12. Criticizing the critics of monetarism

By the start of the twenty-first century monetarism – unlike a surprisingly adaptable Keynesianism – was being referred to in the past tense. For some people it was a convenient swearword, used to express their loathing for everything that had gone wrong (as they saw it) since conservative governments in the USA and the UK embraced free-market economics in the 1980s. A more sympathetic author interpreted the rise and fall of monetarism in Britain as a problem in 'social learning'. In his words, writing in the mid-1990s,

> The social learning process since 1979 has been a mixed affair. The 1980s were a time of policy experiments . . . While it would be wrong to see policy as an unqualified success in the 1980s, it would be equally incorrect to conclude that nothing positive has come from the past 16 years.[1]

A particularly interesting discussion by Thomas Mayer and Patrick Minford appeared in the spring 2004 issue of *World Economics*. Their paper on 'Monetarism: a retrospective' concluded that, 'Monetarism as a distinct school is in decline, but monetarist ideas are flourishing and form a major part of the modern synthesis' (p. 184).[2]

The various assessments generally saw monetarism as an outgrowth 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; and they correctly recognized the strong influence that monetarism had on UK policy-making in the early years of the Thatcher government from 1979. But a common tendency – shared by Mayer and Minford – was to underestimate the success of the monetarist challenge to the styles of policy-making (corporatism and fiscalist Keynesianism) which prevailed, particularly in the UK, before the 1970s. One line of attack on monetarism was technical. In the 1980s a conventional wisdom emerged from a large body of econometric work that demand-for-money functions had become unstable. In some circles the breakdown of money demand stability was thought not only to invalidate the case for money supply targets, but also to argue against the practice of tracking the money supply aggregates for their macroeconomic information. The following discussion is intended as a critique of the criticisms of monetarism. It will concentrate on the UK, although the remarks have wider relevance.

I

In their opening remarks and in a section on 'Basic ideas and history', Mayer and Minford compared monetarism with other schools of macro-economic thought, particularly Keynesianism. In their view the differences were hardly fundamental. Whereas the monetarists believed in the importance of money to national income determination in the short and long runs, the Keynesians accepted the role of money of national income determination in the long run, but questioned it in the short and medium terms; monetarists such as Milton Friedman regarded the proposition that money and national income have similar rates of changes as a reasonable working hypothesis (but acknowledged that the theory of money is an aspect of the theory of portfolio selection), while Keynesians emphasized that desired money holdings may change relative to other types of wealth and income, put questions of portfolio selection first and repudiated a mechanical one-to-one relationship between money and national income; and so on. In this ball of economic theory the dancers changed their partners from time to time, but they all knew the sequence of steps in the Cambridge cash balances equation, the routines of the IS–LM model, and other familiar tunes and rhythms. Everyone enjoyed everyone else's company, and the gap between monetarism and other schools of thought arose from differences of nuance and emphasis. There was no clash of world view and ideology, and no need for polemics.

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.[3] 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.[4] 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 (that is, by the use of fiscal policy) or from overseas (as the world economy waxed and waned, or because the exchange rate changed).[5] 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' (that is, 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 to the 1944 White Paper on *Employment Policy*.

Monetary policy – often defined only in terms of interest rates rather than in terms of the quantity of money – was widely considered to be peripheral to the economy, even though interest rates were recognized as having some effect on 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.[6]

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, 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 twentieth century.[7] Clearly, the greater the reliance on incomes policy to curb inflation, the stronger was the position of the trade unions in key policy debates.

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's words: 'The central controls necessary to ensure full employment will, of course, involve a large extension of the traditional functions of government.'[8] 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.[9]

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.[10] 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-maximizing 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.[11] 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 from 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 per cent 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 per cent in August 1975.[12] Well-respected commentators warned of the possible collapse of British democracy.[13]

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.

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 focused 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 far-reaching. 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.[14] Even into the 1960s many leading figures in British public life saw the mixed economy as a halfway house between the laissez-faire capitalism of the nineteenth century and a communist end-state that was certain to arrive at some future date.[15] 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. In 1979 Tony Benn published a book of *Arguments for Socialism*, which included the proposition that Clause Four had 'growing relevance today as capitalism moves into decline'. In his view, it 'must remain at the core of our work'.[16]

Monetarism represented not just an alternative to Keynesianism and corporatism in technical macroeconomics. More fundamentally, it was an expression of an utterly different world view. 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 financial 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 foundations for the privatizations 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 as civil servants in government positions – had believed from the 1930s 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 world views – about which Mayer and Minford said almost nothing in their appraisal of monetarism – must be mentioned if it is to be understood in a British setting.[17]

II

In May 1979 the intellectual jolt 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 income 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.

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 1981/82 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. A letter from 364 economists to *The Times* – undoubtedly representative of mainstream academic opinion in the UK – was categorical in its repudiation of 'monetarist policies'. The 364 threw down the gauntlet and invited the monetarists (who were far fewer in numbers) to a duel of ideas. Implicitly, the duel was to be decided by the future passage of events. (The material in Essays 9 and 10 above, on pp. 181–229, considers the economy's behaviour in the years after the 1981 Budget.)

This is not the place to provide a narrative account, even in a potted version, of the main policy decisions and outcomes of the subsequent 20 years. However, in any meaningful assessment of British monetarism the main features of policy-making after the 1981 letter to *The Times* must be discussed. Mayer and Minford's paper was quite friendly towards monetarism, but it failed to provide such a discussion. Instead their section on 'Monetarism in the United Kingdom' contained 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 was said about events after 1982, as if the second Thatcher election victory marked the end of 'the monetarist experiment'. Their implicit view – that, in some sense, British monetarism ended in 1982 or 1983 – may be partly responsible for their judgement that 'as a distinct school' it had fallen into 'decline'. 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.

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, Arthur Scargill, the Counter-Inflation Programme, 'the son of £6 a week' 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.

Incomes 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 stabilization 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. 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 25 years 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. Mayer and Minford implied 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'.[18] 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. The MTFS undoubtedly had a major effect on public finance outcomes. Whereas in the 1970s the UK was bracketed with Italy as an incorrigible fiscal spendthrift, by the late 1990s the ratio of public debt to GDP was below the average for the industrial world and down to about a third of that in Italy. The British banking system – whose assets had been dominated by claims on the public sector in the 1950s and which therefore was subject to official restraints on its lending to the private sector – held virtually no public sector debt at the start of the twenty-first century.

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.[19] 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.

Finally, as far as the conduct of monetary policy is concerned, many years have now passed since it was directed to the maximization 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, and is discussed below.) 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 who 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.

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 or so from 1994 saw almost uninterrupted increases in employment and falls in unemployment, so that the UK (mid-2006) 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 characterized 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'. A case can be made that the vital theoretical basis for this policy achievement was a generalization of Friedman's ideas on the link between changes in inflation and departures from the so-called 'natural rate of unemployment'.[20] 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.[21] On a wider canvas, the Labour Party has dropped Clause Four from its constitution and its leaders embrace the market economy, although with reservations.

III

The technical critique of monetarism is directed not against its broad political and philosophical message, but against the practical value of the style of monetary management with which it was associated in the late 1970s and early 1980s. The centrepiece of this style of monetary management was an annual target for the growth rate of the quantity of money. Superficially, the rationale for such targets was simple. If the quantity of money and the level of nominal national income grew at similar rates in the long run (as evidence from many nations suggested they did), control over monetary growth would deliver control over the growth of nominal national income and, at a further remove, the rise in prices. In the UK context in the early 1980s gradual reductions in money supply growth – of the kind announced in the MTFS from 1980 onwards – ought in due course to achieve lower inflation.

In the more naïve presentations of the argument the velocity of circulation of money (that is, the ratio of national income and expenditure to the quantity of money) was said to be stable and predictable, like some of the constants in nature (such as the freezing and boiling points of water, or the speed of light). The trouble with this line of analysis was that it overlooked that money and banking are human institutions, so that the way in which people use money is always changing. The UK experience with money supply targeting was important to the reputation of monetarism, partly because of the ideological passions aroused by the larger debates over Thatcherism and its challenge to middle-way 'Butskellism'.

Unfortunately for the monetarists, both the radicalism of the supply-side reforms introduced after 1979 and the rigour of anti-inflationary policy disturbed the relationship between money and money national income. The ending of exchange controls in October 1979 was vital to the long-run competitiveness of the City of London as an international financial centre, but it encouraged the location in London of new types of financial institution, and their money balances exploded in the 1980s and 1990s. Financial deregulation – notably the liberalization of mortgage credit from 1982 – led to an intensification of competition and a narrowing of banks' profit margins. This made it less expensive for companies and financial institutions simultaneously to hold bank deposits and to have bank borrowings, and again that raised the desired ratio of money to expenditure. The denationalization of large utility companies after 1984 expanded the private sector and, for the reasons given in Essay 6, that increased the corporate demand to hold money. Finally, the leap in interest rates in late 1979 made it more attractive to keep wealth in the form of interest-bearing deposits (which formed a large part of broad money) than before. Whereas the 1970s were mostly a decade of negative real interest rates, the 1980s saw almost continuously positive real interest rates.

The combined effect of all these developments on the monetary scene was drastic. Whereas from 1945 to the late 1970s money had been growing more slowly than national income, after 1979 its long-run tendency was to increase at an annual rate 2 or 3 per cent a year faster than national income. The targets in the first version of the MTFS made insufficient allowance for this change in behaviour. As a result, the money supply targets were pitched much too low and were routinely exceeded. The overshoots caused the whole machinery of money supply targets, and not just the particular set of target numbers chosen, to be derided by critics as inappropriate and harmful. Far from being a natural constant, the velocity of circulation was shown to vary in the long run, as institutions, technology and regulations evolved. Although its behaviour could still be explained in economic terms, expectations of a stable velocity were shown to be rather naïve.

This experience helps to explain why, according to Mayer and Minford, a stable demand function for money 'disappeared' so that 'monetarism was providing no reliable way of predicting GDP'. Other authors reached a similar conclusion. In the words of a 2003 textbook on *Monetary Economics: Policy and Its Theoretical Basis*, by the mid-1980s 'it was clear both that the authorities' ability to target the broad money stock with any degree of accuracy . . . had been severely undermined, and that the rationale for monetary targets had itself broken down in the face of a sharply falling velocity'.[22] The instability of money demand functions and the inadequacy of money as a forecasting tool became part of the conventional wisdom.[23]

But the critics went much too far. As an analytical matter, a change in the velocity of circulation of money does not imply that the demand for money has become unstable. The velocity of circulation of money may alter because of large shifts in the value of arguments in the money demand function other than national income itself. (For example, the desired ratio of money to income may depend on real interest rates and financial technology. If rises in real interest rates and improvements in financial technology cause agents to want a higher ratio of money to income, their underlying preferences for the quality of 'money-ness' in their portfolios may be stable.) Moreover, the finding of instability in money demand functions was not new in the 1980s. Research at the Bank of England and elsewhere had usually found stable demand functions for broad money in the 1960s, but two papers published by Artis and Lewis in 1974 and 1976 argued that these functions had broken down. The publication of the Artis and Lewis work did not stop, at roughly the same time, the then Labour government announcing a money supply target and the IMF introducing targets for a broadly defined measure of DCE (domestic credit expansion). The government's and IMF's actions relied on the demand for money being *stable enough for policy purposes*, even if it was not *stable enough to meet the criteria of statistical significance required for academic papers*. (The two concepts of 'stability' can be a long way apart.) What had changed by the mid-1980s? Indeed, well before Artis and Lewis, Walters had carried out empirical work on money and incomes spanning the 1880–1962 period, and found sub-periods when the link between money and incomes was weak. But this did not prevent Walters becoming one of the leading advocates of control over the growth of the money supply as a means of curbing inflation.

The critics of monetarism also became sloppy in their use of words and careless in their judgements. It was one thing to show that the quality of an econometric relationship between money and incomes was lower in the 1980s than it had been in the 1960s. That meant that – even if the regression coefficient in a simple two-variable money/income equation were one in both the 1960s and 1980s – any forecast in the 1980s would be made with less confidence than in the 1960s.[24] But it was something else to leap from here to the conclusion that the economy would not be affected at all by a shift from a lower to a higher rate of money supply growth. If the regression coefficient were indeed one in both the 1960s and the 1980s, the correct forecast in both decades was that the most likely outcome of an acceleration in annual money supply growth from 5 per cent to 15 per cent was an acceleration in the annual rate of increase in nominal national income also from 5 per cent to 15 per cent.

There seems little doubt that – when the technicians produced their statistical results for senior officials and their political masters – the message was garbled. In a speech at Loughborough University on 22 October 1986 – given when the annual growth rate of the money supply on the M3 measure had climbed well into the teens – the Governor of the Bank of England, Mr Robin Leigh-Pemberton (later Lord Kingsdown), said that it was 'fair to ask whether a broad money target continues to serve any useful purpose' and perhaps 'we would do better to dispense with monetary targetry altogether'. (One is reminded of Mr Polly, in the H.G. Wells novel, who thought that he could not go bankrupt if he dispensed with an accountant.)[25]

The lower quality of the statistical relationships between money and income in the UK in the 1980s did *not* mean that the behaviour of the quantity of money had no macroeconomic impact whatsoever. (A remarkably large number of people seemed to think that this is what it did mean.) Mayer and Minford – following the conventional wisdom – asserted, in their 2004 paper, that 'monetarism was providing no reliable way of predicting GDP'. But this was to ignore entirely the unhappy sequence of events between 1985 and 1992 in the UK and the relative success of monetarist analysts in their prognostications during the period.

In 1986 and 1987 the growth rate of bank deposits increased markedly, and the consequent excess supply of money led to large asset price increases and a wider economic boom. At the beginning of 1988 the overwhelming majority of forecasting groups were nevertheless afflicted by 'forecasters' droop' and expected 1988 to see a slowdown in the economy.[26] They were hopelessly wrong – and their indifference to money supply developments was the fundamental reason for their misjudgements. In fact, 1988 saw the highest increase in private sector domestic demand (in real terms) in the post-war period. Severe overheating resulted in a widening payments deficit and rising inflation. Policy-makers had to more than double interest rates between the spring of 1988 and the autumn of 1989 to compensate for earlier mistakes. In 1990 the annual rate of inflation reached double-digits, while money supply growth collapsed. The squeeze on real money balances hit asset prices, with real estate (including, for the first time in the post-war period, residential housing) suffering significant price falls. Recovery was delayed until 1993. The Conservative Party was stigmatized for economic mismanagement, with its traditional support among the home-owning middle classes being sharply less in the general elections of 1997, 2001 and 2005 than in those of the 1980s.

The whole boom–bust episode was every bit as incompetent as that between 1971 and 1975, which had developed from the 1971–73 explosion in money growth under Heath (as Prime Minister) and Barber (as Chancellor). Ironically, it was the Heath–Barber boom which had caused Keith Joseph to protest against 'inflation-eering', and so had provided the initial stimulus to the adoption of monetarist ideas by leading figures in the Conservative Party. At any rate, the Lawson boom and the subsequent bust demonstrated yet again the validity of the monetary approach to national income determination. Economists who monitored the behaviour of the money supply (on the broadly defined measures) were the most successful in anticipating the large fluctuations in asset prices, demand and inflation which occurred in the decade from 1985. When Mayer and Minford claimed that monetarism 'was providing no reliable way of predicting GDP', they were being very misleading. It would be closer to the truth to say that – in the more extreme phases of the last major UK boom–bust episode – only the monetarists provided reliable forecasts of GDP.[27]

IV

Whatever one's doctrinal affiliations, there is not much dispute that in the 1970s UK macroeconomic policy-making was in crisis. The monetarists set out an agenda for change which was largely adopted by the Labour government in the late 1970s and, with more commitment, by the Conservatives from 1979. It cannot be emphasized too strongly that in these years the monetarists were heavily outnumbered in the academic debate and that in the early 1980s the monetarist agenda was implemented in defiance of beliefs held by the great majority of British university economists.[28] In March 1981 364 of these economists wrote in protest against 'monetarism' in a letter to *The Times*. The 364 were quite wrong in their forecasts of the economy over the following few years, and in their jeremiads about the UK's 'industrial base' , and 'social and political stability'. (See the exchange between Professor Stephen Nickell and the author reprinted here as Essay 10.)

Nevertheless, they and their students continue to dominate the academic profession in the UK, while like-minded economists are in the majority in the academic profession in other English-speaking nations. There should be no surprise that a conventional wisdom has emerged which is carping and mean towards monetarism, and fails to recognize its contribution to the improvement in the British economy's performance. The technical element in the conventional wisdom (with its aspersions on the instability of velocity, the unreliability of forecasts, and so on) is largely wrong and needs a critical reappraisal. The opponents of monetarism have had it too easy for too long.

NOTES

1. M.J. Oliver, *Whatever Happened to Monetarism?* (Aldershot, UK and Brookfield, USA: Ashgate, 1997), pp. 151–2.
2. T. Mayer and P. Minford, 'Monetarism: a retrospective', *World Economics*, vol. 5, no. 2, April–June 2004, pp. 147–85.
3. M. Ricketts and E. 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.
4. The reference to 'pulp forests' was made by Samuel Brittan. (See p. 173 of his paper, 'Inflation and democracy', on pp. 161–85 of F. Hirsch and J.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', in D. Laidler and D. Purdy (eds), *Inflation in Labour Markets* (Manchester: Manchester University Press, 1974), pp. 79–108.
5. 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, 1920–1995* (Oxford: Oxford University Press, 2000).
6. C.A.E. Goodhart, *Money Information and Uncertainty* (1st edition, London: Macmillan, 1975), p. 242.
7. 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 P. Jay, *The Crisis for Western Political Economy* (London: Andre Deutsch, 1984). See p. 47.
8. J.M. Keynes, *The General Theory of Employment, Interest and Money* (London: Macmillan, 1964, paperback reprint of 1936 edition), p. 379.
9. 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 W. 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.' S. Orwell and I. Angus (eds), *The Collected Essays, Journalism and Letters of George Orwell*, vol. III (Harmondsworth: Penguin Books in association with Secker and Warburg, 1971, paperback reprint of 1968 hardback original), p. 414.

10. J. Tobin, *Policies for Prosperity* (Brighton: Wheatsheaf Books, 1987), pp. 265–6.
11. R.J. Ball and T. Burns, 'The inflationary mechanism in the UK economy', *American Economic Review*, vol. 66, September 1976, pp. 467–84.
12. 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'.
13. The alarm was expressed in the weekly columns of Peter Jay in *The Times*, Samuel Brittan in the *Financial Times* and other commentators. On 29 April 1975 *The Wall Street Journal* carried a leading article entitled 'Goodbye, Great Britain'.
14. '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.
15. The first edition of Karl Popper's polemical *The Poverty of Historicism* (London: Routledge and 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.
16. T. Benn, *Arguments for Socialism*, ed. C. Mullin (Harmondsworth: Penguin, 1980, originally published in 1979), p. 44.
17. N. Annan, *Our Age: Portrait of a Generation* (London: Weidenfeld and Nicholson, 1990), *passim* but especially chapter 26 'Our vision of life rejected'; and B. Magee, *Confessions of a Philosopher* (London: Weidenfeld and Nicholson, 1997), pp. 413–15.
18. T. Mayer and P. Minford 'Monetarism: a retrospective', *World Economics*, vol. 5, no. 3, April–June 2004, p. 182. For the antecedents to the MTFS, see G. Pepper and M. Oliver, *Monetarism under Thatcher: Lessons for the Future*, Cheltenham, UK and Northampton, MA, USA: Edward Elgar, 2001, especially pp. 8–20.
19. 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. New Labour's rules are discussed in Essay 5 in this book. The author proposed that fiscal policy should be organized to achieve medium-term stability in the ratio of public debt to GDP in a paper given the Money Study Group at Brasenose College, Oxford, on 14 September 1976 and reprinted in pp. 39–49 of his 1992 *Reflections on Monetarism* (Aldershot, UK and Brookfield, US). In effect, the 1976 Money Study Group paper anticipated the later announcement of New Labour's 'sustainable investment rule' by over 20 years. Nevertheless, a newspaper report of 23 June 2006 ('Warm tributes paid to economic policy-maker', *Financial Times*, occasioned by the tragically early death of the City economist, David Walton), by Chris Giles and Scheherezade Daneshku, said that 'David Walton's greatest legacy to economic policy was in devising two new rules of thumb – debt sustainability and the golden rule – in November 1993 with Gavyn Davies, the former chief economist of Goldman Sachs'. These rules were apparently 'adopted enthusiastically by Mr. [Gordon] Brown in opposition and subsequently in government'. The author has been unable to track down any papers written by Walton and Davies in which they set out the case for New Labour's rules, although they may well have argued for them in oral presentations to Mr Brown.

20. T. 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, and reprinted here as Essay 13.
21. Mayer and Minford did indeed say that 'some of its [monetarism's] basic ideas have become so widely accepted that they are no longer monetarist' (p. 183).
22. K. Bain and P. Howells, *Monetary Economics: Policy and Its Theoretical Basis* (Basingstoke: Palgrave Macmillan, 2003), p. 327.
23. In an important respect the demand for money remained stable throughout the 1980s and 1990s. Of the three non-bank, non-public sectors in the UK (the household, corporate and financial sectors), the largest money-holder from the early 1960s until today has been the household sector. A standard finding in all econometric work is that the household sector's demand-for-money function has remained stable, according to the usual significance tests. (See, for example, L. Drake and K.A. Crystal, 'Personal sector money demand in the UK', *Oxford Economic Papers*, vol. 49, no. 2, April 1997, pp. 188–206, and R.S.J. Thomas, 'The demand for M4: a sectoral analysis. Part I – The personal sector', *Bank of England Working Paper*, no. 61, 1997.) The author first pointed out the stability of household sector money-holding behaviour in a research paper published in May 1986 when he was working for the stockbroking firm, L. Messel & Co., which was then being acquired by (what become) Lehman Brothers. Note that in these years 'the personal sector' became 'the household sector', because of official redefinitions, while the data were often revised. These changes did not alter the key point, that the household/personal sector's demand for money was stable over a period of many decades, despite financial deregulation, macroeconomic upheaval, large changes in interest rates and so on.
24. More precisely, a lower probability value would attach to a specific range of values around, say, the central value of the growth rate of income forecast for a particular value of the growth rate of money.
25. For the Loughborough speech, see 'Financial change and broad money', in the *Bank of England Quarterly Bulletin*, vol. 26, no. 4, December 1986, pp. 499–507. It would be nice to think that Leigh-Pemberton – who had been Thatcher's personal appointee to the governorship – knew what he was talking about. He has written nothing of significance in his own name on monetary theory or policy since leaving the Bank of England. (In his entry in *People of Today*, he lists his recreations as 'country pursuits'.) According to Lawson in *The View from No. 11* (London and New York: Bantam Press, 1992), the 'principal author' (p. 635) of the Loughborough speech was Eddie (later Sir Edward) George, who became the Governor of the Bank of England after Leigh-Pemberton.
26. For an explanation of the phrase 'forecasters' droop', see Essay 3, p. 73.
27. See the three chapters on pp. 50–154 of G. Pepper, *Inside Thatcher's Monetarist Revolution* (London and Basingstoke: Macmillan, 1998) for a comparison of monetarist and non-monetarist forecasts. See also pp. 191–4 of the author's *Reflections on Monetarism*, based on an article in *The Spectator* of 11 March 1989, for an account of the role of monetary data in the largely correct forecast for 1988 made by his forecasting team at L. Messel & Co., and D. Smith, *From Boom to Bust* (Harmondsworth: Penguin, 1992), pp. 69–70. According to Lawson, in the mid-1980s 'nearly all the reputable monetarist gurus – with the exception of the City analyst Tim Congdon – so far from urging broad money targets on me criticized me for giving too much influence to broad money in general and £M3 in particular'. (Lawson, *The View from No. 11*, p. 453.) There is some truth in what Lawson says, but there were in fact a small number of less well-known City economists with similar views to the author's.
28. In view of the lack of support for monetarism among academic economists, it may seem puzzling that monetarism had so much influence on the Conservative Party in the late 1970s and early 1980s. The author's surmise is as follows. The UK has five kinds of economist,

    - academics (who are employed by universities),
    - officials (who work in the Government Economic Service and the Bank of England),

- business economists (who are mostly attached to companies, but are sometimes consultants),
- City economists (who are employed by banks and broking firms in 'the Square Mile', which is to be understood very loosely in geographical terms), and
- economic journalists.

Most academic economists are left of centre, with a majority voting for the Labour Party. (In the 1987 general election, '43 per cent [of the electorate] voted Conservative; even 25 per cent of unemployed people voted Conservative; but only 17 per cent of academics supported the Conservatives.' [D. Willetts, *Modern Conservatism* (Harmondsworth: Penguin, 1992), p. 21, citing a MORI poll in the *Times Higher Education Supplement* of 5 June, 1987.]) Contacts between officials and Opposition politicians are necessarily limited, and so the Conservatives had no access to officials' advice in the late 1970s (as they have none at the time of writing). The politics of business economists are varied. But City economists are and always have been predominantly in favour of sound money and free markets. They tend to vote for the Conservative Party and indeed to give it financial support. Several City economists (including the author) were strongly attracted to monetarism in the 1970s. Through their involvement with think tanks and contacts with economic journalists, City economists were able to have (what may seem to others) a surprising degree of influence over Conservative Party thinking while it was in Opposition. Gordon Pepper, in particular, had direct personal access to Margaret Thatcher. (G. Pepper and M. Oliver, *Monetarism under Thatcher* [Cheltenham, UK and Northampton, MA, USA: Edward Elgar, 2001], p. 29.) Of course, numerous academic economists – who regarded themselves as intellectually superior to their City and business counterparts – were appalled by these developments. (That was why 364 of them tried to make a fuss in early 1981.) But leading Conservative politicians – and indeed leading Labour politicians – had to look for alternatives to the shambles of macroeconomic policy in the mid-1970s. Adventitiously, the most prominent economic journalists – such as Samuel Brittan and Peter Jay – were at that time also inclined to favour a new approach and wrote at length about monetarist ideas. The longer that the Conservatives were in office after 1979, the less important was the City influence and the more susceptible were the politicians to advice from officials. Officials' careers usually began after graduation from university, but some economists were recruited from outside the Civil Service, largely from academic circles.