

## PART FIVE

### Did Monetarism Succeed?

*For almost 15 years now (mid-2006) the British economy has enjoyed unparalleled stability. The inflation targeting regime announced by Mr Norman (later Lord) Lamont in October 1992 has worked far better than anyone expected at the time. Not only has the target been met year after year, but also the path of output growth has been remarkably steady. The obvious question is 'why?'*

*One point is clear. Old-style British Keynesianism – the Keynesianism of incomes policies and fiscal fine-tuning – forms no part of the explanation. Incomes policies and fiscal fine-tuning were dropped by the Conservatives in 1979 and 1980, and New Labour has not brought them back since 1997. Essays 11 and 12 emphasize the importance of monetarism in ending the grip that these two misguided ideas once had on British policy-makers. But that was a largely negative achievement. Monetarism – as it was conceived in the 1970s, with money supply targets as the core of the agenda – cannot claim to have made a major positive contribution to the UK's post-1992 stability. The trend in the equilibrium ratio of money to income changed radically in the early 1980s and invalidated the specific target numbers for money growth envisaged in the Medium-Term Financial Strategy. Essay 12 suggests that there were good reasons for the change in the money/income trend and denies that supposed instabilities in money demand functions justified officialdom's indifference to the explosion in money growth in the late 1980s. The money growth explosion – like that in the early 1970s – resulted in another boom–bust cycle.*

*However, the continuing validity of the monetary theory of national income did not lead to a restoration of money supply targets. Instead the Bank of England's variation of interest rates became the virtual factotum of policy. Experience showed that – contrary to the Keynesian orthodoxy of the 1940s and 1950s – aggregate demand was sufficiently interest-elastic for this one instrument to keep demand growth on track and to deliver on-target inflation. Further, the depoliticization of interest rate decisions – which was completed by the granting of operational independence to the Bank of England in 1997 – established accountability in the institutional framework.*

*Plainly, money-target monetarism was not responsible for the huge improvement in performance, which is quantified in Essay 13. But the vital intellectual argument for an inflation targeting regime was – and remains – Friedman's 1967 rejection of a long-run trade-off between unemployment and inflation. The Introduction and Essay 13 propose that Friedman's theories foreshadowed the development of the concept of 'the output gap' (as that term*

*is now almost universally used), even if Friedman himself did not really see it. The ideas of the natural rate of unemployment and the output gap led to the emergence of the currently dominant structure of central-bank decision-taking. For these reasons output-gap monetarism does deserve the credit for the macroeconomic stability of the past 15 years, both in the UK and elsewhere.*