

### 3 COMMENTARY

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#### **The origins of the ERM**

Sir Alan Budd's Wincott Lecture tries to justify UK macro-economic policy during the late 1980s and early 1990s. In particular, he commends the UK's membership of the European Exchange Rate Mechanism (ERM) between 6 October 1990, when the British government announced that the pound would participate, and 16 September 1992, when it was expelled by heavy selling on the foreign exchanges. But the story really begins in 1972. On 1 May 1972 the British government had decided to join the European 'snake', an exchange rate agreement (under the auspices of the European Economic Community) that was the forerunner of the ERM. From the start the snake was, to all intents and purposes, led by West Germany's central bank, the Bundesbank. On 26 June – after a mere eight weeks – the UK left the snake and floated the pound, having lost \$2.5 billion of foreign exchange reserves in six days.

The context of the pound's misfortunes in the summer of 1972 was the realisation by European countries that the Bretton Woods system of fixed exchange rates had broken down. In the heyday of that system (i.e. in the 1950s and early 1960s) the US managed

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its own currency in a sound, anti-inflationary way, virtually all the world's currencies were tied to the US dollar and, because of the exchange rate link, the world as a whole enjoyed the benefits of low American inflation. But between the mid-1960s and the early 1980s US monetary policy was irresponsible and inflationary. West Germany – a nation scarred by its memories of the Weimar hyper-inflation of the 1920s – wanted to avoid the contamination of domestic monetary policy by US mistakes. Ever since its foundation in 1957 the Bundesbank had believed in a monetary theory of inflation (i.e. that inflation is caused by excessive growth of the quantity of money relative to the growth of output). In the five years to end-1972 the US money supply (on the M3 measure) grew at a compound annual rate of 9.7 per cent. If the German currency – the Deutschmark – had stayed pegged to the US dollar while the US money supply was growing at this sort of rate, West Germany could not have avoided significant inflation. In May 1971 the German government broke the link with the dollar and let the Deutschmark float upwards on the foreign exchange markets.

Over the next few months West Germany and its EEC partners tried to assemble a European fixed exchange rate system. On 7 March 1972 EEC finance ministers decided to form the snake, in which the participant European currencies could fluctuate relative to each other within a narrow 2.25 per cent band. This was the beginning of the process of European monetary integration which was to culminate in the introduction of the euro on 1 January 1999. Throughout the following 27 years West Germany – with its voice at international gatherings often being indistinguishable from the Bundesbank's – was the key nation promoting monetary integration. The attitude of other European nations varied widely. The Netherlands joined forces with West Germany from the outset

and never wavered. In the mid- and late 1970s West Germany, the Netherlands, Austria and Switzerland formed an island of financial stability in a mismanaged and highly inflationary world. The UK was equivocal about European monetary integration in 1972 and remains so to this day.

### **British economists' opposition to the monetary theory of inflation**

Intellectual trends in the economics profession of the English-speaking nations – and particularly in Britain itself – had been hostile to the monetary theory of inflation since the publication of Keynes's *The General Theory of Employment, Interest and Money* in 1936. But the lesson of West Germany's success in the 1970s was not lost on the British political class, even if it was beyond a surprisingly high proportion of British economists. UK inflation, as measured by the annual change in the retail price index, peaked in August 1975 at 26.9 per cent. Money supply targets – expressed in terms of broad money – were introduced in July 1976. With long-term intellectual impetus from Enoch Powell and Keith Joseph, the Conservative Party accepted the monetary theory of inflation. After her success in the 1979 general election the leader of the Conservative Party, Mrs Thatcher, made clear that her government would reduce inflation by controlling the money supply, not by means of administered price and wage controls.

So outraged was the British economics profession by Thatcher's monetary (or 'monetarist') approach that the government had considerable difficulty finding academic sympathisers who would advise it on its favoured course of action. Fortunately, economists at the London Business School – notably James Ball, Terence Burns

and Alan Budd – had written papers in the mid- and late 1970s on monetary topics, and were regarded as generally in favour of monetarism. Burns was appointed the government's Chief Economic Adviser in 1979 at the young age of 35. Burns or Budd (or sometimes Burns and Budd) occupied important positions in the economic policy-making machine for the next 20 years. Burns was the driving force within the official machine behind the introduction of the Medium Term Financial Strategy (MTFS) in March 1980. This strategy specified targets for the budget deficit and money supply growth for the next four years.

As Budd says, the early 1980s were a difficult period in the implementation of the agenda of monetary control. Financial liberalisation and the abolition of exchange controls were contemporaneous with a step-shift in the level of real interest rates, from negative values in the 1970s to positive values in the 1980s. The result was an abrupt change in the trend of the equilibrium ratio of money to income. Whereas this ratio had been falling for over thirty years until the late 1970s, it was on a rising trend thereafter. Budd is correct in saying that this change of trend weakened the credibility of the money supply targets set out in the 1980 version of the MTFS, because these were patently too low. An unexpectedly large once-for-all adjustment to the sterling M3 money measure in the summer of 1980, following the scrapping of the 'corset', was a particularly serious presentational problem.<sup>2</sup>

However, the government insisted – correctly – that low inflation could be restored only by reductions in money supply growth. Considerable political courage was shown by Sir Geoffrey Howe in

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<sup>2</sup> The 'corset' was a quantified limit on banks' eligible liabilities. These liabilities included bank deposits, which were the dominant part of sterling M3.

adhering to the essence of the MTFS while he remained Chancellor of the Exchequer. The annual rate of broad money growth (on the sterling M3 measure), which had often been in the high teens or even the twenties in the 1970s, was just above 10 per cent in the years to end-1983 and end-1984. Because of the rise in the desired ratio of money to incomes, these numbers were consistent with 5 per cent inflation.

### **Policy mistakes in the mid-1980s**

By 1985 money supply targets had been in existence for almost a decade and had achieved a signal improvement in the UK's macroeconomic circumstances. Inflation was somewhat higher than in West Germany and the Netherlands, but it was lower than in France or Italy. Despite all the brickbats hurled at monetarism in the early 1980s, domestic monetary control had worked. The UK had reduced annual inflation from numbers well above 20 per cent to an internationally respectable 5 per cent, and it had done so while remaining outside the European snake and the European Monetary System (which succeeded the snake in 1979). The Conservatives' original agenda could have been retained in the late 1980s, with further reductions in money supply growth and the eventual establishment of price stability.

But this was not what the Thatcher government did. Instead, Nigel Lawson – who had succeeded Howe as Chancellor in 1983 – committed a U-turn in monetary policy. He suspended targets for the growth of broad money in October 1985, as the prelude to scrapping them in 1986. Money supply growth accelerated in late 1985 and 1986, and by the end of 1986 the annual rate of increase in the sterling M3 measure had soared to 18 per cent. It

continued to run at this sort of rate until 1989. The result of the abandonment of domestic monetary control was predictable and predicted.<sup>3</sup> Marked asset price inflation developed in 1986 and 1987, and was accompanied by a sharp upturn in the growth of domestic demand. Output boomed, unemployment fell and the current account of the balance of payments lurched heavily into the red. By late 1989 – when Lawson resigned – inflation was plainly on the rise. The annual rate of increase in the retail price index was to peak at over 10 per cent one year later.

### **One mistake compounded by another**

It was the catastrophic failure on inflation which led to the decision by Lawson's successor, John Major, to join the ERM in November 1990. As Budd says, the Treasury and the Bank of England had decided that the job of conducting British monetary policy was too difficult for them, and that they ought to give it to the Bundesbank. By this stage the ERM was far more meaningful than the original snake. France, Belgium and Luxembourg had made almost as emphatic a commitment to exchange rate stability

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3 See Congdon (1992), which gives a selection of his articles in *The Times* from 1985 to 1988, where he warned of the likely consequences of rapid money supply growth. His newspaper articles borrowed from themes of his work at the stock-brokers L. Messel & Co. In a Messel research note of 18 October 1985, 'Sterling M3 is not meaningless', written only a few days after Lawson's suspension of the broad money target, he wrote, 'In the early stages of both the Barber boom and the Healey boomlet [which had seen rising money growth, followed by higher inflation], excess sterling M3 growth was accompanied by low inflation. It took two or three years before the full inflationary damage came through. Inflation may drop in 1986 [it did], but that does not allow Mr. Lawson to claim that he is innocent to the charge of monetary mismanagement. A better verdict would be "not yet proven guilty, while awaiting trial".' (The research note is available from the author at [tim.congdon@lombardstreetresearch.com](mailto:tim.congdon@lombardstreetresearch.com).)

within Europe, and to eventual European monetary integration, as the Netherlands had at the outset. Meanwhile the Bundesbank had adhered to money supply targets – expressed in terms of the broad M<sub>3</sub> measure – for over fifteen years and maintained its reputation for inflation control.

But – very plainly – the UK did *not* have to join the ERM in order to combat double-digit inflation. To repeat, the UK had between 1976 and 1985 reduced inflation from over 20 per cent to 5 per cent by domestic monetary control. As in West Germany, the centrepiece of the UK's system had been money targets expressed in terms of a broad measure of money. Despite many technical embarrassments, that system worked.<sup>4</sup> Contrary to Budd's claim that the UK needed 'a nominal anchor' in the form of a fixed exchange rate, the UK's experience in the period from 1972 to 1985 had demonstrated two unsurprising points. The first point was that inflation is caused by faster growth in the quantity of money than that in goods and services, and the second was that control over the

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4 It is even possible that by 1989 Lawson came to realise that his U-turn on money supply targets had been a blunder, even though he denies this in his account of his years as Chancellor of the Exchequer in Lawson (1992). Lawson's final Mansion House speech, in October 1989, included a detailed discussion of broad money and funding policy. The extent of his comments was such that he evidently continued to worry about the subject, even if he remained critical of the pre-1985 system of monetary control. In an article in the *Financial Times* on 23 October, Samuel Brittan said that the days of 'old M<sub>3</sub>' were 'still immensely better than what is normally said on such occasions'. (This statement was curiously out of character. Brittan has been highly critical of money supply targets as 'monetarist mumbo-jumbo' over the last 20 years.) On 26 October Lawson resigned, ostensibly in protest against Sir Alan Walters's influence on the Prime Minister's views on economic policy. In an article on Lawson's resignation on 27 October Brittan remarked that the fiscal side of the medium-term financial strategy was 'very much alive and the monetary side will be taken up again'. It is well known that Lawson and Brittan conferred frequently in this period.

quantity of money is necessary and sufficient for a reduction in inflation. The right step in 1989 was to reintroduce an effective system of domestic monetary restraint, perhaps buttressed by granting independence to the Bank of England. The lesson of history – in West Germany, the UK and many other countries – was that broad money targets constituted such a system.<sup>5</sup>

### **Monetary growth is the best predictor of inflation**

It was the blunder in ending broad money targets in 1985 and the subsequent explosion in money supply growth which were responsible for the Lawson boom. Budd asserts, 'Money supply targets were unsatisfactory because it was extremely difficult, if not impossible, to establish stable demand functions for money.' This statement is politely described as an evasion in search of a half-truth. The supposed absence (or disappearance) of a stable money demand function would indeed have had a message for the conduct of macroeconomic policy, but words need to be used with care when econometric results are translated into policy prescriptions.

When a statistical relationship is estimated between, say, the rate of change in nominal national income (as the dependent or 'y' variable) and the rate of change in a money aggregate (as the independent or 'x' variable), it has a number of properties represented by the values of the regression coefficient, the correlation coefficient, the standard error of the equation, the so-called 't'-statistics indicating the statistical significance of the regression coefficient (or coefficients), and so on. Suppose that the money–GDP rela-

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<sup>5</sup> The argument was made in Congdon (1989).



tionship was less stable in the 1980s than in the 1970s. The meaning of the decline in stability is that – because the correlation coefficient was lower and the standard error higher with the 1980s equation than with the 1970s equation – a policy-maker in the later decade can forecast *with less confidence* the central value of the rate of increase in nominal GDP associated with a particular rate of increase in money.<sup>6</sup>

This would be a disappointment for a supporter of money supply targets, but it would not be the end of the world. *A change in the degree of confidence* with which a forecast is delivered must not be confused with *a change in the central value of the dependent variable(s) implied by particular values of the independent variable(s)*. Even after the supposed deterioration in the stability of the money–income relationships in the early 1980s, it was still essential for policy-makers to know *the most likely value* of the increase in nominal GDP that would follow a particular rate of money supply growth. That depended on the regression coefficient, not the correlation coefficient or the standard error. As long as the regression coefficient on an estimated money–GDP relationship was significantly positive, it remained true in 1985 (as it was in 1975, or indeed 1875 or 2005) that *the most likely outcome of an acceleration in money supply growth would be an acceleration in the growth rate of nominal GDP and, in due course, of inflation*.

#### *Money and inflation in the mid- to late 1980s*

Budd has three problems here. The first is that the alleged instability of the demand function for broad money was not new in

<sup>6</sup> Strictly, the probability statements apply to a band of values either side of the most likely central value.

the mid-1980s. Research at the Bank of England and elsewhere had usually found stable demand functions for broad money in the 1960s, but two papers were published by Artis and Lewis in 1974 and 1976 arguing that these functions had broken down.<sup>7</sup> The breakdown was evidenced in lower values of correlation coefficients and higher values of standard errors, but (as far as the author is aware) a routine finding in all the 1970s work remained that the regression coefficients in money–GDP relationships were significantly positive. The relatively poor correlation coefficients and standard errors in the broad money equations had a clear policy implication, but – contrary to Budd’s claim – this was not that the whole machinery of money supply targets should be dumped. Because it was unrealistic to expect a reliable *y* per cent nominal GDP response to a particular *x* per cent money growth rate in any one year, control over the money aggregates had to extend over several years. Money targets had to be medium term and pragmatic in nature, as they were in West Germany. That was one reason why supporters of the Conservatives’ monetarist agenda advocated a *medium-term* financial strategy.<sup>8</sup>

Budd’s second difficulty is that the contrast in the rates of money growth before and after mid-1985 was so large and egre-

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7 Artis and Lewis (1981: 17). In fact the difficulties with money demand functions in the UK were not new even in the mid-1970s. One of the earliest studies of money and the business cycle in the UK was by Walters (1966). Walters noted that money had a good relationship with nominal GDP in the 1877–1913 and 1921–38 periods, but his comment on the quarterly data in the 1955–62 period was that they ‘fail to demonstrate the existence of a marked systematic relationship between the quantity of money and prices and income’.

8 The advocacy of money supply targets over a medium-term horizon was also influenced by the recommendation of ‘gradualism’ in monetary restraint made by Professors David Laidler and Michael Parkin at the Manchester Inflation Workshop in the mid-1970s.

gious that any statistical difficulties in the money–income relationship were incidental. But, whereas sterling M3 rose at an annual rate of 10.3 per cent in the three years to mid-1985, it climbed at an annual rate of 19.4 per cent in the three years to mid-1988! Bluntly, it is astonishing that the Treasury and the Bank of England did not foresee what would happen to the economy in general terms, even if no forecaster could be confident (to a level of statistical significance arbitrarily determined by an econometric boffin) of a decimal-point forecast of nominal GDP, inflation, consumption and so on.

The third point is that it is far from clear that the demand for money in the UK did become unstable in the 1980s. The change in the trend of the money–income ratio cannot be disputed, and it was undoubtedly a major embarrassment for the government and supporters of money supply targets. But a change in the equilibrium money–income ratio could be attributable to changes in the values of the determinants of the quantity of money demanded rather than to large changes in the properties (the regression and correlation coefficients, and so on) of money demand functions. The author – with the support of teams at L. Messel & Co. in the 1980s and Lombard Street Research in the 1990s – has had no difficulty in identifying a stable demand function for personal sector money throughout the period.<sup>9</sup> Since the personal sector was and remains the largest holder of money balances in the UK economy,

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<sup>9</sup> See Congdon (2004). The author first reported in May 1986 on the stability of personal sector money demand in a joint L. Messel & Co. research note with Peter Warburton (available at [tim.congdon@lombardstreetresearch.com](mailto:tim.congdon@lombardstreetresearch.com)). The stability of the personal sector's money demand function has been corroborated by other researchers and is now widely accepted: see Drake and Chrystal (1997) and Thomas (1997).

this finding goes far to refute Budd's scepticism about money demand functions. Further, the behaviour of the two other components of the private sector – companies and financial institutions – was undoubtedly influenced by their balance-sheet positions (including their money holdings) in the 1980s, as it was in every other decade in modern British history. (Treasury officials may not have to explain themselves to the bank manager, but finance directors and small businessmen don't have that luxury.)

### **Britain's economic performance since ERM exit**

But that is enough on the technicalities. The passage of events since 1992 tells its own tale, without the need to rely on high-powered econometrics. It is surely obvious that the UK's inflation record since 1992 refutes Budd's central contention. The UK has kept inflation down at a moderate figure with remarkably little variation, while eschewing both membership of the ERM and adoption of the euro. If it has been able for over a decade to maintain low inflation without the artificial crutch of a fixed exchange rate, it could have reduced inflation from 1989 to 1992 also without the artificial crutch of a fixed exchange rate. Budd's Wincott Lecture has its attractive side, with its wit and humour about mistakes in high places. But in its failure to acknowledge the main lesson from over twenty years of policy-making, it is misguided. The pound was kicked out of the snake on 26 June 1972 in humiliating circumstances, because earlier mismanagement of domestic monetary policy had made the exchange rate untenable; and it was again kicked out of the ERM on 16 September 1992 in humiliating circumstances, because earlier mismanagement of domestic monetary policy had made the exchange rate untenable.

The imperative – in 1972, in 1992 and in all the years in between – was to manage domestic monetary policy properly.

As Germany showed by its pursuit of money supply targets throughout this period, a consistent, intellectually coherent and self-confident approach to policy-making would deliver results. The Lawson boom and the two years of bust in the ERM were episodes of shocking incompetence. If the UK had persevered with a steady reduction in money supply growth from 1985 onwards, it could have enjoyed stable growth with falling inflation in the late 1980s and early 1990s. It could have avoided the disastrous boom-bust cycle for which Budd is much too ready to find a face-saving explanation.

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