Introduction

The purpose of this collection of articles and papers is to add insights to the analysis of British economic policy in a particularly interesting period. Between the mid-1970s and the late 1980s the main theme of British macroeconomic management was the attempt to establish an efficient framework of monetary control. For much of the period this framework was provided by a target for the growth of the money supply (broadly defined, to include bank deposits). The rationale was simple: if excessive monetary growth caused inflation, targeted reductions in the rate of monetary growth would stop it.

The ideas behind the policy framework were known in public debate as 'monetarism'. The usage has become so standard that it cannot be shaken off. But there is no precise connection between policy in Britain and the theoretical proposals of the 'monetarism' associated with certain universities in the American Mid-West, particularly the University of Chicago. Academic Chicago monetarism places heavy emphasis on the advantages of monetary base control, a technique of money market management never embraced by British policy-makers, while it ignores aspects of policy formation which they saw as crucial. Two aspects of the British approach deserve special mention; first, the discouragement of bank lending as part of a larger exercise in monetary restraint and, secondly, the integration of decisions on fiscal policy with those on monetary policy. In view of the differences, it seems best to call policy developments in Britain 'British monetarism'. (The distinction is developed in some detail in the paper 'Keynes, British monetarism and American monetarism', on pp. 209–34. It was initially also broached in two articles in *The Times* in 1975, 'Price stability and the "natural" level of unemployment' and 'Making headway through the gentle therapy of British monetarism', reprinted here as 'Gradual monetary deceleration – a theme in British monetarism' on pp. 24–7 and 27–30.)

Our story falls easily into two parts – the rise of British monetarism from the mid-1970s to 1985 and its fall from 1985 onwards. My position in this story, and the background to the pieces collected here, is best explained if I give some autobiographical details. I first became interested in the relationship between monetary growth and inflation while I was working on the economics staff of *The Times* between 1973 and 1976, where I was strongly influenced by the Economics Editor, Mr Peter Jay. Mr Jay had warned in 1972 and early 1973 that the rapid monetary growth then being recorded would inevitably cause a sharp increase in inflation. He was an articulate and effective critic of the reflationary policies being pursued by the Conservative Chancellor of the Exchequer, Mr Anthony (later Lord) Barber. Having just done a degree in Modern History and Economics at Oxford University (where monetary economics was not emphasized), I was a little puzzled by his forecasts of doom and disaster. But he was right. In late 1975 inflation exceeded 25 per cent, remarkably similar to the peak rate of monetary growth three years earlier.

I became persuaded that monetary mismanagement was the root cause of the instability and high inflation from which the British economy suffered, and started to write articles urging the adoption of a more stable monetary framework. Although I moved from Fleet Street to the City in 1976, where I worked as an economist at the stockbroking firm, L. Messel & Co., I continued to write for the financial press, particularly *The Times*. (I would not want to give the impression that I learnt all my macroeconomics while I was a journalist and stockbroker. I was helped by having read, and tried to understand, such classics as Keynes's *General Theory*, Hicks's *Value and Capital* and Patinkin's *Money, Interest and Prices* both before and while I was at Oxford.)

Since exchange rates were floating in the mid-1970s, monetary policy could be sensibly quantified and formulated only in terms of domestic monetary variables, either interest rates or a money supply target. But the precise meaning of any particular nominal interest rate was difficult to interpret, mainly because of the ambiguity of inflation expectations. So the best approach seemed to me to reduce monetary growth steadily over time in order to combat inflation, while minimizing fluctuations around the monetary growth path so that the economy would avoid sharp cyclical swings in business activity. (The first two pieces, from *The Times* of 2 July 1975 and 19 January 1976, give some of the reasoning for the agenda.) These policies, which were being advocated by a number of other people, including Mr Jay and Mr Samuel Brittan of the *Financial Times*, were known in public debate as 'monetarism'. So I became a 'monetarist'. I did so without initially thinking much about what it meant, although I was well aware that I was only reflecting a general trend.

I was not alone in being uncertain about the precise meaning of 'monetarism'. Mr (later Sir) Alfred Sherman, the Director of Studies at the Centre for Policy Studies, who had liked an article I wrote about Keynes in *Encounter* (reprinted here, 'Are we really all Keynesians now?', pp. 197–209), asked me to write a pamphlet for the Centre defining the term. This appeared in

1978 as *Monetarism: an Essay in Definition*. Since the Centre was closely associated with Sir Keith (later Lord) Joseph and Mrs Margaret Thatcher, I found myself involved in the debate about economic policy in the Conservative Party. As a strong advocate of the policies described in this book as 'British monetarism', I was also inevitably described as a 'Thatcherite'. But I had no direct involvement in policy-making while Mrs Thatcher was Prime Minister.

Nevertheless, my views about monetary policy were sought by Sir Geoffrey Howe when he was Chancellor of the Exchequer between 1979 and 1983. From time to time he convened a 'brains trust' of economists outside the official machine who were sympathetic to the Government's agenda. I participated in these occasions several times and was present at the key meeting in the Treasury on 5 October 1979 when the idea of the Medium-Term Financial Strategy (MTFS) was discussed. (The material reprinted here from the June 1979 issue of L. Messel & Co.'s *Financial Analysis* (see pp. 55–65) was one of the position papers for the meeting.) Sir Geoffrey Howe proved to be a most successful Chancellor. Because he persevered with a rigorous anti-inflationary financial framework even when the overwhelming majority of press comment was hostile, he achieved the largest fall in Britain's underlying inflation rate in peacetime. In late 1975, when monetarism as an intellectual force was just emerging, Britain's inflation rate was above 25 per cent; by following a deliberate programme of monetary restraint, Sir Geoffrey Howe reduced it to under 5 per cent in 1983.

Unhappily, Sir Geoffrey Howe's successor, Mr Nigel Lawson, has a less glorious part in our story. For a variety of reasons he decided to abandon broad money targets in 1985. I was also dropped from my previous informal advisory role and was given to understand that the new Chancellor was no longer much interested in monetarism or any of its affiliated ideas. The abandonment of targets was soon followed by an acceleration in broad money growth. Because of the slack in the economy at that time and the long lag between money supply growth and rising prices, there was no immediate anxiety about inflation. But I was worried that, if broad money growth remained indefinitely above 15 per cent a year, the economy would enter an unsustainable boom and eventually inflation would take off. I expressed my concern in weekly commentaries for L. Messel & Co. and in a sequence of articles in *The Times*. This sequence of articles (of which nine are reprinted here) gave the Government ample warning, far ahead of the event, that it was heading for big trouble with inflation.

The first of these pieces ('Is Lawson heading for another Barber bubble?', 17 October 1985) tried hard to be fair to Mr Lawson, and I paid tribute to 'the seriousness of his commitment and the depth of his understanding'. I could not believe that the Conservative Party and British economists had learnt nothing from the experiences of the previous 15 years and, in particular, from the Barber boom of the early 1970s. But I was too charitable. It became clear in 1986 and 1987 that Mr Lawson was going to repeat Barber's mistakes. Of course, the Lawson boom was not identical to the Barber boom, but there were several remarkable (and depressing) similarities. Rapid growth in credit and the money supply stimulated a sharp upturn in private expenditure, particularly on housing, consumer durables and office construction. Whereas in the early 1980s I had been one of the few loyal supporters of the Thatcher Government's economic policies, I became in 1986 and 1987 a lonely critic. With hardly any exceptions, the policy-making establishment in the Treasury and the Bank of England, British academic economists and City editors in the newspapers approved of Mr Lawson's expansionist policies.

I was described as 'the City's last monetarist'. This was an exaggeration, because it overlooked a small band of other City economists with similar views. But it served as a pointer to where I stood. In 1987 my research team at L. Messel & Co. forecast that inflation would move up to the 8 to 10 per cent level and stay there for some time. It also said that, if the credit boom was to be broken, base rates (9 per cent at the time) would have to increase to 12 per cent and remain there for at least six months. Both these forecasts were dismissed by mainstream British economists as pessimistic to the point of eccentricity, even laughable. (What about the 'small band of other City economists with similar views'? Mr David Smith of the brokers, Williams de Broe, and Mr Paul Turnbull and Mr Roger Nightingale, both of Smith New Court, were certainly worried about excessive monetary growth. Professor Gordon Pepper, then of Midland Montagu, gave warnings from mid-1987 onwards. I should also mention my close colleague at L. Messel & Co. and Shearson Lehman, Dr Peter Warburton, who shared my views and helped me to develop them. L. Messel & Co. was taken over by Shearson Lehman in 1987 and I was Shearson's chief London economist for a short period. Finally, I must make an obvious tribute. The articles I wrote in *The Times* between 1985 and 1988 about the Lawson boom echoed, very self-consciously, the articles Mr Jay wrote in *The Times* between 1972 and 1974 about the Barber boom. There was nothing particularly original in giving warnings about 'booms that must go bust'.)

Everyone involved in the debates of the 1980s will agree that they were difficult. Many observers may want to shrug their shoulders and say that the differences will never be resolved. They will argue that no completely objective appraisal of economic policy is possible, certainly not so soon after the event. I find this agnosticism strange and unacceptable. In my view there is little doubt that monetarism was responsible for Britain's financial rehabilitation in the ten years from 1976, when money supply targets were first introduced, to 1985, when they were abandoned. (Three articles reprinted here – 'Winning the economic war' from *The Spectator* of 29 May 1982, 'Following Friedman' from *The Spectator* of 28 May 1983 and 'Alternatives galore, but none of them better' from *The Times* of 28 September 1985 – were written when monetarism appeared to have won the argument.) There is also little doubt, I believe, that the abandonment of money supply targets in 1985 was responsible for the change from the relative macroeconomic stability and falling inflation of the 1981–86 period to the macroeconomic upheavals and rising inflation of the 1986–91 period. For that reason the abandonment of money supply targets was a dreadful mistake. This may be the most controversial message of the book.

The articles and papers collected here were written at different times, for different audiences and at different levels of technical difficulty. I hope that the story running through them is nevertheless consecutive and easy to follow. An attempt has been made to ease the exposition by prefacing all the pieces with a short comment. Many of them were written at great speed, often to a newspaper deadline in only two or three hours, and this shows in some cases. I have therefore felt free to carry out extensive editorial changes, although without altering the original sense. There is in fact only one piece ('Monetarism and the budget deficit', on pp. 38–49) where I would now want to change the substance of the argument radically. But I have left it much as it was, partly because of its role in the development of the MTFS and partly because it could be seen as a rough draft for the more satisfactory paper on 'The analytical foundations of the Medium-Term Financial Strategy', published in *Fiscal Studies* in 1984, which is reprinted on pp. 65–77.

I hope that the collection will be read by academic economists and policy-makers. None of the pieces are technically complicated and the whole book should be easy for any interested layman to follow. Indeed, I expect that many non-economists will be puzzled and dismayed by the story that the book tells.

The last 20 years have seen three boom–bust cycles – the Barber boom of 1972 and 1973, followed by the recession of 1974 and 1975; a period of above-trend growth in 1978 and 1979 (which might be called 'the Healey boomlet', after Mr Denis Healey, the Chancellor of the Exchequer at the time), followed by the manufacturing slump of 1980 and 1981; and the Lawson boom of mid-1986 to mid-1988, followed by the recession of 1990 and 1991. Each of these cycles has been accompanied by great disturbance to business and industry. The false optimism of the boom has given way to the disappointment of expectations in the recession. Speculative fortunes have been made and lost, people have been recruited unwisely and then sacked for no good reason, bad businesses have been established on invalid assumptions about continuing boom, and good businesses have been closed down on equally invalid assumptions about never-ending recession. In short, there has been immense and unnecessary waste. Indeed, it is not going too far to say that the lives of many decent, hard-working people have been ruined by Britain's macroeconomic volatility.

All of the cycles were associated with – and, in my view, mainly caused by – large swings in monetary growth. If policy-makers had over the whole 20-year period concentrated on stabilizing monetary growth at a low rate, the cycles would have been smaller and less harmful, and inflation would have been lower. Of course, this claim cannot be proved beyond contradiction. Perhaps fortunately, laboratory experiments are not possible in economics. But an unfavourable comparison with Germany, also a middle-ranking European industrial nation, is easy to draw. There the Bundesbank has concentrated since the early 1970s on stabilizing monetary growth at a low rate, and business cycles have certainly been smaller and less harmful, and inflation consistently lower, than in Britain.

The questions arise, 'why were so many blunders made?' and 'how could successive governments have been so foolish?'. One answer is to pin the blame on politicians, particularly on three Chancellors of the Exchequer: Barber, Healey and Lawson. But I believe that is a mistake. Politicians are far less important than they like to think. Their decisions rarely come from their own intuitions or judgement, but are taken on the basis of advice from a wide range of sources. This pattern of advice depends, in turn, on a climate of informed opinion which is strongly influenced by the consensus of academic views, particularly (in Britain) by academic views from Oxford and Cambridge. If we want to understand why Britain has had three destructive boom–bust cycles in a 20-year period, it is to this climate of informed opinion and this consensus of academic views that we must look.

The root of the problem is that the majority of British academic economists do not believe that the behaviour of the money supply is relevant to macroeconomic outcomes. They also pay little attention to other monetary variables, such as bank credit to the private sector, and sometimes argue that interest rates are of only marginal importance for decisions to save and invest. How – the puzzled layman might ask – can they hold these views, which have been so thoroughly refuted by the events of the last 20 years? The standard answer of the British academic economist is 'I am a Keynesian', as if – by invoking the name of the greatest economist of the 20th century – he exonerates himself from having to think about such painful topics as credit, the money supply and interest rates.

The third part of the book therefore considers the relationship between Keynes and monetarism. The subject turns out to be complicated and controversial, but one point is clear. This is that Keynes was fascinated, throughout his career, by the interrelationships between monetary and real variables, and saw the behaviour of credit and money as fundamental to macroeconomic outcomes. The attitude of most British economists towards credit and money then becomes even more of an enigma. I used the opportunity of an inaugural lecture at Cardiff Business School (where I became an honorary professor in 1990) to explore this enigma. (The lecture is reprinted on pp. 234–55).

The argument of the lecture is that for most of the 19th and early 20th centuries leaders of informed opinion thought that the ideal monetary policy for Britain should be specified in terms of the sterling price of gold or, in other words, the exchange rate; not in terms of quantities of credit or money. Although the emphasis moved away from gold after the Second World War, Britain participated in the Bretton Woods system of fixed exchange rates and monetary policy remained focused on the exchange rate. Hence, there was no compelling need for British economists to consider the domestic aspects of monetary policy. Ironically, Keynes himself had always favoured a 'managed currency' in which these domestic aspects would have been paramount. (That was the key point of his early essay *A Tract on Monetary Reform* and explains his lifelong antagonism towards gold.)

The neglect of monetary economics can also be blamed on the long period – from 1939 to the mid-1950s – when much of the British economy was subject to direct controls of one sort or another. Extensive controls originated in the War, but they were retained far longer than strictly necessary for military purposes. In fact, a large number of influential intellectuals on the left of British politics wanted them to be retained indefinitely after the War, as a way of building socialism. In a planned economy of the type they favoured, monetary policy would have been of little importance in macroeconomic management and interest rates would have been otiose in the allocation of resources.

The denigration of monetary economics can therefore be attributed, at least in part, to the impact of such socialist thinkers as G. D. H. Cole, R. H. Tawney and the Webbs on a generation of British economists. Roughly, this was the generation educated between 1940 and 1965, who were most active in teaching and policy advice in the 1970s and 1980s. If the conjecture seems far-fetched, I would direct the reader to p. 245, which mentions an important book on *The Labour Government's Economic Record: 1964–70*. This book, published in 1972 with contributions predominantly from Oxbridge economists, had only one index reference to 'the money supply', but no less than 41 to the National Plan and 'planning'. Is it an accident, in view of the declared interests and attitudes of these influential British economists at the start of the Barber boom, that the 20 years after 1972 were to see gross monetary mismanagement?

There is no point being mealy-mouthed about this subject. The great majority of British academic economists have no time for either monetarism narrowly understood, or for monetary economics as a whole. They sometimes deny the relevance or meaningfulness of monetary policy in any shape or form whatsoever. It is hardly surprising, therefore, that the academic economics profession should have been appalled by the Thatcher Government's commitment to monetary control in its early years. In 1981 two Cambridge economists were able to assemble 364 signatures from academic economists to protest, in a letter to *The Times*, against the allegedly 'monetarist' Budget of that year. The letter claimed that the Government's policies would 'deepen the depression...and threaten' Britain's 'social and political stability'.

The 364 economists were wrong, but that does not mean their letter was unimportant. As I said in the Cardiff lecture, the letter 'accurately reflected the overwhelming consensus of British academic opinion. Whenever officials from the Treasury or the Bank of England took part in academic conferences, both in these years [i.e., the early 1980s] and later, they were subjected to a barrage of scorn for obeying their political masters and implementing money supply targets'. As money supply targets encountered various technical and measurement difficulties, these officials became thoroughly weary of the whole subject. They were delighted that Mr Lawson agreed to scrap them in 1985. When the monetary excesses of 1986, 1987 and 1988 followed, neither the academic economics profession nor the official advisers close to the Government were prepared to ring the alarm bells about future inflation. Moreover, most of them were not at all sorry about the increase in inflation which occurred in 1989 and 1990. On the contrary, it is a fair guess that a good 90 per cent of the 364 were jubilant that rising inflation ruined the reputation of Mrs Thatcher and her Government for basic managerial competence in economic policy. In this sense the Lawson boom was the revenge of the 364.

The larger message of my lecture was therefore that the macroeconomic volatility of the 1970s and 1980s was due to 'British economists' lack of recognition of how credit and money affect demand, output, employment and inflation' or, in a phrase, to 'a great vacuum in intellectual understanding'. The consequent indictment of 'an entire profession, the profession of academic economists in this country' was not meant in fun, but as a serious comment on a tragic national failure.

The non-academic reader may wonder precisely what has happened to British macroeconomics over the last 50 years. After all, Keynes's *General Theory*, published in 1936, is undoubtedly one of the greatest contributions to macroeconomic understanding this century. How could its endowment to British economics have been so thoroughly squandered? It seems to me that the *General Theory* should be seen, as the inaugural lecture says, as 'both the climax and the terminus of the 19th-century tradition of trade cycle theorizing, in which credit and money had been so important'. Such great economists as Henry Thornton, John Stuart Mill, Bagehot and Alfred Marshall, and Keynes's contemporaries, Dennis Robertson and Ralph Hawtrey, belonged to the tradition, and it was surely the dominant strand of British monetary thought until (say) 1950. May I suggest that the pieces brought together here are a small attempt to rescue some of its key ideas? If so, they are not really monetarist at all. Perhaps it is a pity that they will, inevitably, receive the 'monetarist' label.

Two period pieces complete this collection. They do not fit neatly into the chronology of the story, but are included because they introduced themes which were important at various times in the public debate about economic policy.

Because this collection brings together work over a period of more than 15 years, I will not be able to acknowledge everyone who has helped or influenced me. My first debt of gratitude (as will be clear from this Introduction) is to Mr Peter Jay, who offered me a position on the economics staff of *The Times* in 1973. I also owe a great deal to Lord Rees-Mogg, who, as Editor of *The Times* in the mid-1970s, took a close interest in my work and has subsequently helped me in several ways. Important influences have been Professor Charles Goodhart and Professor David Laidler, who (I feel) are two lonely representatives of the great tradition of British monetary economics; Sir Alan Walters and Professor Patrick Minford, but (as we shall see) my disagreements with them are profound; Sir Terence Burns and Sir Peter Middleton, with whom I had such fruitful discussions in the late 1970s, although I have not spoken to them so much recently; and Dr Walter Eltis, Mr David Gowland and Professor Douglas McWilliams, who have been an intellectual stimulus for over 20 years.

I have benefited from the friendship (and occasional rivalry) of many City economists and financial journalists. I would particularly like to mention two former colleagues, Mr Paul Turnbull and Dr Peter Warburton, and two former competitors, Mr Richard Coghlan and Professor Gordon Pepper. Lord Joseph has taken a close interest in my work since the mid-1970s and I much value his continuing support. It is not an accident that most of my pamphlets have been published by the Centre for Policy Studies. I am deeply grateful to Professor Christopher Green and Dr Kent Matthews, whom I met through the Money Study Group, for recommending that I be appointed to an honorary professorship at the Cardiff Business School.

I have a number of other thanks in connection with my work in the City, first to the other partners of L. Messel & Co., for (more or less) allowing me to proceed unhindered with my analysis and propaganda for such a long

time, and to the directors of Gerrard & National, for providing me with a new City home in the last three years. Mr Brian Williamson, the Chairman of Gerrard & National, has been particularly helpful. My colleagues at Lombard Street Research Ltd, Mr Jonathan Morris and Mr Simon Ward, have also been more easy-going than I deserve. I owe a special debt of thanks to my secretary, Miss Grace Graham, who has worked with me now for almost ten years. She has helped in the preparation of this book with her usual diligence and cheerfulness. Mr Gabriel Stein also gave invaluable help in the delicate task of transferring files between disks

I should emphasize that none of the above is responsible for any factual errors remaining in the book or necessarily agrees with the views expressed.

I am grateful to the various editors for permission to reprint these pieces again.

Last, but certainly not least, I must thank my wife, Dorianne, for her loyal support, tolerance and affection. The preparation of this book coincided with the arrival of our first child, Venetia, and – like my pamphlet, *For a Stable Pound*, last year – it is dedicated to Dorianne and Venetia.