5. Early warnings

In the middle of 1985 British monetary policy changed radically. The Government stopped its previous practice of adjusting the quantity of official gilt-edged sales to meet its broad money target. Without active use of this policy instrument (known as 'funding'), broad money growth accelerated sharply. In the Mansion House speech of 17 October 1985 Mr. Lawson announced the 'suspension' of the broad money target. In fact, the speech signalled the end of broad money targeting. Although a broad money target was included in the 1986 Budget, it was not taken seriously and was also 'suspended' when it became inconvenient.

I was dismayed by this turn of events. Even worse was to follow. In all official statements over the next few years the Government insisted that it still paid attention to the behaviour of credit and broad money in its assessment of monetary conditions. In fact, it neglected credit and broad money totally. The growth rate of sterling M3 increased from about 10 per cent in late 1984 and early 1985 to the high teens in late 1985 and 1986, and then on to over 20 per cent in 1987 and early 1988. Predictably, the economy started to grow quickly in late 1986. By mid-1987 it was booming. Mr. Lawson, commonly described as 'the architect of monetarism', seemed intent on repeating in the mid- and late 1980s the same mistakes made by Barber in the early 1970s. The Lawson boom continued unchecked until mid-1988. In its sheer bravado and dash, Mr. Lawson's performance was remarkable. In effect, he defied everything that the Thatcher Government had represented in economic policy when it had been elected in 1979.

All through these years I expected an announcement that the Government was re-considering its approach and would restore broad money targets. But nothing of the sort happened. I wrote a sequence of articles in *The Times*, roughly from October 1985 to October 1988, urging a return to the original principles on which the Thatcher Government's anti-inflation successes had been based. As remarked in the Introduction, these articles in *The Times* echoed, very self-consciously, the articles Peter Jay had written between 1972 and 1974 about the Barber boom.

The warnings contained in the first three articles republished here were carefully measured. The economy in late 1985 and early 1986 still had high unemployment and a substantial margin of slack. As a result, rapid monetary growth would impact on output and employment first, and might have little effect on inflation. My worry was what would happen if rapid monetary growth persisted 'for a year or more' (see the article of 17 October 1985). It also seemed to me that 'a mini-boom based on fast credit and money growth' (see the article of 9 January 1986) was a betrayal of the Thatcher Government's commitment to price stability and a sound currency.

It is quite untrue that, in the early stage of the game, I gave an unequivocal forecast of an imminent return to inflation over 10 per cent. I want to emphasize this. In 1987, and even in 1988, some mainstream economists decried my warnings on the grounds that I had been too alarmist about inflation in 1985. It is very clear from the articles that my warnings were long term in nature. To repeat the lessons of Friedman's classic empirical work, the first effects of an acceleration in monetary growth are on output. The damage to inflation comes through after 'long and variable lags' which, in the British case, can be as much as three or four years.

The decision to abandon broad money targets was defended by most leading economists, including Professor Sir James Ball, who had made the London Business School so well known for macroeconomic forecasting in the 1970s and encouraged such important figures as Sir Terence Burns and Professor Alan Budd. (Burns was the Government's Chief Economic Adviser from 1979 to 1990; Budd is currently Chief Economic Adviser.) In the 1988 Deloitte Haskins and Sells lecture at the Cardiff Business School, Ball said that the instability of the relationship between broad money and nominal national product in the early 1980s had made broad money targets 'look pretty silly'. Seven years after the abandonment of those targets one has to wonder whether the severe macroeconomic instability of the late 1980s, with the wild boom of 1987 and 1988 followed by a rise in inflation to over 10 per cent and the most severe recession since the 1930s, has not made a number of British economists also 'look pretty silly'.

Is Lawson Heading for Another Barber Bubble?

From an article of the same name in The Times *of 17 October 1985.*

The article is self-explanatory. I believe that it was the first time the phrase 'the Lawson boom' was used.

Memories of the Barber boom haunt the Conservative Party. It began merrily enough, with rapid growth in bank credit and the money supply encouraging a speculative surge in property values, a vigorous boom in output and much superficial prosperity. It ended in misery, with inflation reaching the highest levels in our peacetime history and the Heath Government suffering a humiliating electoral defeat.

When the Chancellor of the Exchequer, Mr Nigel Lawson forecast 4 per cent inflation by mid-1986 in his speech to the Conservative Party conference last week, he and his audience took it for granted that the Barber boom could never happen again. If the Thatcher Government stands for anything, it stands for the prevention of the follies of the early 1970s. The conference delegates had no doubts that Lawson believes in monetary control and that he will act on his beliefs. Tonight Lawson faces a more sceptical audience at the Mansion House dinner. The assembled bankers and financial experts will know that in the last six months the rate of money supply growth has been similar to that in the first six months of the Barber boom. They will also expect the Chancellor to indicate, at least in general terms, what he is going to do about it.

The offending aggregate is the broad measure of money known as sterling M3. Since the Budget in March it has been advancing at an annual rate of 18½ per cent, far ahead of the official target range of 5 to 9 per cent (see Table 5.1). There has been only one other six-month period since the Barber boom that has seen a faster increase; the Healey boomlet in late 1977 and early 1978. As with Barber the early stages were enjoyable, with output moving ahead nicely, unemployment falling and inflation not reacting too badly. But the later stages were again very unhappy. A 20 per cent annualized rate of increase in sterling M3 in the six months to April 1978 was followed by a 20 per cent inflation rate in early 1980. There were other influences at work – such as the increase in value added tax in the 1979 Budget – to

Table 5.1 The acceleration in money supply growth in 1985

	Increase in sterling M3 in month (%)	Annualized increase in previous six months (%)
February	0.3	11.6
March	0.9	10.8
April	2.9	16.4
May	0.5	12.4
June	2.3	16.9
July	–0.8	12.8
August	2.0	16.6
September	1.75	18.5

Source: Bank of England

explain the jump in inflation, but the coincidence still needs to be mentioned.

Given the record and the facts, the $18^1/_2$ per cent annualized growth rate in sterling M3 in recent months is certain to arouse critical comment. In one respect, moreover, the figures are slightly worse today than under Healey. Over the last few years inflation has been lower than in the late 1970s. In consequence, a high rate of increase in sterling M3 generates a faster rate of increase in the real money supply – the actual money supply adjusted for inflation. At the peak of the 1977/78 monetary acceleration the real money supply was about $7^1/_2$ per cent up on a year earlier; today the figure is 8 per cent.

Despite all the unfavourable arithmetic, it would be unfair and wrong to start talking about the 'Lawson boom'. The Chancellor is genuinely concerned about money supply numbers. He also has a far stronger grasp than his predecessors of the theoretical justification for monetary control and the institutional technicalities involved. It is precisely because of the seriousness of his commitment and the depth of his understanding that the City regards tonight's speech as one of the most important he has had to make since becoming Chancellor. He has to reassure financial markets that the recent overshoot on money supply targets of the recent past will not have the same dire effects as earlier misdemeanours. He also has to outline the Government's attitude towards sterling M3 and the future mechanics of monetary management.

There is a chance that the latest burst of high money growth will not be damaging in the long run. The economy has a reasonable margin of spare machine capacity and, with unemployment so high, there are no shortages of labour. If all goes well the latest phase of above-target money growth may lead solely to more output and not at all to higher prices. Further, it can be argued that the relationship between sterling M3 and the economy is changing. (Lawson will probably endorse this argument tonight.) Because of the competitive and deregulated financial system Britain is now fortunate to possess, the banking system may be expanding faster than the economy as a whole. Its deposit liabilities may increase permanently as a proportion of national income. If so, there need be no inflationary risk if these liabilities, which account for most of sterling M3, grow quickly for a short period.

However, they cannot be allowed to grow at the recent very rapid rates for a year or more. Despite the many difficulties in interpretation, sterling M3 must not be cast aside because its monetary message has become inconvenient. Lawson's task tonight is the old, familiar and necessary one of maintaining financial confidence. He knows very well that the City will be more difficult to convince than the Conservative Party conference.

Why the European Monetary System is no Easy Option

From an article of the same name in The Times *of 22 November 1985.*

In late 1985, at a session of the Cabinet's economic committee, Lawson and Sir Geoffrey Howe pressed Mrs Thatcher to agree to an important change in economic policy. They wanted the pound to join the exchange rate mechanism (ERM) of the European Monetary System. Mrs Thatcher said no. Although the proceedings of the Cabinet committee did not become known until some years later, there was a widespread understanding at the time that the EMS option was under careful consideration. The trouble was that a fixed exchange rate (of the kind implied by EMS membership) might at times conflict with the requirements of domestic monetary policy, as expressed in money supply targets. (See the article 'Money supply targets vs fixed exchange rates', on pp. 18–21, from The Times *of 19 January 1976, for a simple statement of the point.) It seemed to me that the debate about the EMS symptomized 'an apparently predestined cycle of economic management and mismanagement'.*

A few weeks ago there was a chance that Britain would become a full member of the European Monetary System in the same manner as it had acquired an empire, out of sheer absent-mindedness. Full membership would have involved sterling's participation in the semi-fixed exchange rate system known as the 'exchange rate mechanism'. A powerful and vocal lobby in favour was forming. The Government could easily have agreed that the EMS was a 'good idea' and that 'something should be done'.

The process was obstructed by a sceptical verdict on the EMS in the Treasury and Civil Service Committee's latest report. But the debate is not over yet. The Confederation of British Industry and influential groups of economists, notably the London Business School, have recently declared their support for membership. Their enthusiasm can be seen as a response to disillusionment with the Medium-Term Financial Strategy. The MTFS has, in fact, been gradually de-emphasized for some time. It is far from clear that this was intended or desired by Nigel Lawson and the Treasury. Nevertheless, the result of a sequence of policy announcements, each quite minor, is that no one takes the MTFS at face value any longer.

The first stage in the process was the proposal of a target for M0, a narrow money measure, in the 1983 Mansion House speech. The City regarded the new aggregate as an upstart and maintained its allegiance to sterling M3. In the 1985 Mansion House speech Lawson completed the usurpation, saying the sterling M3 target would be suspended until the next Budget. While monetary targets have been side-stepped, the fiscal arithmetic has been conducted more casually. The 1985 Budget speech suggested that the precise mix of monetary and fiscal targets should no longer be regarded as 'sacrosanct'. This was directly contrary to the analytical basis of the MTFS, in which gradual reductions in the public sector borrowing requirement were seen as an essential support to the targeted deceleration in money supply growth.

The most recent blow to the MTFS was the admission in the Autumn Statement last week that the Government's targets for spending, taxation and borrowing in both 1985/86 and 1986/87 would not be achieved. If a medium-term financial strategy is not to impose some sort of discipline on finances in the medium term, it is difficult to see what purpose it serves.

It is against this background of doubt about the MTFS that the case for joining the EMS has become persuasive. Two years ago the Government's sound-money supporters were, almost to a man, absolutely loyal to money supply and PSBR targets, and regarded EMS membership as a third or fourth-best option. Today many of them think that the MTFS has been so thoroughly compromised that an exchange rate target would be preferable. Their change of attitude should not be interpreted as a softening on inflation control. It cannot be emphasized too strongly that, by establishing a tie between the pound and the Deutschmark, Britain would be obliged to bring its inflation rate into line with West Germany's.

That would prove hard work after the slippage on financial control of recent years. It is ironic that 'wet' critics of the Government should advocate EMS entry as an alternative to the rigours of the MTFS. They do not seem to understand that a Deutschmark-dominated exchange rate system could prove much more financially rigorous than a Treasury-determined monetary strategy. In any British Cabinet, spending ministers heavily outnumber Treasury ministers. The consequence is that spending and borrowing have a persistent tendency to run ahead of target. The corrective is a financial crisis which for a period (not usually very long and never before a general election) forces the Prime Minister to give the Chancellor of the Exchequer wholehearted support. The Chancellor is then all-powerful. He can cut spending, reduce borrowing and restore the nation's finances to order.

For a generation and more Britain had an exchange rate target. The benign and necessary financial crisis took the form of a run on sterling which threatened the rate against the dollar ($2.80 until 1967; $2.40 afterwards). This check was removed by the decision to float the pound in 1972. Four years of economic anarchy followed, including the highest inflation rate and balance-of-payments deficit in our peacetime history. A new system of control, organized around money supply and PSBR targets, began in 1976 under IMF guidance. It reached its apogee in the early years of the MTFS in 1982 and 1983, when it succeeded in curbing inflation to 5 per cent. But Lawson, perhaps unintentionally, has let it fall into disrepair. Britain looks as if it might once again adopt an exchange rate target, now focused on Europe rather than the US.

None of this is to be understood as a recommendation for EMS membership. It is only a description of an apparently predestined cycle of economic management and mismanagement. If Britain were governed by logic rather than by whim, there could hardly be a sillier time to join the EMS than now, when oil prices are liable to fall sharply any day and hit sterling hard on the foreign exchanges.

A Forecast of a Lawson 'Mini-Boom'

From an article 'Why Lawson must repent' in The Times *of 9 January 1986.*

Like its predecessor, 'Is Lawson heading for another Barber bubble?' of 17 October 1985, this article is self-explanatory.

As Treasury ministers and officials meet at Chevening this weekend to discuss Budget strategy, their main problem is less economic than moral. They must decide whether, having sinned, they should enjoy it or repent.

There can be no doubt that, according to the strict canon of the monetarist creed to which they were once so committed, they have sinned. In the year to December sterling M3 rose by 15 per cent, far ahead of the top end of the Government's original target of 5 to 9 per cent growth. In his Mansion House speech last October Nigel Lawson reacted to the overshoot by suspending the sterling M3 target band, claiming that this measure of the money stock gave a misleading guide to monetary conditions.

Every day more evidence becomes available that the rapid growth of sterling M3 is not misleading, but is having standard and predictable effects on economic behaviour. Most obviously, cash-rich companies are using their spare bank deposits, which are included in and bloat sterling M3, to expand by acquisition rather than organically. If sterling M3 were under proper control, they would not have such a high level of bank deposits and could not so easily embark on expensive takeover struggles. Meanwhile, if surplus cash in the corporate sector is financing takeovers and so driving up share prices, surplus cash in the personal sector is starting to affect house prices. When people have more money in the bank than they need, they transfer it to building societies, which lend it out for mortgages. A substantial increase in mortgage lending tends to raise property prices. In 1985 house prices went up by about 10 per cent, much above the general inflation rate. Most of the increase was in the second half of the year as a strong upturn in the volume of mortgage lending gathered pace. The process has further to go: at the end of November the building societies' outstanding commitments to lend stood at £6.2 billion, an all-time record and 30 per cent higher than a year earlier.

As with so many government misdemeanours, the initial results of excess monetary growth are pleasurable. High takeover activity and buoyant house prices are classic symptoms of an economy in the early stages of a cyclical upswing and contradict the large number of forecasts that the economy will expand more slowly in 1986 than in 1985. Already the employment situation is improving in sympathy with a better outlook for demand and output. Unemployment fell in each of the three months to November, despite continuing growth in the number of people of working age, while the latest survey by the Institute of Directors indicates that more companies are considering new recruitment in the first half of 1986 than for many years. Lawson and his colleagues must welcome the short-term employment gains from their monetary trespasses more than they fear the long-term inflation dangers. After all, if higher inflation comes after the next general election, it is politically harmless.

The remoteness of the inflation risk is perhaps the major argument for enjoying the monetary overshoot fully and shamelessly. Indeed, a case could be made that these inflation risks – even after the usual 18-month to three-year lag – should not be all that great. At present the economy can plausibly be said to have 'too much money chasing too few assets'. But it is nonsense, while unemployment remains above three million, industry has abundant spare capacity and there is scope to increase output, to say that 'too much money is chasing too few goods'.

There is a chance that the monetary excesses of 1985 and early 1986 will, in the end, impact only on output and employment, and not at all on price levels. If that turns out to be right, they could be regarded as wholly benign, giving a phase of unsustainable demand stimulus similar to that urged on the Chancellor by his Keynesian critics years ago. Ironically, the stimulus would have been in the monetary form he once deplored instead of the fiscal variety they advocated.

But is a mini-boom based on fast credit and money growth what Lawson said he would achieve? Was not his principal policy objective in his first Mansion House speech in 1983 the attainment of price stability? Have not both he and Mrs Thatcher subsequently and frequently said that further reductions in inflation remain their foremost economic goal? If Lawson wants to restore credibility to his old statements, he must not boast about the mini-boom, but apologize and repent. He has to bring back the Medium-Term Financial Strategy in all its former glory. In policy terms, that would have two main implications.

First, he has to reintroduce a target for broad money. Sterling M3 has several drawbacks, but so do the alternatives, and it has the important virtue that the financial markets are familiar with it. In fact, in the Mansion House speech Lawson did say that a target for broad money would be announced in the Budget. It is realistic to expect some sign of penitence in this area. Yesterday's 1 per cent increase in base rates could be regarded as an earnest of good intent. Secondly, he has to re-emphasize that fiscal policy will support monetary restraint. In the 1985 Budget he flirted with the idea of changing the mix between fiscal and monetary policies. Some observers have interpreted this, understandably enough, as a shift towards 'Reaganomics', with an increased budget deficit supposed to be boosting demand and high interest rates protecting the exchange rate.

It is far from clear that any such shift was either intended or achieved. But the ambiguity of Lawson's statements has led to much confusion in market thinking, with no one really sure whether he is more concerned about the exchange rate or domestic monetary trends in interest rate decisions. Even worse, there has been an erosion of confidence as the apparently more pragmatic view on public sector borrowing has been accompanied by asset sales and falling oil prices. Critics have remarked that, without the receipts from asset sales, the public sector borrowing requirement in 1986/87 would be £4¾ billion higher than the £7 billion envisaged in the Government's economic forecast. Some asset sales were always part of official plans, but not on the present scale, and to return to the spirit of the original medium-term strategy it would be necessary to reduce the PSBR to about £5 billion.

No one outside the Whitehall machine expects that, as it would limit the scope for tax cuts too severely. But some brave soul at Chevening – perhaps John MacGregor, the new Chief Secretary – might suggest that a gesture towards fiscal probity would be appropriate, with the PSBR down to, say, £6 billion. The viability of the lower figure in practice would depend as much on the Organization of Petroleum Exporting Countries' (OPEC) ability to hold the current level of oil prices as on anything the British Government can do.

But at present the Treasury's worst impieties are monetary, not fiscal. A firm, clear-cut decision to reinstate a broad money target and to stick to it would be more fundamental than the most inspired guess about how much room a fall in oil prices will leave for tax cuts.

Broad Money vs Narrow Money

From an article 'Time to take a broader view of money' in The Financial Times *of 16 April 1986.*

An important influence on economic policy-making during the Lawson boom was the Group of Outside Economic Advisers (GOEA). It met over dinner at No. 11 Downing Street every few months, with the Chancellor of the Exchequer in attendance. The central debate within the GOEA was between advocates of British membership of the ERM (led by Mr Samuel Brittan) and supporters of narrow money targets (led by Professor Patrick Minford). No one in the GOEA favoured broad money targets or regarded the rapid growth of broad money as likely to cause rising inflation. The meetings of the GOEA were confidential, but it has become known who was saying what and why. (In view of its inglorious record and despite its considerable contemporary influence, the GOEA may not be mentioned in the history books. It should be. It demonstrates only too clearly that important policy debates should be conducted by means of written statements open to public scrutiny, preferably under parliamentary auspices. No wonder policy blunders were made during the Lawson boom if the Chancellor formed his views on the basis of casual, off-the-record remarks delivered over port and brandy.)

In early 1986 I had no idea that the GOEA was in existence, but I was well aware that the Government was listening to Minford and paying attention to his views on narrow money. I therefore wrote an article on the relative virtues of broad and narrow money ahead of a speech by Lawson to the Lombard Association in the City of London.

The Battle of the Aggregates has been one of the most hard-fought intellectual struggles in the Government's long anti-inflationary campaign. Its objective has been to determine which measure of money is most suitable as a target for monetary policy. In his speech to the Lombard Association tonight Mr Nigel Lawson, the Chancellor, will give an official verdict on the latest tussles between the two sides.

The supporters of broad aggregates have normally favoured sterling M3, which includes all bank deposits as well as notes and coin. For much of the period since 1976 (when monetary targets were first introduced) sterling M3 was in virtually total command of the battlefield. However, its hegemony was undermined in 1981 and 1982 when several commentators urged that narrow money, as measured by either M1 or M0, had a more reliable relationship with national income. (M1 includes sight deposits and notes and coin; M0 only notes and coin.)

Their views were reflected in official statements, particularly after Mr Lawson became Chancellor, and the Government began to stress that M0 and sterling M3 played an equal role in determining interest rates. It appeared that sterling M3 was in headlong retreat and would soon be judged unfit for combat. However, the M0 camp has also recently suffered an embarrassing reverse. At the end of last year some of its adherents tried to use M0 for forecasting purposes. Most notably, Professor Patrick Minford of Liverpool University claimed in a Centre for Policy Studies publication in December that, as M0 had grown at a 'miserable' $1^1/_2$ per cent over the previous six months, 'we now have the tightest monetary policy we have ever had'. He warned that 'a stalling in the growth rate' was 'increasingly likely' unless immediate action was taken to reduce interest rates.

In fact, interest rates were raised slightly in the first quarter of 1986, but there is almost no sign of the slowdown Professor Minford predicted. The most telling counter-evidence is the buoyancy of the housing market and the resilience, at high levels, of retail sales and car registrations. Indeed, in January new orders for private residential construction – widely recognized to be a good lead indicator for the economy as a whole – were stronger than for three years.

But it would be unfair, in a criticism of M0, to concentrate on one particular forecasting error. The failure of prognosis here is the result of a more general drawback of all narrow money aggregates. Narrow money – in either its M0 or M1 versions – does not determine important economic variables, such as prices and output, but is determined by them; it follows rather than leads the economy. The reason for this subordinate role is easy to explain. Consider the behaviour of an average individual with a bank or building society deposit. Every week or fortnight he draws some cash from his deposit to suit the flow of his minor transactions. The amount of cash he has adjusts to the value of his transactions, not the other way around.

More generally, M0 – which, to repeat, consists only of cash – is determined by what is happening in the economy now; it does not determine what will happen to the economy in future. To use M0 as a predictive tool indicates a rather serious misunderstanding of how money interacts with the economy. For this to be valid, ICI would have to base its investment plans on fluctuations in its petty cash tills and Prudential Assurance would have to alter asset allocations in accordance with the value of the notes held by its staff canteen and sports club.

The recent behaviour of sterling M3, unlike that of M0, has given many useful clues to the economy. When the Government abandoned overfunding last summer, the growth rate of broad money accelerated. As is usually the case in the early stages of any monetary upswing, most of the extra bank deposits were held by companies and financial institutions, not by the personal sector. In fact, companies and financial institutions had more bank deposits than they needed and have been trying hard to get rid of their excess liquidity. In particular, they have been buying financial assets with great enthusiasm. The takeover boom, and the 20 per cent surge in share prices in the first quarter, can be interpreted as the direct consequence of the recent misbehaviour of sterling M3.

In the Budget speech Mr Lawson sanctioned a target range for sterling M3 of 11 to 15 per cent in the 1986/87 financial year, after a 12-month period in which it had increased by 16½ per cent. It may take another year to 18 months before such fast monetary growth is reflected in higher inflation in terms of goods and services, but it has already been reflected in higher inflation in terms of asset prices. If he is to show himself a prudent monetary general, Mr Lawson should concede some ground to sterling M3 in his speech tonight. If he instead tries to end the Battle of the Aggregates once and for all by relegating sterling M3 from target status, he will find that its supporters in the City can put up a staunch defence.