11. Assessing the Conservatives' record

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'. Did the Conservatives – in the end – deliver a worthwhile reduction in inflation? Was inflation much lower in their final years before the 1997 general election than when they came to power?

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 regarded as the key measure of performance, the Conservative government of 1979 to 1997 was successful. If an end-of term report were prepared in 1997, the case for an 'alpha' mark might be unconvincing because it did not restore full price stability, but a highly commendable 'beta plus' would be fair. But the facts may be deceptive. Because inflation fell in all the main industrial countries from the 1970s to the 1990s, the Conservatives' achievement was far from unique. Critics might argue that international pressures – such as falling commodity prices and the almost universal adoption of anti-inflationary monetary policies – were 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.

The question becomes, 'to what extent was the decline in inflation due to the government's own decisions, as it tried to fulfil a predetermined 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. In June 1979 most members of the newly elected government, including the Prime Minister Mrs (later 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 subsequently denied any formal affiliation to a precise set of ideas.

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 characterized 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*.) In particular, monetarism was targeted against two doctrines – which may be labelled corporatism and Keynesianism – whose influence was greatest in the Labour-dominated period from 1964 to 1979.

I

The heart of the first doctrine ('corporatism') was that the state should co-operate with the organized representatives of labour and capital, namely 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. 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.

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 co-operation 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. 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 less than 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 in the 1980s and early 1990s restored managements' ability to manage. One result was that productivity gains in the once heavily unionized industries of energy supply, steel and cars were spectacular, far higher than in manufacturing industry as a whole. These productivity gains helped to curb inflation, although they did so not by dampening the rate of growth of the quantity of money, but by boosting the rate of growth of the quantity of output. More fundamentally, in the early 1980s, the month-by-month movements in the money supply were monitored closely for their future inflationary message. Although this approach to macroeconomic management had been largely (but not entirely) abandoned by the 1990s, it was followed by exactly the decline in inflation that the monetarists wanted.

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 appeared under the banner of 'the Keynesian revolution'. 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 (that is, 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.

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 (on the measure known at the time as 'the public sector borrowing requirement' [PSBR], but relabelled 'the public sector net cash requirement' in 1997) 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.

The monetarists pressed these points convincingly in the public debate over the 20 years to 1997 and much of their agenda was implemented in practice.[3] Every projection of fiscal policy in the Conservative years was framed within a medium- or long-term context, with one eye on the implications for the accumulation of public debt and another on the scope for tax cuts if expenditure were kept within proper limits. Apart from Norway, the UK was the only country in the industrial world where the ratio of public debt to national income was lower in 1997 than it had been in 1979. (The New Labour government from 1997 changed the form of the fiscal rules, but retained the medium-term planning context.) The shift towards regarding inflation, not unemployment, as the central concern of macroeconomic policy-making was also surprisingly complete. In part, this shift reflected a new theoretical consensus among economists, that there is no long-run trade-off between unemployment and inflation. In part, it stemmed from a hard-headed recognition that unemployment may be due not to a lack of demand, but to overgenerous social security benefits which leave the unemployed little incentive to seek work.

So – in its intellectual and policy-making struggles with corporatism and Keynesianism – monetarism notched up major victories. Even if it did not force them into unconditional surrender, corporatism and Keynesianism retreated to their university fastnesses, and by the mid-1990s their protagonists declined pitched battle in public debate.[4] By the late 1990s almost no one proposed incomes policy as the most efficient antidote to inflation or aggressive fiscal reflation as the best way to cut unemployment.

II

Sure enough, the number of references to all the 'isms' in the newspapers was drastically lower in the late 1990s than it had been 20 years earlier. Indeed, many of the residual comments on monetarism were derogatory and in the past tense. Such worthies as Will Hutton at the *Observer*, Philip Stephens at the *Financial Times* and Anatole Kaletsky at *The Times*, as well as a host of lesser commentators, poked fun at monetarism from time to time. But none of them were silly enough to suggest that the Trades Union Congress (TUC) determines the inflation rate or that a PSBR of 6 or 7 per cent of national income is financially responsible. They seemed to have forgotten that in the late 1970s the majority of opinion-forms in Britain did believe that the TUC could determine inflation, while fiscal reflation – even with the PSBR already 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 of its Department of Economic Affairs.

The question evolves again. If monetarism did achieve in the 1980s and the 1990s much of what its supporters had hoped in the 1970s, why did references to it become so rude and dismissive? A large part of 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 actual policy instruments, such as the setting of interest rates and the management of the public debt. Only a handful of British economists – probably not more than 30 or 40 at the peak – called themselves 'monetarists'. Nevertheless, this small group, 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. (Their views also differed from those of their counterparts on the other side of the Atlantic, as explained in Essay 7.)[5]

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' (that is, 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 overdue measures of financial liberalization 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' (equivalent to only notes and coin, or notes and coin plus bank deposits which could be spent without a notice period, such as current accounts). Walters nevertheless favoured a domestic focus for monetary policy and strongly rejected the proposition that a fixed exchange rate system, such as the European Monetary System, was appropriate for the UK.

The debate between broad and narrow monetarists has continued since the early 1980s, and undoubtedly reminds non-participants of medieval scholasticism. As a junior Treasury minister in the early 1980s Mr Nigel (later Lord) Lawson was impatient with all the technicalities. On 15 June 1981 he sent a long note to Sir Geoffrey (later Lord) Howe, the Chancellor of the Exchequer, arguing that the discipline of the European Monetary System (EMS) – and not money supply targets – should become 'the prime determinant' for monetary policy.[6] By the mid-1980s Howe, who had become Foreign Secretary and generally adopted a 'pro-European' stance towards policy issues throughout his career, shared Lawson's enthusiasm for the EMS. It is an ancient principle of monetary economics that a nation cannot simultaneously pursue a money supply target and a fixed exchange rate.[7] EMS membership, focused on a fixed exchange rate between the pound and other European currencies, therefore meant the end of British monetarism, in which money supply targets were an essential ingredient. It was consistent that Lawson – who had succeeded Howe as Chancellor in 1983 – should suspend broad money targets in October 1985, as a prelude to ending them altogether a year later.

But Thatcher – advised by Walters – was against EMS membership. By the late 1980s Thatcher and Walters were engaged in a long-running row with Lawson and Howe about macroeconomic policy, which in its intellectual raucousness and media visibility was comparable to a highbrow Punch and Judy show. 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 the annual rate of broad money growth had been gradually declining and by late 1984 was down to about 10 per cent. But in 1986 and 1987 it accelerated to over 15 per cent a year. In the characteristic manner of such cycles, the first impact on excess money growth was on asset prices which surged forward in 1986 and 1987.[8] A boom in demand and output followed, and it was justly labelled 'the Lawson boom' after the Chancellor who presided over it. As so often, Friedman's 'long and variable lags' between money and inflation confused the interpretation of events. Nevertheless, 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 (RPI) again went into double digits.[9]

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 (or indeed Westminster and Whitehall, and Oxford, Cambridge and other universities) saw it. Instead of reinstating the policy framework of 1979, the new administration led by Mr John Major stood by the ERM (exchange rate mechanism). 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, as high interest rates deterred banks' customers from borrowing and undermined banks' ability to lend as asset price falls hit their capital bases.[10] 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. With the exchange rate no longer the 'prime determinant' of monetary policy (to recall Lawson's own phrase), interest rates tumbled. Clearing bank base rates went down from 10 per cent in early September 1992 to 6 per cent in January 1993. A recovery began and mildly above-trend growth continued, with fits and starts, until the late 1990s. 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 averaged under 3 per cent, with a degree of variation from year to year which was remarkably small compared with the previous 25 years. But – as is evident from the erratic record of official intentions, rationalizations and excuses – this outcome should not be seen as some sort of monetarist nirvana. (It was a fluke.)

In 1995 and 1996 money supply growth again accelerated, and the annual rate of increase in the M4 money measure was to peak at about 12 per cent in the third quarter of 1997. Britain's economists were indifferent to this development. They saw no connection between, on the one hand, the faster rate of money growth and, on the other, the strengthening of asset prices and marked upturn in domestic demand which soon became apparent. They also failed to warn about the risks of a future rise in inflation. This followed a familiar and recurrent pattern. With only a few dozen exceptions, Britain's economists continued to deny that the cyclical turmoil and high inflation of the first 50 post-war years had any relationship with volatile and excessive money supply growth. Fortunately, the Bank of England – which was granted operational independence to set interest rates by the newly elected Labour government in May 1997 – raised interest rates in a sequence of steps to 7½ per cent in June 1998. The effect was to restraint the growth rates of credit and money, and at a further remove to keep the expansion of demand in line with the economy's productive potential.

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 failed almost completely. Keynes's ghost had many occasions to chuckle. 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 late 1970s and early 1980s monetarism was important in shifting the attitudes of Britain's political class away from the quack remedies of the 1960s, namely incomes policy and fiscal activism. At the level of ideas, it refuted both corporatism and the more naïve versions of Keynesianism. Moreover, the reluctant adoption of money supply targets in the late 1970s, and their retention through the early 1980s, did lead to a large fall in inflation, and this achievement makes Lawson's abandonment of broad money targets in 1985 all the more curious.

Looking back, the monetarists' central problem was unexpected. Despite the millions of words written on the subject from a monetary perspective, they did not have an agreed theory of how changes in the quantity of money 'cause' changes in the equilibrium level of money national income. In jargon, they lacked an account of 'the transmission mechanism'. But their problem was also a problem for the Keynesians and, indeed, for any macroeconomist who thought seriously about his subject. The sorry truth is that, over 70 years after the publication of Keynes's *General Theory*, economics does not have a definitive theory of the determination of national income. (The standard income-expenditure approach – which has no room for monetary influences on national income – is unsatisfactory, as explained in Essay 9.) British policy-makers' failures to control the business cycle and prevent inflation over the 25 years from the ending of the Bretton Woods system in 1971 should be interpreted as largely due to this theoretical lacuna.

NOTES

1. See Essay 4, on 'Did Britain have a "Keynesian revolution"?', for more discussion.
2. As noted in Essay 7, the emphasis on controlling the PSBR as a key aspect of monetarism seems to have been distinctively British. The author set out the background to British monetarists' concern about high budget deficits 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 T. Congdon, *Reflections on Monetarism* (Aldershot, UK and Brookfield, US: Edward Elgar for the Institute of Economic Affairs, 1992).
3. 'Academic adherents of monetarism were in a small minority in Britain in the 1970s. However, the impact of [their] theories on policy would seem to have been substantial.'

(J. Tomlinson, *Public Policy and the Economy since 1900* [Oxford: Clarendon Press, 1990], p. 297.)

4. Large tax increases led to a big reduction in the cyclically adjusted budget deficit between 1992 and 1995, while the level of output was beneath trend. But – in contrast with the somewhat similar circumstances in 1981 which prompted the letter to *The Times* from the 364 – there was barely a whimper of dissent from the academic Keynesians about the 'tightening' of fiscal policy.
5. Chapter 8 of Lawson's semi-autobiography *The View from No. 11* is on 'the black art of monetary control'. In a footnote on p. 77 he says that the subject matter of the chapter 'is an issue of passionate interest to a small number of people and mind-numbing gobbledygook to many others'. He then remarks, 'The general reader can safely turn straight away to Chapter 9 without losing the thread of this book'. (N. Lawson, *The View from No. 11* [London and New York: Bantam Press, 1992].) But the debates between the 'small number of people' to whom Lawson refers were ultimately fundamental in deciding the macroeconomic outcomes of his period as Chancellor and, later, the reputation of the Conservative Party for competence in managing the economy.
6. Lawson, *The View from No. 11*, p. 111.
7. The author argued that domestically focused money supply targets were incompatible with a fixed exchange rate in an article in *The Times* on 19 January, 1976. (See pp. 18–21 of his *Reflections on Monetarism*, where the article is reprinted.) In view of the disastrous results of the period of ERM membership between 1990 and 1992, two sentences from the 1976 article may be apposite. '[T]o adopt a fixed exchange rate is to abandon the independence of monetary policy. It leaves internal inflation and employment objectives at the mercy of foreign central banks.'
8. The role of asset prices in the transmission mechanism from money to the economy is discussed in more detail in the author's *Money and Asset Prices in Boom and Bust* (London: Institute of Economic Affairs, 2005).
9. In Thatcher's own writings the author has found only one reference to his criticisms of her government's monetary policy. (These criticisms began in early 1986, shortly after the effective ending of broad money targets in October 1985.) The reference is a footnote on p. 710 of the second volume of her memoirs where she says, 'The suggestion that the inflation which began at the end of 1988 and lasted until mid-1991 could be explained by decisions on interest rates and monetary policy in 1985 assumed almost a four-year lag in the effect of monetary expansion on inflation. We know that lags, in Milton Friedman's words, are "long and variable" with an average of about eighteen months. So three to four years is possible, but hardly plausible.' (M. Thatcher, *The Downing Street Years* [London: HarperCollins, 1993].) In fact, the length of the money/inflation lag after the Lawson boom was similar to that after the Heath–Barber boom, which had made 'Thatcherite monetarism' relevant in the late 1970s and so provided the intellectual rationale for the policies the Thatcher government pursued in the early 1980s. (The upturn in money growth in the early 1970s began in the final quarter of 1971, but the peak in inflation came in mid-1975. The money measure under consideration here is a broadly defined one.) The interpretation of both the two major inflationary episodes under the Conservatives is full of misunderstandings. A biography of Keith Joseph by Denham and Garnett notices – over the 1983–88 period – a gap between the 15 per cent annual growth of money and the 5 per cent annual rate of increase in prices. It then remarks, 'Not even the monetarist theory of "time-lags" could explain away this discrepancy.' (A. Denham and M. Garnett, *Keith Joseph* [Chesham: Acumen Publishing, 2001], p. 411.) But the gap between the annual rates of money growth and inflation in the early 1970s was greater than that in the mid and late 1980s, and both periods were followed by sharp upturns in inflation. (In the years to end-1972 and end-1973 M3 rose by 25.5 per cent and 27.4 per cent respectively, while the retail prices index went up by 7.7 per cent and 10.2 per cent respectively. The peak in inflation came in August 1975, when the annual rate of increase in the RPI was 26.9 per cent. Ironically, it was the similarity of the money supply growth rates and the *eventual* inflation outcome that was crucial in persuading Joseph that there was something to the monetary theory of inflation.) A large

short-run divergence between the growth rates of money and prices is not inconsistent with the stability of money demand functions, as the author has explained on many occasions. For a reference, see T. Congdon, 'Monetarism: a rejoinder', *World Economics*, vol. 5, no. 3, July–September 2004, pp. 179–97, particularly pp. 188–94.

10. This sentence invites the misinterpretation that bank lending causes inflation. Note that – in the normal course of events – a new bank loan creates a new bank deposit. So the growth rate of bank lending usually has an important bearing on the growth rate of bank deposits. But bank deposits, not loans, are money. The equilibrium relationships between money and money national income hold, whether the money is created by new bank lending or by banks' purchases of securities.