PART SIX

How the Economy Works

The current fashions in the theory of macroeconomic policy-making are towards radical simplification and the suppression of references to the quantity of money, where this phrase refers to an aggregate dominated by bank deposits. In a recent book on The New Monetary Policy *Arestis and Sawyer outline what they term the New Consensus Monetary Policy (NCMP), which is closely related to the so-called (and in my view misnamed) New Keynesianism of the Introduction. According to Arestis and Sawyer, the context of decision-taking under NCMP can be described with only three equations. Technically, the first is an aggregate demand function (a sort of IS curve, in terms of the familiar IS–LM model), the second is a Phillips curve, in which inflation depends on the output gap, and past and future inflation, and the third is a so-called 'Taylor rule' for the nominal interest rate which is to be set by the central bank according to the output gap, two inflation variables and the 'equilibrium' real interest rate. (See the paper by P. Arestis and M. Sawyer in P. Arestis et al. [eds]* The New Monetary Policy *[Cheltenham, UK and Northampton, MA, USA: Edward Elgar, 2005], particularly pp. 7–8.)*

This approach has no active role for money in the determination of macroeconomic outcomes. It is true that, implicitly, the 'interest rate' in the third rule is a money market rate set by the intersection of the supply and demand 'curves' for high-powered money. But – since the central bank is a monopoly supplier of high-powered money – the way that 'the interest rate' is set has no wider behavioural significance. What matters are how aggregate demand responds to 'the interest rate', how the level of the output gap reacts to the fluctuations in aggregate demand and how the inflation rate varies with the output gap. Clearly, in this framework neither the banking system nor a deposit-dominated quantity of money matters at all. As noted in the Introduction, New Keynesianism shares with the New Classical Economics an aversion to traditional monetary economics, in which bank deposits were crucial in the determination of bond yields (in Keynes's liquidity preference theory of money-holding behaviour), asset prices and national income.

The two final papers in this collection summarize my own experience of over 30 years of interpreting the UK monetary situation and using the data to draw conclusions about the future of the economy. My view is that real interest rates are so volatile that it is almost impossible to use them for forecasting purposes. Instead, careful analysis of the growth of money – both in the aggregate and by sector – yields powerful insights into future spending patterns. Essay 14 presents an analysis of the UK economy in which bank deposits held by companies and financial institution play a critical role in asset

price determination. But constant arbitrage between different types of asset, and between assets and goods, ensures that money is relevant to the joint *determination of* both *asset prices and national income. As Essay 15 explains, certain key empirical relationships between money and the economy that 'worked' in the 25 years to 1989 continued to 'work' in the following 15 years, when I used them commercially in my forecasting and consultancy business, Lombard Street Research. One aim of my forthcoming* Money in a Modern Economy *will be to argue that banking and money (meaning 'bank deposits') remain fundamental to macroeconomic analysis.*