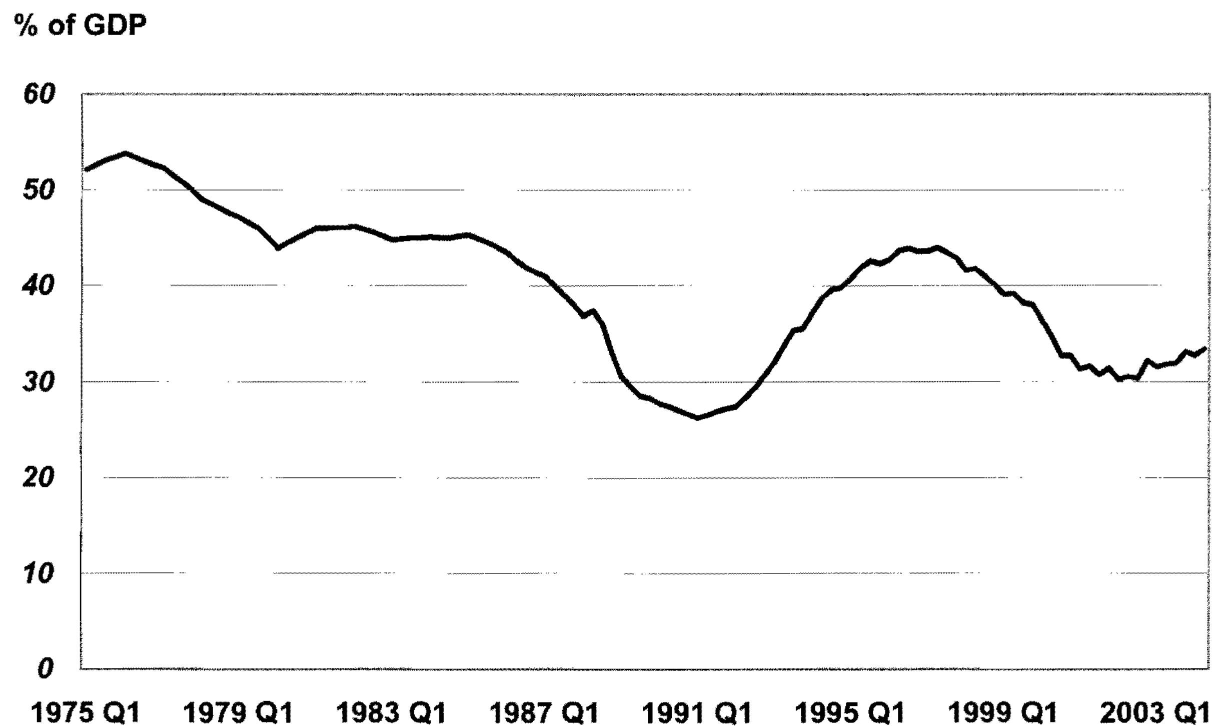
What has happened in the three crucial areas of incomes policy, fiscal policy and the conduct of monetary policy? Incomes policy may be taken first. If monetarism had really fallen into "decline", a fair expectation might be that British economists would again be lauding the virtues of incomes policy as a way of curbing inflation. But that is not so. In sharp contrast to "the pulp forests" consumed in comment about and advocacy of incomes policy in the 1960s and 1970s, it is difficult to think of a single recent book on the topic. Academic articles and historical monographs may still be written about Jack Jones, Vic Feather, the Counter-Inflation Programme and that sort of thing, but incomes policy is no longer a live and relevant option for policy-makers. Trade union membership has fallen heavily, while newspapers no longer feel obliged to report the proceedings of the Trades Union Congress as if "the union barons" were a major power in the land. In this respect the contrast between Britain today and Britain in the early 1970s could hardly be more total. For all practical purposes incomes policy is dead.

Income policy did not become a permanent fixture in standard macroeconomics texts and has been easy to forget. Fiscal policy is another matter entirely. Its validity as a stabilisation tool has been asserted in most textbooks since 1945, and its supposed effectiveness in this role is still widely seen as the explanation for the increased stability of the American and British economies compared with the 1930s.

The control of public debt

Fiscal policy subordinate to medium-term financial stability

Chart shows ratio of public sector net debt to GDP quarterly data back to 1975, but with most quarterly values interpolated until 1993. (Only Q1 values available from 1975 to 1993).
Source: Office for National Statistics website



In the 1960s and 1970s a recurrent feature of the British scene – compared by J. K. Galbraith to the lions in the Trafalgar Square – was the "sterling crisis". Falls in the value of the pound on the foreign exchanges were countered by foreign exchange intervention, but that led to declines in the dollar reserves. Austerity packages – with cuts in the budget deficit and higher interest rates – became necessary. The most humiliating such episode was in the summer of 1976, which was followed by a mission from the International Monetary Fund. In the last 25 years Keynesian fiscal activism – which involved increases in the budget deficit to boost the economy when external conditions allowed – has been abandoned. Mr. Gordon Brown's "sustainable investment rule", which limits public debt to 40% of GDP, has imposed a medium-term constraint on the budget deficit. Many people alive today (i.e., those under the age of 35 or so) have no memory of sterling crises.

But in fact the textbooks have lost touch with reality. The announcement of the MTFS in 1980 marked the beginning of a period of over two decades in which fiscal policy decisions would be set within a medium-term framework, with one key objective being to ensure that the ratio of debt to GDP was kept under control. MM give the impression that a veil was drawn over the MTFS by embarrassed policy-makers in the early 1980s. In their words, "the MTFS was widely written off as a failure at this time...and it came to be seen as a temporary interlude before traditional politics resumed". (15) On the contrary, a version of the MTFS was retained in all the Budgets until 1997. Although its contents evolved over the years and the monetary element was downplayed, the MTFS continued to set the context for fiscal policy decisions throughout the long period of Conservative rule. It undoubtedly had a major effect on public finance outcomes. For example, the UK and Norway were the only members of the Organization of Economic Cooperation and Development to have a lower ratio of public debt to GDP in 1997 than in 1980, while the British banking system – whose assets had been dominated by claims on the public sector in the 1950s – held virtually no public sector debt at the start of the 21st century.

ii. Keynesianism, in sense of activist fiscal policy to manage demand, is defunct, and

There may still be a debate about the wisdom of orienting fiscal policy on medium-term debt sustainability rather than short-run demand management. But, if there is such a debate in the UK, it is a very quiet one. When a Labour government replaced the Conservatives in 1997, the MTFS was dropped, but Mr. Gordon Brown did not revert to old-style Keynesianism. Instead a commitment to medium-term fiscal stability was a hallmark of Mr. Brown's supposedly new policy regime. He announced a "golden rule" (in which current expenditure was to be covered by taxation) and a "sustainable investment rule" (which set a limit on the ratio of public debt to GDP). Both these rules had nothing whatever to do with the type of fiscal demand management recommended by British Keynesians in the 1950s and 1960s, and could more plausibly be interpreted as a modern refurbishment of Gladstonian principles of public finance. (16) Again, for all practical purposes Keynesianism – in the sense of short-run changes in the fiscal position to manage demand – is defunct in the UK.

iii. monetary policy is not geared to full employment

Finally, as far as the conduct of monetary policy is concerned, many years have now passed since it was directed to the maximisation of employment. The first half of the Thatcher premiership showed that monetary policy could be used to reduce inflation, without relying on the crutch of incomes policy. (The second half – which saw a marked acceleration in money supply growth in the unfortunate "Lawson boom" and a subsequent rise in inflation – also demonstrated the validity of the monetary theory of inflation. A puzzling aspect of MM's paper – noted at more length in the concluding remarks – is their complete neglect of this episode.) In the 1990s decision-making on interest rates was transferred from politicians to

monetary specialists in two steps, first the publication of the minutes of the monthly meetings between the Chancellor of the Exchequer and the Governor of the Bank of England from early 1993, and secondly the granting of operational independence to the Bank of England in 1997. This transfer of power was possible only because informed opinion was quite different from what it had been in the 1960s. The UK's sorry experience of boom and bust had persuaded almost everyone that mattered in policy formation (politicians in all three main parties, their advisers, leading civil servants, the most influential newspaper commentators) of the validity of Friedman's 1967 proposition that no long-run trade-off exists between inflation and unemployment. The phrase "full employment" had lost its totemic status in public debate.

Monetary policy de-politicised

It was therefore sensible for the setting of interest rates to be taken out of the political domain and given to technicians. Paradoxically, the decade from 1994 saw almost uninterrupted increases in employment and falls in unemployment, so that the UK now has high labour force participation and low unemployment by European standards. These gains can be interpreted as partly due to policy and, in particular, to supply-side reforms to improve labour market flexibility, which date back to the early 1980s. But no one in officialdom had planned them in the sense of having a quantified target for either employment or unemployment, and no one in the Treasury or the Bank of England would have dreamt at any stage in the 1990s of adjusting interest rates to raise or lower employment. Indeed, the decade from 1992 was characterised by extraordinary macroeconomic stability compared with any previous decade in the post-war period, including the years from 1948 to the early 1970s, the heyday of the supposed "Keynesian revolution".

and has been extraordinarily successful in last decade

By defeating Keynesianism and corporatism at the level of ideas, monetarism made possible highly beneficial changes to UK policy-making

A case can be made that the vital theoretical basis for this policy achievement was a generalisation of Friedman's ideas on the link between changes in inflation and departures from the so-called "natural rate of unemployment". (17) If so, it is monetarism – and certainly not corporatism or Keynesianism – that deserves the accolades for Britain's much improved macroeconomic performance. To say that monetarism is "in decline" is a travesty. It may be in decline in the sense that the number of references to it in newspapers and parliamentary debates has fallen heavily, but the lack of attention is due to the general acceptance of its core recommendations on the structure of policy-making. (18) On a wider canvas, the Labour Party has dropped Clause Four from its constitution and its leaders embrace the market economy, although with reservations. MM have therefore not given enough weight to the role of monetarism in causing a comprehensive change in the structure of UK policy-making in the final 25 years of the 20th century and they have not recognised the improvement in outcomes which followed these changes.

At times MM praise monetarism, but the praise is faint and reluctant. They endorse

MM make too many concessions to conventional wisdom on supposed instability of money demand

the conventional wisdom that the demand for money became unstable in the early 1980s and that the instability undermined not just monetary target-ry, but the feasibility of using money in macroeconomic forecasts. When they make statements along these lines, they are invariably referring to the broad money measures – such as M3, sterling M3 or M4 – which were the focus of UK monetary policy for much of the late 1970s and the 1980s, and (to a markedly lesser degree) in the early 1990s. But careful econometric work shows that the demand for broad money was sufficiently stable through all the turbulence of those years for it to have a clear relationship with macroeconomic outcomes. (The clarity of the relationships is particularly clear when the money-demand estimation is performed at the level of sectors, i.e., the household sector, the company sector and so on.) (19)

The tragedy of the Lawson boom showed continued validity of monetary theory of national income determination

Indeed, the tragedy of British economic policy in the late 1980s was that the Chancellor of the Exchequer, Nigel Lawson, was diverted from sound money. Money supply targets had originally been at the heart of the Thatcher government's economic policy. But instead of pursuing money supply targets, Lawson came to believe in the virtues of the European exchange rate mechanism and a fixed exchange rate between the pound and the deutschemark. Money supply growth – as measured by the broad aggregates – accelerated from 1985 and remained at a high level until 1990. (See the accompanying chart. The rate of broad money growth varied from month to month, and from aggregate to aggregate, but was typically in the mid teens, when expressed at an annual rate.) The result of rapid money growth was wild asset price inflation between 1986 and 1988, rapid growth in domestic demand ("the Lawson boom") from 1986 to late 1989, and high and rising inflation from 1988 to 1991. This experience demonstrated that the underlying relationships between broad money, on the one hand, and asset prices and national expenditure, on the other, were robust. (20)

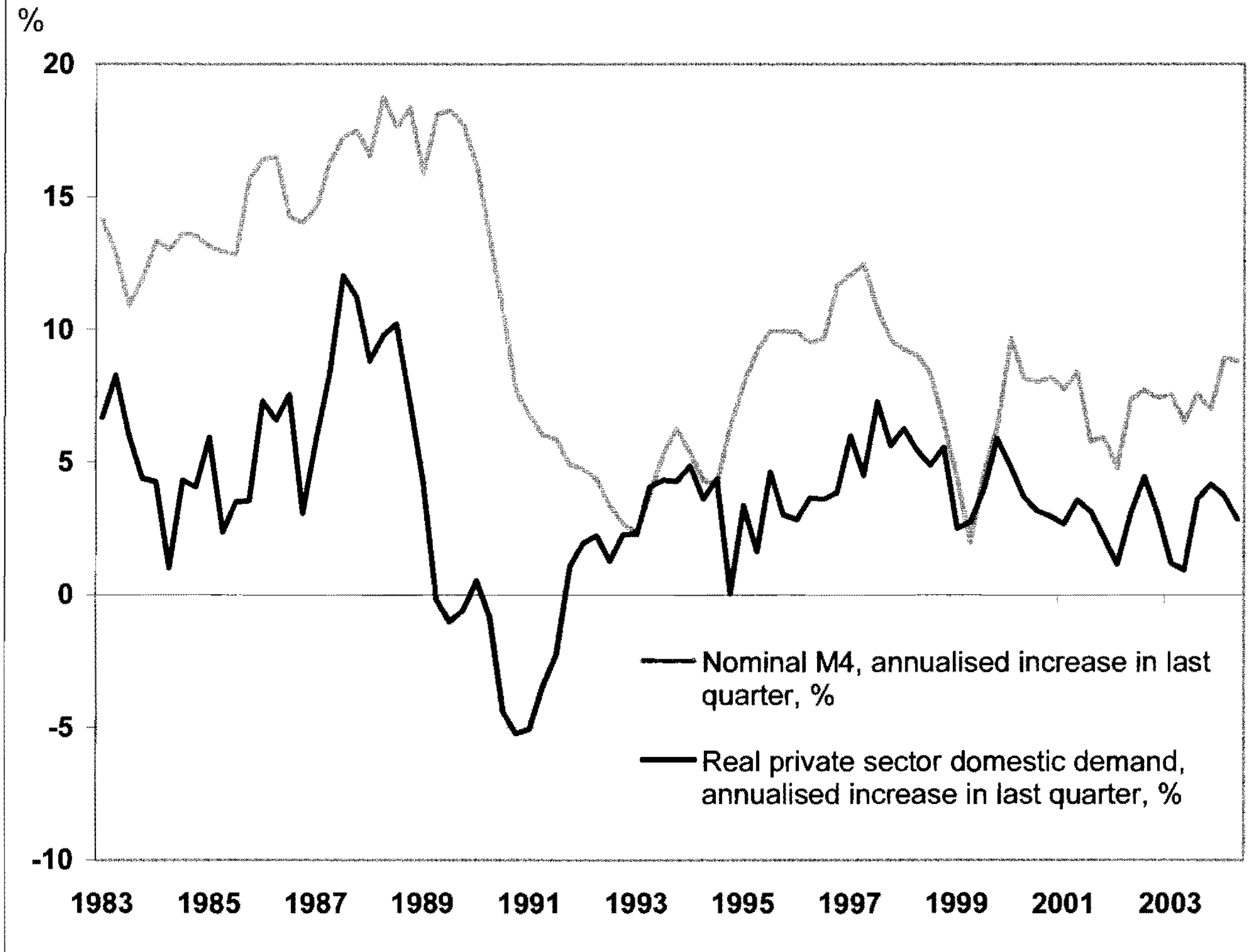
Analysts who used money in their macroeconomic forecasts were largely correct in their prognoses in those years; the "leading forecasting groups" (which ignored money) failed ignominiously. (21) MM's neglect of the episode is peculiar, given its central importance in Britain's subsequent political economy. (The Conservatives have been stigmatised as the party of boom and bust by leading Labour politicians, and have lost the reputation for economic competence which they held – rightly or wrongly – for most of the second half of the 20th century.) In effect MM fail to recognise that the high inflation of 1990 and 1991 was, like all high inflations, a monetary phenomenon. This oversight seriously undermines the authority of their paper. (22) A more detailed and rigorous account of events would show that the behaviour of money was as fundamental to UK macroeconomic developments in the 1980s and 1990s as it was in any earlier period. The behaviour of money will remain fundamental to UK macroeconomic developments in future.

Behaviour of money will remain fundamental to the business cycle

Excess money, excess demand

The Lawson boom had monetary origins

Chart compares annualised increases in last quarter of changes in nominal M4 and changes in real private sector demand. (Both series are three-quarter moving averages, because of pronounced quarter-by-quarter volatility.) Sources are ONS website and Lombard Street Research estimates.



In the four years to the fourth quarter of 1989 the M4 measure of money rose at an average annual rate of 16.7%. Friedman's generalisation – from the experience of many countries over many periods – was that money affected output first and inflation later, after a lag of about two years. In fact, the average rate of retail price inflation in the four years to the fourth quarter of 1991 was 6.8%, with a peak of over 10% in late 1990. If the government had not raised interest rates so sharply in 1988 and 1989 (leading to a collapse in credit and money growth in late 1990 and 1991), the inflationary damage from the money supply excesses of the late 1980s would have been much greater. Since 1993 the average annual growth rate of M4 has been about 7 ½%, somewhat ahead of the average annual growth rate of nominal GDP but not dramatically so. Inflation has been much lower and less volatile than in the 1970s and 1980s.

Notes

(1) Martin Ricketts and Edward Shoesmith *British Economic Opinion: a survey of a thousand economists* (London: Institute of Economic Affairs, 1990). A large majority of survey respondents disagreed that the central bank should follow a money supply rule, but agreed – if with reservations – to a wages policy as a means of controlling inflation. See pp. 74 – 8.

(2) The reference to "pulp forests" was made by Samuel Brittan. (See p. 173 of his paper, 'Inflation and democracy', on pp. 161 – 85, of Fred Hirsch and John H. Goldthorpe [eds.] *The Political Economy of Inflation* [London: Martin Robertson, 1978].) Literally thousands of papers were written in the 1960s and 1970s about the influence of trade union bargaining on inflation. See, for example, J. Johnston and M. Timbrell 'Empirical tests of a bargaining theory of wage rate determination', pp. 79 – 108, in David Laidler and D. Purdy (eds.) *Inflation in Labour markets* (Manchester: Manchester University Press, 1974).

(3) An example of strong emphasis on the income-expenditure model of national income determination is provided by the opening pages of Christopher Dow's *Major Recessions: Britain and the World, 1920 - 95* (Oxford: Oxford University Press, 2000).

(4) Charles E. E. Goodhart *Money, Information and Uncertainty*, 1st edition (London: Macmillan, 1975), p. 242.

(5) The word "corporatism" was used, for example, by Mr. Peter Jay in his Wincott Lecture on 'A general hypothesis of employment, inflation and politics', reproduced on pp. 33 – 55 of Peter Jay *The Crisis for Western Political Economy* (London: Andre Deutsch, 1984). See p. 47.

(6) John Maynard Keynes *The General Theory of Employment, Interest and Money* (London: Macmillan & Co., 1964 paperback reprint of 1936 edition), p. 379.

(7) The phrase "interventionist bias" may seem a little shrill, but opinion surveys of British university economists confirm that the great majority have been and remain supporters of planning and intervention with the price mechanism. See Ricketts and Shoesmith *British Economic Opinion* and Wilfred Beckerman (ed.) *The Labour Government's Economic Record: 1964 – 70* (London: Duckworth, 1972), both *passim*. There can also be little doubt about the bias of elite opinion in the immediate aftermath of the Second World War. According to George Orwell, writing in 1945, "Among the intelligentsia, it hardly needs saying that the dominant form of nationalism is Communism...A Communist, for my purposes here, is one who looks upon the U.S.S.R. as his Fatherland and feels it his duty to justify Russian policy and advance Russian interests at all costs. Obviously, such people abound in England today, and their direct and indirect influence is very great." Sonia Orwell and Ian Angus (eds.) *The Collected Essays, Journalism and Letters of George Orwell*, vol. III (Harmondsworth: Penguin Books in association with Secker & Warburg, 1971 paperback reprint of 1968 hardback original), p. 414.

(8) James Tobin *Policies for Prosperity* (Brighton: Wheatsheaf Books, 1987), pp. 265-6.

(9) R. J. Ball and T. Burns 'The inflationary mechanism in the UK economy', *American Economic Review*, volume 66, September 1976.

(10) In its *Quarterly Review* of May 1973 the National Institute opined – in the middle of the biggest boom in the post-war period – that "there is no reason why the present boom should either bust or have to be busted".

(11) The alarm was expressed in the weekly columns of Peter Jay in *The Times*, Samuel Brittan in *The Financial Times* and other commentators. On 29th April 1975 the *Wall Street Journal* carried a leading article entitled "Goodbye, Great Britain".

(12) "Butskellite" is a corruption of the names of Reginald Butler, Conservative Chancellor of the Exchequer from 1951 to 1955, and Hugh Gaitskell, leader of the Labour Party in the 1950s.

(13) The first edition of Karl Popper's polemical *The Poverty of Historicism* (London: Routledge & Kegan Paul), written "in memory of the countless men and women of all creeds or nations or races who fell victims to the fascist and communist belief in Inexorable Laws of Historical Destiny", was published in 1957 and went through five reprints in the 1960s.

(14) Noel Annan *Our Age: Portrait of a Generation* (London: Weidenfeld and Nicholson, 1990), passim but especially Chapter 26 'Our vision of life rejected', and Bryan Magee *Confessions of a Philosopher* (London: Weidenfeld & Nicholson, 1997), pp. 413 – 5.

(15) MM, p. 182. Incidentally, MM's statement on p. 181 that the ending of incomes policy and exchange controls, and associated measures of financial deregulation, was part of the MTFS is wrong. They occurred in 1979, ahead of the announcement of the MTFS in the 1980 Budget.

(16) A large part of the rationale for the references to "prudence" in Mr. Gordon Brown's speeches and to the more extended treatment in the 1998 Treasury paper on *Stability and investment for the long term* is to be sought in ideas of inter-generational equity developed in the last 20 years by the American economist, Laurence Kotlikoff, and others. These ideas have nothing whatever to do with Keynes or Keynesianism.

(17) See Tim Congdon 'The UK's achievement of economic stability: how and why did it happen?' *World Economics*, vol. 3, no. 4 (October – December) 2002, pp. 25 – 41, reprinted as the research paper in the September/October 2002 issue of Lombard Street Research's *Monthly Economic Review.*

(18) MM do say that "some of its [monetarism's] basic ideas have become so widely accepted that they are no longer monetarist" (p. 183).

(19) The stability of the personal/household sector's demand for money was frequently mentioned in the author's research for the stockbrokers, L. Messel & Co., in the 1980s. For subsequent papers, see Tim Congdon and Simon Ward 'The personal sector's demand for M4 balances', *Lombard Street Research Econometric Research Note*, May 1993; R. S. J. Thomas 'The demand for M4: a sectoral analysis. Part 1 – The personal sector' *Bank of England Working Papers* paper no. 61 (London: Bank of England, 1997) and Thomas 'The demand for M4...Part 2 – The company sector', ditto, paper no. 62; and L. Drake and K. A. Chrystal 'Personal sector money demand in the UK', pp. 188 – 206 *Oxford Economic Papers* (Oxford: Clarendon Press, 1997), vol. 49 (2), April 1997.

(20) The rapid money supply growth of the late 1980s is all the more astonishing in view of the Conservatives' commitment to low money supply growth when they came to power in 1979. In an article in *The Times* of 20th October 1987 the author described the Thatcher government's record in this central area of policy-making as "bewildering to the point of perversity".

(21) Christopher Smallwood, writing in *The Sunday Times* in March 1989, remarked that, "For economic forecasters 1988 will go down as the *annus horrendus*. It was the year they all got it wrong. And not just a little bit wrong, but spectacularly wrong." This overlooked the largely correct forecasts made by the author and his team at L. Messel & Co. (soon to be absorbed in the American firm, Shearson Lehman), where the analysis of trends in broad money was part of the forecasting exercise. See 'The importance of money in macroeconomic forecasting – part 2', pp. 191 – 4, in Tim Congdon's *Reflections on Monetarism* (Aldershot and Brookfield, USA: Edward Elgar, 1992), based on an article in *The Spectator*, and chapters six to nine of Gordon Pepper *Inside Thatcher's Monetarist Revolution* (Basingstoke and London: Macmillan, 1998). Pepper provides a detailed comparison of monetarist and non-monetarist forecasts.

(22) Minford was well-known for his belief – in the late 1980s and subsequently – that the M0 measure of money should be the lodestar of monetary policy. M0 was in fact targeted in the late 1980s, but it failed abjectly to give policy-makers the right signals. The author has criticised Minford's views on narrow and broad money in several places – for example, in 'An Open Letter to Professor Patrick Minford: money and banking, and their relevance to boom and bust' in the July 1996 issue of Lombard Street Research's *Monthly Economic Review*. Minford has in fact written relatively little about the virtues of M0 in recent years.