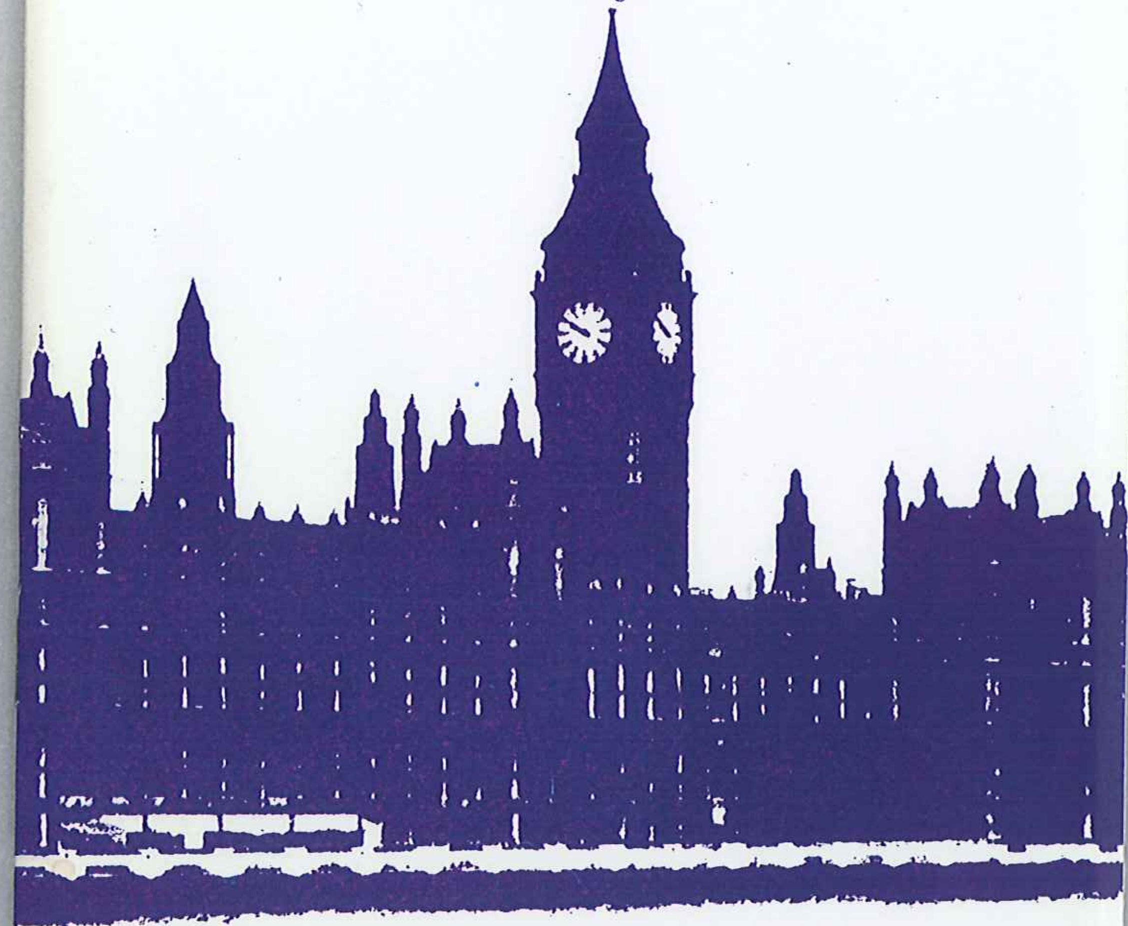
Policy Study No 106

Monetarism Lost

and why it must be regained

Tim Congdon



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The author

Tim Congdon is one of the City's leading economic commentators. As a journalist on *The Times* between 1973 and 1976, and as the economist at L. Messel & Co., the stockbrokers between 1976 and 1987 (and, briefly, as Chief UK Economist at Shearson Lehman Hutton), he established a reputation for economic research which explored the relationships between financial variables, security prices and the economy. He was a strong supporter of the monetarist policies pursued in the early years of Mrs Thatcher's Government. More recently, he and his colleagues at Messel and Shearson Lehman were uniquely successful in forecasting the boom of 1987 and 1988 and in warning about the consequent rise in inflation. In 1978 the CPS published his first book, *Monetarism: An Essay in Definition*. Tim Congdon has recently been appointed Economic Adviser to Gerrard & National.

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1
The issue defined:
why was there another stop-go cycle in the mid-1980s?

BETWEEN MID-1986 AND MID-1988 THE BRITISH ECONOMY EXPERIENCED a full-scale boom. Over the two years national output rose by almost 10 per cent, much faster than could be sustained in the long term. Yet the rate of output growth, rapid though it was, understates the intensity of the boom. As the current account of the balance of payments moved from virtual balance in 1986 to a deficit of over 3 per cent of gross domestic product in 1988, domestic demand must have risen by about 3 per cent more than output.[1] Economists, particularly British economists, debate about many things, but no one believes that 13 per cent growth of domestic demand within two years is a sign of good macroeconomic management. Recognising this the Government took deliberate steps late in 1988 to restrain growth; and in 1989 the pace of expansion has duly slowed down. In effect, the years from 1986 to 1989 saw a stop-go cycle of a kind which had been all too familiar in the first three post-war decades.

The return of the stop-go cycle was a setback for the Thatcher Government. It had been elected in 1979 with an unusually explicit commitment to reduce inflation and to avoid the stop-go cycle. Its chosen method, about which it had been very articulate, was to reduce and stabilise the growth of the money supply. In view of the central role of monetary responsibility in Mrs. Thatcher's original agenda, the boom of mid-1986 to mid-1988 was a puzzling episode. Quite apart from the damage to business planning from the volatile behaviour of domestic expenditure and the balance of payments, the above-trend growth of these two years put excessive pressure on the nation's productive capacity and halted progress in reducing inflation. The question, 'why and how did the boom develop?', has to be asked.

This essay tries to provide an answer. At the level of technical economic analysis, its aim is to identify the main causes of the upturn in economic growth. Some surprise might be expressed that an exercise in identification is needed, since

economists are supposed to have a sound understanding of the reasons for business fluctuations. In most textbooks this understanding is embodied in the Keynesian income-expenditure model, with national income and expenditure determined as some multiple of exogenous components of demand* such as investment, government expenditure and exports. In fact, however, economists disagree strongly among themselves, even with the benefit of hindsight, about why growth is high in some years and low in others.

The argument of this essay is that the boom of the mid-1980s, like its many predecessors, is best seen as the result of changes in interest rates, credit expansion and monetary growth. The behaviour of monetary variables – not of some putatively 'exogenous', Keynesian demand components – is therefore regarded as critical.

Readers should be warned that the argument does not reflect any established professional consensus and may be described pejoratively by those who do not agree with it as 'extreme monetarist' or something of the kind. But, of course, the views expressed need to be judged on their own merits. They neither depend on a label for their validity, nor can they be refuted by mere name-calling.

A further task of explanation is to explore the motivations for, and thinking behind, the decisions which were taken. The key issue here is to find out why leading members of the Treasury team, including the Chancellor of the Exchequer, Mr. Lawson, seemed to change the emphasis of economic management – from the reduction of inflation to the promotion of economic growth, and from monetary control to a rather ill-defined pragmatism – at some point, difficult to define precisely, in 1984 or 1985. There are two main possibilities. The first is that the change of course was determined by electoral considerations, the Government being eager to foment a boom ahead of the 1987 general election; and the second is that policy-makers made a number of honest errors in analysis and judgement. As we shall see, the evidence is mostly against the political interpretation and suggests rather

* Exogenous components of demand are components of aggregate demand for a nation's output which are not themselves determined by the level of its output or income.

that honest errors were to blame.

The procedure of the essay will be to give a fairly continuous narrative of events, with occasional interruptions to consider key analytical issues. The narrative starts in the early 1970s, over a decade before the period of most direct concern. This historical approach reflects a belief that the evolution of policy is influenced by policy-makers' attitudes and beliefs, and that these attitudes and beliefs are in turn strongly conditioned by events which the policy-makers have experienced. A concluding chapter reflects on the 1986-89 cycle as a whole and puts forward some recommendations for avoiding stop-go cycles in future.

2
Before the boom

The economic policies of the early years of Mrs Thatcher's Government are best understood as a reaction to — indeed, a complete reversal of — the economic policies in the last two years of the Heath Government. Accordingly our first section starts with a short summary of the economic situation in 1972 and 1973, moves on to consider the rather confused state of both the economy and financial policy in the mid-1970s and, finally, shows how policy-makers began to clarify their thinking in the late 1970s. The second section describes the refinement of the so-called 'monetarist' system, which dominated policy-making between 1978 and 1982. The third and fourth sections consider how this system came to be undermined in the early 1980s, so that by the end of 1985 monetary targets exercised little influence on the major decisions.

Monetarism before 1979

In 1972 M3 (the broad measure of the money supply, which includes notes, coin and all bank deposits) grew by 27.2 per cent; in 1973, by 27.1 per cent. These rates of monetary expansion were extraordinarily high by all past British standards and had no precedent in peacetime. They were accompanied by fiscal reflation, with the public sector borrowing requirement soaring from £1.0b. (1.7 per cent of gross domestic product) in 1971/72 to £4.4b. (5.9 per cent of GDP) in 1973/74. Mr. Barber, the Chancellor of the Exchequer, regarded this increase in the budget deficit as an integral part of his 'dash for growth'. The combination of powerful monetary and fiscal stimuli led to rapid growth in demand and output, and helped to reduce unemployment. In relation to the Heath Government's priorities, the fall in unemployment was particularly welcome. The jobless total had exceeded the politically embarrassing figure of one million (on the 'headline' definition, including school-leavers, not seasonally adjusted) in early 1972, for the first time in the post-war period.

If, however, the high unemployment of early 1972 was politically embarrassing, the sequel to the falling unemployment

of late 1972 and 1973 proved electorally disastrous. The economy followed the familiar pattern of all previous cycles. Booming domestic demand attracted more imports and led to heavy deterioration in the balance of payments, while the drop in unemployment tightened the labour market and foreshadowed a marked increase in inflation. The Heath Government had relied on incomes policy, with specific legally-enforceable maxima for increases in pay and prices to keep inflation at bay. In late 1973 this policy was challenged by the coal-miners, who wanted a larger increase in pay than was permitted by the rules of the incomes policy. The subsequent confrontation between the Government and the National Union of Mineworkers developed into a debate about 'who governs Britain?'. Mr. Heath thought the issue could be resolved by an appeal to the electorate and called a general election for 28 February 1974. The Conservatives lost narrowly. A more clear-cut defeat in a further general election in October 1974 condemned them to five years in opposition.

These years were not the most glorious in British history or in the annals of the Conservative Party. The deficit on the current account of the balance of payments amounted to almost 4.5 per cent of GDP in 1974, the highest figure in the post- war period. The inflation rate, as measured by the twelve-month increase in the retail price index, reached 26.7 per cent in August 1975, again the highest in the post-war period. Not all the blame could be placed on the Labour Government, since it had clearly inherited a difficult financial position. Indeed the poor economic statistics of 1974 and 1975 were widely interpreted as a direct, if delayed, consequence of the monetary irresponsibility of 1972 and 1973.

In September 1974 Sir Keith Joseph issued a forthright intellectual challenge to Heathite economic policies in a speech at Preston. He argued:-

> when the money supply grows too quickly, inflation results. This has been known for centuries.

He went on to repudiate incomes policy as a method of controlling inflation and characterised much of the Conservatives' past electioneering as 'inflationeering'. Keith

Joseph's views remained of great importance both in 1979 when the Conservatives were re-elected and in the immediately succeeding years when they applied anti-inflationary monetary policies. The Preston speech is vital to understanding why the Government refused to reverse those policies in 1980 and 1981 despite a sharp rise in unemployment. *The Times*, whose editorial line was strongly influenced by its economics editor, Peter Jay, gave the speech extensive coverage and became a leading advocate of more stable monetary policies.

Sir Keith Joseph's Preston speech reflected a commonly-held view that Heath and Barber had bungled economic policy. His call for a return to sound money was made more convincing by the Conservatives' defeats in the two general elections of 1974, since these suggested that deliberate inflationeering was not always good electioneering. However, Keith Joseph's speeches did not constitute a detailed policy blueprint. The striking resemblance between the 27 per cent peak in M3 growth and the 27 per cent peak in inflation suggested that control over the M3 measure of the money supply should in future be the key to anti-inflation policy. But there was much more to say. There were worries about how money supply targets would fit into the existing policy structure, with its traditional focus on fiscal variables and the exchange rate. There were also uncertainties about the precise position of monetary targets and inflation control in the list of policy priorities.

The clarification of the monetarist agenda is often attributed to Mrs Thatcher's Government after its election in 1979. In fact, most of the uncertainties about the operation of money supply targets were resolved under the Labour Government of Mr Callaghan between 1976 and 1979. It was a Labour Chancellor of the Exchequer, Denis Healey, who said in his Budget speech of 6 April 1976:-

> it remains my aim that the growth of the money supply should not be allowed to fuel inflation as it did under my predecessor. To this end, I aim to see that the growth of the money supply is consistent with my plans for the growth of demand expressed in current prices.[1]

After this, the declaration of money supply targets could

hardly come as a great surprise. On 22 July 1976 Denis Healey announced to the House of Commons, as part of a more general statement on economic policy, that for the 1976/77 financial year as a whole, 'money supply growth should amount to about 12 per cent'. It was the first time a British government had quantified its financial objectives in such terms.

Monetary targets still had to be refined and tested before they could dominate policy making. The first trial came in 1977 when an abrupt change in foreign exchange sentiment made the pound, at least for a few months, the world's most popular currency. Sterling's rise made the Government anxious that British exports would lose their competitiveness in foreign markets. The Bank of England therefore intervened massively to check the currency's appreciation. While these operations boosted Britain's reserve of foreign exchange, they also increased the money supply. (In order to sell pounds on the foreign exchanges, the Government had to borrow them from the banks, which increased bank deposits, the main component of the money supply.) The foreign exchange intervention was on such a scale that the official money supply target for 1977/78 was breached by a wide margin. Debates developed about whether export competitiveness should have had precedence over the money supply target and whether the above-target monetary growth would cause inflation.

A second problem was that the Government had not repudiated the demand-management function traditionally assigned to fiscal policy. If he was so minded, the Chancellor could cut taxes in the Budget, widening the public sector deficit, and at the same time announce that the target rate of monetary growth was to be reduced. This was plainly inconsistent, since a large public sector borrowing requirement (or PSBR) tends to complicate the task of monetary control. (If the Government finances its deficit by bank borrowing, the money supply rises.) Money supply targets need to be supported, rather than undermined, by fiscal policy.

Denis Healey spelt out the official position on these two issues in his Mansion House speech of 19 October 1978. He rejected deliberate devaluation as a policy weapon, noting that:-

> hard experience confirms the findings of economic

research – that the price increases generated by a fall in the exchange rate are tending to feed through a good deal faster into rising labour costs than they used to. Depreciation can no longer be treated as a soft option.

Implicit here was the promotion of monetary targets and the demotion of export competitiveness in the list of official priorities. He also downgraded discretionary fiscal policy. Perhaps realising that tax cuts in the 1978 Budget had been inappropriately large, he said that the Government was 'determined to control the growth of public expenditure so that its fiscal policy is consistent with its monetary stance'.

This speech put money supply targets, expressed in terms of the broad money aggregate, sterling M3, at the centre of policy-making. In its frank recognition of the tensions between monetary targets and other aspects of policy, and its clear emphasis on the priority of the monetary targets, it was more important as a landmark in the development of monetarism than any comparable statement from Mrs Thatcher's Government. Indeed, when the Conservatives were elected to power in May 1979, hardly any changes were necessary to the framework of financial policy. To be sure, the Conservatives' first Budget, presented on 12 June 1979 by the new Chancellor, Sir Geoffrey Howe, included a radical shift from direct to indirect taxation. But the changes in monetary policy were marginal. The sterling M3 target for 1979/80 was set at growth of between 7 and 11 per cent, compared to a 1978/79 target of between 8 and 12 per cent and an outturn of 8.6 per cent, while the 1979/80 PSBR objective was £8.25b., compared to an outturn in 1978/79 of £9.2b. The structure and form of policy, with the focus on quantified limits to monetary growth and the PSBR, were identical to those in the last two-and-a-half years of Denis Healey's Chancellorship.

Perhaps the best way of summarising the change in the policy framework between the mid and late 1970s was that decisions came to be based on rules.The hope was that policy-makers could do better than make random responses to the pound's latest gyrations on the foreign exchanges. Forecasts from the Treasury's macro-economic forecast were also relegated

to a subordinate role in the policy-making process because of their failure to anticipate the inflationary sequel to the Heath-Barber policies. Considerable discretion was allowed about how the rules, embodied in the money-supply and PSBR targets, should be applied. But the rules still had to be respected. This deliberate cramping of economic policy reduced the Government's scope both for managing and for mismanaging the economy.

The monetarist system

The Thatcher Government's contribution to this trend was to emphasise that monetary and PSBR targets would be specified not just for the year to come, but would instead be tightened over a sequence of years. In this sense policy became more determined and doctrinaire. The 'medium-term financial strategy' announced in the 1980 Budget envisaged a steady and continuous reduction in the growth of money supply and the PSBR through the next four years. It is not going too far to see the strategy as the logical completion of the argument begun in Sir Keith Joseph's speeches of the mid-1970s. With the Government committed by its own policy statements to a smaller PSBR and lower monetary growth in 1983/4 than in 1980/1, fiscal and monetary reflation of the Heath-Barber kind was outlawed. Mrs. Thatcher's praise for 'good housekeeping' and manifesto rhetoric on the need for a sound currency reinforced the message that the Conservatives were more serious than Labour about tackling inflation.

But the technical aspects of monetary policy changed relatively little in the Thatcher Government's first two years. There was a definite continuity in policy approach from Denis Healey's Mansion House speech of October 1978 to Sir Geoffrey Howe's Budget of March 1982. At the time this approach was generally understood to be 'monetarist' and was criticised (or praised) as such in the media and in Parliament.[2] The Government's version of monetarism was outlined in key policy documents such as the 1980 Green Paper on *Monetary Control* and in a number of speeches from Treasury ministers, with Nigel Lawson, the Financial Secretary, making a particularly notable attempt to defend and explain it. At a press conference for Regional City Editors on 9 June 1980 he said:-

> The medium-term financial strategy is essentially a monetary – or, if you like, monetarist – strategy. We believe that in order to reduce the inflation rate on anything more than a strictly ephemeral basis it is necessary to reduce the rate of monetary growth. For this reason the centrepiece of the strategy is a medium-term monetary target, to which we are committed.

The monetarist system had four main parts. The first was that the money supply target, acknowledged as the linchpin of its economic policy, was expressed in terms of the broad money aggregate, sterling M3. The reason for this was partly historical. The very high growth rates of broad money in 1972 and 1973 had foreshadowed the very high inflation of 1974 and 1975, whereas the measures of 'narrow money' had been less alarming and less accurate as inflation predictors*. But another important consideration was that broad money was easy to relate to other dimensions of policy, including fiscal policy and exchange rate management.

The links between the different parts of policy were captured by the so-called 'credit counterparts identity', which relied on the arithmetical equivalence between the growth of banks' liabilities (dominated by deposits, which constituted most of broad money) and the growth of bank assets. When the Government borrowed from the banks, to finance either the PSBR or the accumulation of foreign exchange reserves, both banks' assets and deposits (and so broad money) expanded. Bank lending to the private sector had the same effect, since any addition to a bank's portfolio of loans implied a more or less identical addition to the deposits available to its customers. The credit counterparts identity was integral to broad money targetry, since it identified the causes of excessive (or deficient) money growth. If money growth was above target but bank lending to the private sector was low, the obvious culprit was instead the budget deficit, in which case the appropriate response was to raise taxes or trim public expenditure. If, on the other hand, the biggest contributor to money growth was official intervention in the foreign exchanges to keep the pound low, then the right answer was to let the pound float upwards. Broad money targets, in conjunction with the credit counterparts arithmetic, gave policy-makers an agenda and a continuous flow of signals about how to implement it.

Two other elements of the monetarist system were consequences of the first. These were that the pound should be free to float against other currencies and that fiscal policy should be subordinate to the monetary targets. As we have seen, it was these two crucial points which Denis Healey had accepted in his 1978 Mansion House speech. The floating pound implied the virtual absence of foreign exchange intervention, which enabled policy-makers to concentrate on their first priority of the money supply target. The subordination of fiscal policy showed that the Government had rejected the Keynesian fine-tuning of demand, which had in the past so often led to payments crises or rapid inflation.

There was a further justification for adjusting fiscal policy to monetary objectives. In the mid-1970s the Government's policy had tried to marry large employment-promoting budget deficits with restrictive inflation-beating money supply targets, but it had not been a happy union. Because the Government had to finance the budget deficit partly by borrowing from the banking system, the budget deficit constantly threatened to cause excessive growth of the money supply. One way to escape this was to push up interest rates, which encouraged long-term, non-bank investors to buy government debt and so avoid monetary financing of the deficit. But high interest rates deterred bank lending to companies and reduced private investment.

In effect, a large budget deficit – which gave the Government the resources for more public consumption – 'crowded-out' private investment. As Nigel Lawson argued in a speech to the Institute for Fiscal Studies on 23 March 1981:-

> given a particular rate of monetary growth, the

* Broad money includes notes, coin, all bank deposits and (on some definitions) building society deposits. Narrow money includes notes, coin and (on some definitions) a restricted range of deposits, mostly those available for making payments without notice. Notes and coin outstanding (i.e., M0, roughly) rose 12.4 per cent between December 1971 and December 1972, and 10.2 per cent between December 1972 and December 1973, figures which were similar to the rise in nominal GDP in 1972 and 1973, but gave no advance warning of the inflationary trauma of 1974 and 1975.

> fiscal stance has its main impact upon the distribution of demand rather than upon the level of domestic demand. In particular, as a result of the level of interest rates, a low deficit tends to favour investment rather than consumption, whereas a high deficit favours consumption rather than investment.

In this speech, and several others at the same time, Nigel Lawson displayed a sound understanding of the credit counterparts' arithmetic and its implications. For example, he saw that, given a fixed money supply, less public sector borrowing could be replaced by more bank lending to the private sector. He went on to ask 'is there any special merit in public sector borrowing?' and said 'I must confess I cannot see it'.

The final aspect of the monetarist system was that the Government actively marketed public sector debt, particularly gilt-edged securities, in order to achieve its broad money targets. Again, this part of the programme was implied by the credit counterparts' arithmetic. When private individuals or financial institutions write cheques to the Government to purchase gilts, they reduce their bank deposits. Hence, debt sales to the non-bank public could be adjusted to bring the money supply closer to target. In practice, variations in official gilt sales (known as 'funding') became a vital weapon in monetary targetry. They were needed to offset changes in the other counterparts, which were usually erratic and difficult to predict.

These four arrangements — targets expressed in terms of broad money, floating exchange rate, co-ordination of fiscal and monetary policy, and active funding policy — were interdependent. They fitted together like a building, with foundations and joists holding up the walls and beams. If any one part were taken away, the entire system would lose its structural integrity. If the Government fixed the exchange rate, ran an excessive budget deficit and/or renounced an active funding policy, broad money targets would be attained only by accident. If the broad money target was scrapped, there would no longer be a precise guideline for medium-term PSBR targets or official gilt-edged sales. If the Government joined an international exchange-rate agreement (like the European Monetary System), the consequent need to intervene to protect the exchange rate might override the broad money objective. The monetarism so closely associated with the early years of the Thatcher Government was a coherent package. All four components were needed for monetary control to work harmoniously.

Monetarism on trial

The monetarist approach,in the ascendancy from late 1978 until early 1982, reached the pinnacle of its reputation in mid-1980. It was at that time, shortly after the announcement of the medium-term financial strategy, that Nigel Lawson could describe the Government's programme as 'essentially . . . monetary – or, if you like, monetarist'. But during the following five years two divergent tendencies emerged. On the one hand, the Government successfully implemented its strategy and, despite many trials and tribulations, achieved most of its original objectives. On the other, official support for the monetarist system was eroded. This may sound strange and paradoxical. If the strategy was implemented and was largely a success, why did confidence in it wane? As we shall see, no simple answer to this question emerges.

The first test of the strategy came very soon. The so-called 'corset', a system for artificially constraining the growth of bank balance sheets (and thereby the bank deposits which make up most of sterling M3), was abolished in June 1980. Financial business which had been diverted away from the banking system rushed back into it. Sterling M3 rose by 5 per cent in July and by 3 per cent in August. These increases were far larger than had been officially expected and made a mockery of the Government's target to keep growth of sterling M3 for the whole financial year between 7 and 11 per cent. In the end, sterling M3 rose by almost 18 per cent in the target period. Although this overshoot was more of a tactical embarrassment than a strategic reverse, the embarrassment was nevertheless severe. It cast initial doubts, which were never fully shaken off, about the appropriateness of sterling M3 as the target aggregate.

More fundamental, although related, was the problem of exchange rate overvaluation which developed in late 1980 and early 1981. In order to moderate broad money growth, the

Government had raised interest rates sharply. On 15 November, 1979 Minimum Lending Rate was put up to 17 per cent, the highest level in British peacetime history and much above short-term interest rates in other industrial countries. These high rates acted as a magnet for internationally mobile funds and so drove up the value of the pound on the foreign exchanges. With Britain also favourably regarded because of its newly-elected Conservative Government and its status as an oil exporter in a period of rising oil prices, the pound's exchange rate against the deutschemark rose from under DM3.8 in November 1979 to almost DM5 in February 1981. The consequent decline in industrial competitiveness was drastic. Manufacturing output began to decline in early 1980 and was in virtual free fall during the second half of the year. By the first quarter of 1981, it was more than 15 per cent lower than in the fourth quarter of 1979. During this period the number of people working in factories went down by almost 1 per cent a month, equivalent to about 60,000 people. The Labour Party drew parallels with casualty-lists from the trenches in the First World War.

This trauma may have been inevitable. It can be interpreted largely as a correction to years of industrial over-manning, rather than as a by-product of a transient phase in macroeconomic policy. However, in certain respects monetary policy clearly contributed to the harshness of the slump. Sterling M3 was growing above target; an increase in interest rates was recognised as the antidote to excessive monetary expansion; the Government had therefore raised interest rates to unprecedented levels; and high interest rates were undoubtedly a cause of exchange rate appreciation. It is particularly telling that sterling's rise against the deutschemark began shortly after the increase in MLR to 17 per cent. The chain of connection is too logical and obvious to deny.

At any rate, the industrial slump of 1980 and 1981 came to be associated in economic debate with monetarism and, more specifically, with 'doctrinaire monetarism' and sterling M3. Sir Alan Walters, who was appointed as the Prime Minister's Personal Economic Adviser in early 1981, was particularly critical of the concentration on sterling M3 and favoured a more catholic approach to the monetary aggregates. Many Conservative politicians had always been suspicious of monetarist

technicalities and experts. According to Lord Thorneycroft:

> M3 being central stemmed from the advisers, not from Mrs. Thatcher. She thought it made no sense to spend money you hadn't got – this was the Grantham approach – and mistakenly allowed to be inserted into speeches references to monetarism that were academically correct but politically foolish.

Another Cabinet minister recalled that 'the monetary thing was too dominant and monetary policy pursued in too legalistic a way.'[3] Meanwhile Denis Healey, from the Opposition front bench, not only refused to support the system he had played such a large part in creating, but actually poured scorn on it. He derided the rules on broad money growth and the PSBR as 'punk monetarism'.

While political support ebbed away from the original monetarist programme, it also came under hostile technical review. The 1982 Budget signalled the first major policy re-assessment. Three main changes were introduced. The role of monetary targets was diminished, with the Treasury saying that in future the exchange rate would also be considered in any appraisal of monetary conditions; the status of sterling M3 in what remained of monetary targets was downgraded, with the Chancellor stating that equal attention would be paid to other measures of money such as M1 and PSL2*; and the targets for annual growth in sterling M3 during 1982/3 and 1983/4 as set in the 1980 Budget, were revised upwards by 3 per cent (i.e. the original target for 1982/3 of 5 to 9 per cent was raised to 8 to 12 per cent). These changes did not mean that monetarism was at an end. But since the broad money target had been so pivotal in the 1978-82 period, it was a definite change of course. In the words of David Smith, economics correspondent of *The Times*, 'it was the start of the official process of unwinding the policy, beginning with a pragmatic monetarism that was to give way to total pragmatism.'[4]

* M1 consists of notes, coin and sight deposits; PSL2 (private sector liquidity, second measures) consisted of M1, plus other bank deposits and building society deposits. PSL2 was renamed M5 in May 1987.

The two-and-a-half years following the 1982 Budget were a stable period for economic policy and a relatively stable period for the economy. Broad money targets were still in being and they continued to limit departures from the original monetarist blueprint. Foreign exchange intervention was modest; the PSBR was kept under control and made consistent, if in a rough-and-ready way, with the broad money targets; and close attention was paid to the growth of private sector credit, particularly bank lending. The steadiness of policy was accompanied by a growth in output broadly in line with the underlying growth of productive capacity (about 2.5 per cent to 3 per cent a year), and by a moderating rate of inflation, while the balance of payments recorded small surpluses on current account.

By late 1984 and early 1985 the Government was in a self-congratulatory mood about the economy. In a speech to the Newspaper Society on 30 January 1985 Nigel Lawson, now Chancellor of the Exchequer, referred to 'our considerable achievement, particularly over inflation'. The reduction in inflation was attributed to 'the careful implementation of a well-designed and coherent financial policy', with 'firm control of the money supply . . . and reduced Government borrowing to buttress monetary control'. While recognising that the exchange rate influenced the interpretation of financial conditions, Nigel Lawson noted that 'We have no target for the exchange rate' and added that 'I have never believed in intervention in the foreign exchange market as a way of life, still less as a substitute for firm fiscal and monetary action'. He also denied suggestions from 'some pundits' that 'our priorities have shifted from the elimination of inflation to the reduction of unemployment'. On the contrary, he was convinced that 'to abandon the battle against inflation would be the worst possible recipe for new jobs'.

Even so policy-makers were not altogether happy with the detailed operation of the system. Economists at the Treasury and the Bank of England were engaged in an elaborate mathematical hunt for the monetary aggregate whose changes corresponded most closely with those in money GDP*. The vital

* Money GDP = GDP in current prices, as contrasted with 'real GDP' which has been adjusted ('deflated') to take account of changes in price levels.

statistics (correlation coefficient, standard error and the like) of the broad money aggregates, such as M3 and PSL2, were clearly unsatisfactory in these econometric beauty contests. Narrow money measures looked more attractive and were soon being ogled by the Government's economic advisers. The fairest aggregate of all, in terms of the closeness of its relationship with money GDP, was a very narrow money measure known as M0*.[5] In the 1983 Mansion House speech Nigel Lawson announced that this would become the aggregate in which the narrow money target would be expressed. Unhappily, since M0 was widely believed to follow rather than lead economic activity, it was despised by many City analysts. Nigel Lawson therefore used the occasion of the 1984 Mansion House speech to advise these analysts that the Government paid considerable attention to M0.

The downfall of monetarism

Despite the new interest in M0 and official readiness to keep an eye on the exchange rate, the monetarist system was still largely intact at the beginning of 1985. Indeed, Nigel Lawson's speech to the Newspaper Society on 30 January was similar in approach and mood to, if not so insistent on the technicalities as, many speeches he had given as Financial Secretary to the Treasury in 1980 and 1981. But over the next few months all four of the defining characteristics of the system were challenged and then abandoned. By the end of the year it was clear that monetarism had been scrapped. The combined effect of a number of policy changes in 1985 represented a watershed in British monetary policy.

One of the reasons for reassessing policy was a sharp fall in the pound in January, when there was a distinct possibility that its value would fall beneath $1. The Government responded with a sharp increase in interest rates. Base rates climbed from 9.5 per cent at the start of the year to 10.5 per cent on 11 January, 12 per cent on 14 January and 14 per cent on 28 January. Weak sterling was largely a by-product of a perversely and unsustainably strong dollar. Since the dollar began its long

* M0 consists of notes and coin in circulation with the public and the banks, and bankers' balances at the Bank of England.

retreat against other major currencies in February, it can be argued that the episode should not have been allowed to have any long-term impact on British economic policy. But it did.

The sterling crisis of early 1985 was important partly because of its effect on the policy debate. Surprising though it may seem in retrospect, some British economists believed at the time that the large US budget deficit was responsible for the strength of the dollar. They therefore wanted the Government to increase the British budget deficit, both to bolster the pound on the foreign exchanges and to offset the deflationary effect of high interest rates at home. As Nigel Lawson noted in the Budget speech, certain commentators believed that 'the present high level of interest rates would justify a more relaxed fiscal stance'. He went on to suggest that 'there is nothing sacrosanct about the precise mix of monetary and fiscal policies required to meet the objectives of the medium-term financial strategy'.

This statement contradicted the analytical basis for the MTFS, that reducing the budget deficit over a number of years was an essential step towards reducing the rate of growth in the money supply. After all, in the mid-1970s a high PSBR had constantly bedevilled attempts to curb monetary expansion. The 1985 Budget speech was also at variance with a critical sentence in the section on the MTFS in the official 1985 *Financial Statement and Budget Report* published only a few minutes after the Chancellor's remarks to the House of Commons. This sentence said that the MTFS 'is designed to achieve falling inflation, with the ultimate objective of stable prices, through a progressive decline in monetary growth supported by lower public sector borrowing'. The main Budget document, unlike the Chancellor, was clear that a lower PSBR was a necessary condition for monetary deceleration and that the 'precise mix' of the two branches of financial policy, if not exactly 'sacrosanct', was subject to definite constraints.

Nigel Lawson's flirtation with a more relaxed fiscal policy might have led to a major departure from the Government's original financial framework. In practice, it did not matter much. Over the next four years public spending was held under such tight control and tax revenues were buoyed up so strongly by a general economic boom that the PSBR continued to decline as a share of GDP. Indeed, eventually it was transformed into a

large budget surplus. But the Chancellor had indicated a willingness to experiment and tinker, which appeared inconsistent with the ideal of continuity so fundamental to the original MTFS. In particular, the co-ordination of fiscal and monetary decisions no longer seemed central to policy formation.

Next to come under review was the practice of adjusting official sales of gilt-edged securities to achieve broad monetary targets. This practice had become increasingly important over the years, but it had not worked in quite the way first expected. The idea had been that official gilt-edged sales would neutralise the monetary effects of a large budget deficit. However, by the mid-1980s the budget deficit had fallen to such a low level that it was easily covered by official gilt-edged sales. Instead the authorities were now selling gilts in order to neutralise the monetary effects of high bank lending to the private sector. This often involved gilt sales to non-banks larger than the PSBR, a state of affairs known as 'overfunding'. By the middle of 1985 overfunding had led to a certain awkwardness in money-market management, with stockbrokers' circulars criticising the Government for technical embarrassments such as a distorted yield curve for gilts and a 'mountain' of commercial bills at the Bank of England. Although it is doubtful whether distorted yield curves and high bill mountains have much impact on the wealth, health and happiness of nations, the Government was so perplexed by them that it decided to stop overfunding.

Nigel Lawson and his advisers may have believed that putting an end to overfunding was a purely technical change, without implications for the real economy or the price level. In fact, its inevitable consequence was the dropping of sterling M3 as the Government's monetary pilot and, hence, the end of British monetarism. Deprived of the option to overfund, the authorities could not increase official gilt sales to counteract the monetary effects of high bank lending. They therefore could no longer be confident of meeting broad money targets. In April 1985 sterling M3 rose by 2.9 per cent, in June by 2.2 per cent and in August by 2.0 per cent. These monthly increases were far above the level consistent with the target of annual growth between 5 per cent and 9 per cent set at Budget time. In the Mansion House speech on 17 October Nigel Lawson announced that the sterling M3 target for 1985/86 had been set 'too low' and

would be suspended. In retrospect, it is clear that this speech marked the demise of broad money targets. Another broad money target was announced in the 1986 Budget, but no one in officialdom took it seriously, and it too was suspended in the 1986 Mansion House speech.

The link between the apparently abstruse question of overfunding and the highly practical issue of the appropriate aggregate for monetary targeting needs to be emphasised. It demonstrates the interdependence of the main elements of the financial framework established in the late 1970s and early 1980s. Once the Treasury and the Bank of England had denied themselves the instrument of funding policy, there was no longer much scope to offset surprise movements in the credit counterparts by changing the volume of gilt sales. The practice of watching credit counterparts – which had been integral to monetary management for almost a decade – had been devalued. And once part of the foundation of the monetarist structure had been removed, all the walls started to fall in.

The demolition job could still have been halted. If Nigel Lawson had continued to believe that broad money targets were of overriding importance to the anti-inflationary task, it would have been a simple matter to resume overfunding at some point in 1986 or 1987, and to announce a meaningful target for sterling M3 once again. But by early 1986 Nigel Lawson had left sterling M3 and its parochial technicalities far behind. He had begun to take part in regular meetings with finance ministers from other industrial countries, with the ambitious aim of stabilising exchange rates and managing the global economy.

The first of these meetings – which came to be known as the 'G5' or 'G7' meetings because they were attended by finance ministers from the top five or seven industrial countries – was held in New York at the Plaza Hotel on 21 and 22 September 1985. The meetings envisaged that the participant countries would take explicit measures, in the form of agreed changes in interest rates and/or intervention in foreign exchange markets, to hold exchange rates within specified bands. The key exchange rates were the dollar/yen and dollar/deutschemark cross-rates and the key countries were the USA, West Germany and Japan. The British Government could have abstained from these discussions had it wanted. It could have continued to focus its

monetary policy on controlling domestic credit.

But by joining the G5/G7 meetings the Government compromised the domestic orientation of monetary policy. After the Plaza Accord Nigel Lawson could no longer maintain – as he had in his speech on 30 January 1985 – that 'we have no target for the exchange rate'. The lesson of 1977 and 1978 – that monetary and exchange rate targets could not be pursued simultaneously – had been put to one side. Britain had become party to an agreement which might involve deliberate and massive foreign exchange intervention to sustain the international value of the dollar. Such intervention would be bound to affect the growth of broad money in Britain and might intrude on the unfinished task of controlling domestic inflation.

By the end of 1985 British monetary policy had lost all the clarity it possessed at the beginning of the 1980s. Instead of concentrating on a single target monetary aggregate, policy-makers in effect 'looked at everything'. Whereas the direction of policy change in the late 1970s had been away from forecasts and towards rules, in the early and mid-1980s there was a shift back towards forecasts and away from rules. This was to become important at Budget time in 1987 and 1988. Even more fundamentally, the ideal of stability in monetary policy had been undermined both by several revisions to financial targets and the shift of emphasis towards the exchange rate. As we saw earlier, a commitment to continuity had been the Conservatives' only distinctive addition to the monetary framework introduced at the end of the Healey Chancellorship. As the adjustments to policy in 1985 and 1986 became wider in scope, this commitment began to look less definite. Intellectually, the Conservatives had just won the argument against the advocates of a U-turn in economic policy. Practically, they were about to deny that the argument taught any clear lesson about policy.

Of course, the new indifference to rapid monetary expansion would not have mattered if, as Nigel Lawson and Treasury officials now began to claim in private, broad money had little relevance to the behaviour of the economy. There is little doubt that in late 1985 the majority of economic commentators, in both Fleet Street and the City, thought that faster growth in sterling M3 would not affect either the overall level of economic activity or the rate of inflation.

3

During the boom:

before the general election

Just as the early 1980s had been an experiment in monetarism, so the three years from late 1985 were a test of what would happen if the copy-book maxims of monetarism were ignored. It was clear by the beginning of 1986 that the extremely high increases in M3 during April, June and August of 1985 were not a flash in the pan, but rather the beginning of a sharp change in trend. Given the prevailing consensus that broad money was of only limited relevance to economic conditions, little respect in official circles was paid to a few warnings from the City that the acceleration in monetary growth would lead to a boom accompanied by rising inflation.[1] Opinion became polarised between the majority of economists, who thought that faster monetary growth did not matter, and a small minority who thought that it did. This chapter considers the causes and scale of the upsurge in monetary growth, and its effects.

Faster monetary growth in 1986 and 1987

As already explained, the immediate cause of the monetary acceleration of late 1985 was the end of overfunding. Whereas in the year to the first quarter 1985 the PSBR had been overfunded by £4.6b., in the year to the first quarter 1986 overfunding fell to a trivial £0.4b. This change by itself therefore added about £4b. – or 4 per cent – to the growth of M3. But in the course of 1986 the Government's increasingly cavalier attitude towards broad money led to the increased importance of another influence. For several years bank lending to the private sector had been, in simple numerical terms, the largest counterpart to monetary growth. Given a framework of financial targets in which broad money was paramount, policy-makers had to be concerned about the behaviour of bank lending. But, with the demotion of broad money, bank lending received less attention. In 1986 and 1987 a remarkable upturn in lending to the private sector was therefore allowed to develop and it became the dominant influence behind the increase in broad money growth.

Sterling bank lending to the private sector had risen quickly throughout the early 1980s. Indeed, it had grown annually at no less than 19.2 per cent between the end of 1980 and the end of 1985. Since the economy seemed able to reconcile this very high figure with a slowdown in inflation, policy-makers may have been lulled into believing that it was not necessary to restrain bank credit in order to conquer inflation. At any rate, between 1984 and 1987 bank lending boomed. In 1984 sterling lending from the banks to the private sector was £14,666m. and its rate of growth (from year-end to year-end) was 15.1 per cent; in 1985 the corresponding figures were £19,806m. and 17.5 per cent; in 1986 they were £29,972m. and 22.6 per cent; and in 1987 £42,379m. and 26.1 per cent. In other words, the amount of new bank lending trebled in four years and the rate of growth almost doubled.[2]

Against this background, it was hardly surprising that the growth rate of M3 should have increased substantially. In the year to mid-1985, just before the fateful decision to end overfunding was taken, M3 went up by 11.7 per cent. In the second half of 1985 the annualised rate of increase moved up to 12.9 per cent, the first sign of acceleration; in the first half of 1986 it was 26.7 per cent, abruptly different from any previous six-month period in the 1980s; and in the second half of 1986 it was slower but still fast at 15.8 per cent. Of course, there were always special factors to explain away particularly bad monthly numbers. But over 1986 as a whole M3 increased by 20.6 per cent, the highest figure since the Barber boom of 1973, and twelve-months-worth of a phenomenon is too much to rationalise in terms of 'temporary' or non-recurring distortions. The official excuses became thinner and more sporadic, and failed to carry conviction. The true position could not be disguised. Faster monetary expansion was the direct consequence of the deliberate change in policy announced in the Mansion House speech of 17 October 1985.

The general boom in credit was spearheaded by buoyant lending to finance the purchase of houses. In part such loans were supplied by banks. Their net advances for house purchase more than doubled from £2,043m. in 1984 to £4,223m. in 1985, rose steadily in 1986 to £4,671m. and then doubled again to £10,041m. in 1987. The quintupling of bank mortgage credit in

these four years played a significant role in the trebling of bank lending as a whole. But the building societies continued to be, as they had been in the past, the largest source of housing finance. Their net advances increased from £14,572m. in 1984 to £19,541m. in 1986. Taking banks, building societies and all other mortgage intermediaries together, net lending for house purchase climbed from £17,072m. in 1984 to £26,582m. in 1986 and £29,763m. in 1987. As we shall see later, the surge in mortgage finance had a profound effect on the market in residential property, with important repercussions for house prices and consumer spending.

It had always been recognised that links between broad money and economic activity are uncertain in timing and intensity, and that the processes by which monetary policy affects the economy are not easy to identify. On 20 June 1980, in the heyday of monetarism, the Treasury had presented evidence to the Treasury and Civil Service Committee of the House of Commons warning that:-

> The mechanisms by which changes in the money stock are transmitted to the price level may be different in different countries and different periods of history.[3]

Even so, monetarists tended to agree with an approximate timetable made familiar by Professor Milton Friedman of the Hoover Institution. When giving evidence in 1980 to the Treasury and Civil Service Committee, Friedman suggested that:

> the lag between a change in monetary growth and output is roughly six to nine months, between the change in monetary growth and inflation, two years.[4]

If this timetable was correct, then the upturn in monetary growth which began in late 1985 and became indisputable in early 1986 should have started to affect economic activity by late 1986 and early 1987. This was roughly what happened. Gross domestic product (on the output measure), which had risen very slowly in the second half of 1985 and in line with trend at an annual rate of 3.2 per cent in the first half of 1986, grew at clearly above-trend annual rates of 4.6 per cent in the second half of

1986 and 4.3 per cent in the first half of 1987. Moreover, the structure of the growth in demand reflected the pattern of the credit boom. Mortgage credit increased much more than net new investment in residential housing and the excess became available, through a process known as 'equity withdrawal', to boost consumer expenditure.[5] Spending on durables and cars benefited particularly. In 1986 spending on consumer durables went up by 8.1 per cent, while total consumers' spending advanced by 5.4 per cent. This increase was the fastest since 1978.

But it was not just the behaviour of demand which suggested that the monetary environment had become more relaxed. In the summer and autumn of 1986 the pound weakened significantly on the foreign exchanges, with the official exchange rate index falling from 76.2 (compared with a base of 100 in 1975) in April to 67.8 in October. In the late 1970s exchange rate depreciation had come to be regarded by some economists, notably 'international monetarists' at the Manchester University Inflation Workshop and the London Business School, as a by-product of excessive monetary expansion. Indeed, it was widely seen as the principal mechanism by which, in an open, medium-sized economy, monetary irresponsibility was translated into higher inflation. Sterling's decline in mid-1986 could therefore be seen as both the result of the accelerated growth in broad money and a warning of future rises in the inflation rate.

The boom gathers pace

Despite the emerging consumer boom and obvious sterling weakness there was little criticism of the relaxed official attitude towards credit growth and broad money. In various speeches and publications the Treasury and the Bank of England presented their reasons for thinking that the emphasis should be switched away from broad money to other indicators. Most commentators, who seemed to believe (incorrectly) that broad money targets had been consistently overshot in the early 1980s, accepted the official view. Samuel Brittan, the influential economic columnist on *The Financial Times*, later remarked:

> [it was] silly to make debating points over these overshoots, as the relationship between specific

> measures of the money supply and nominal national income, which provided the intellectual foundation of monetary targets, collapsed in most countries, and most spectacularly in the USA and Britain.[6]

Two arguments against broad money targets were heard particularly often in the public debate. The first was that changes in the banking system, arising from the removal of official controls and improvements in financial technology, had disturbed the relationship between broad money and money national income. This view was expressed in most detail in a speech by the Governor of the Bank of England at Loughborough University on 22 October 1986. It contained many interesting ideas, including the suggestion that the unusually rapid growth of bank deposits held by financial institutions reflected the substantial appreciation in the price of assets of the early 1980s. So, in the Governor's view, it was 'scarcely surprising that in a period when the balance sheets of non-bank financial intermediaries are growing more rapidly than nominal income . . . the growth in sterling M3 should exceed that of nominal incomes'.

The difficulty with the Governor's speech was that many of its points could have been made at any time in the previous ten years, during all of which broad money targets had been enforced. No abrupt change took place in the pace of financial liberalisation and innovation in mid-1985 which could account for a new trend in broad money growth. In fact, since the major measures of financial liberalisation (abolition of exchange controls, scrapping of the 'corset', removal of restraints on bank mortgages) had been completed by 1982, they ought to have led to faster growth in broad money before 1985 than afterwards. But growth in broad money proved almost twice as fast in the three years after 1985 as in the three years before 1985. Moreover, some of the influences which had enabled broad money to rise faster than nominal national income were unsustainable. For example, although everyone enjoyed the appreciation in asset prices of the early 1980s, it was naive to imagine that the prices of shares and houses could forever rise faster than nominal GDP.

A second common pretext for playing down the broad money explosion was the view that M0 was the really crucial aggregate. By late 1986 the Treasury's econometric boffins had managed to convince themselves that — contrary to the prevailing City consensus — M0 led inflation rather than followed it. M0 was also praised by Professor Patrick Minford of Liverpool University, who in a pamphlet for the Centre for Policy Studies in late 1985 approved the elevation of M0 to 'principal indicator' on the grounds that it was 'the base of the whole money and credit pyramid'.[7] In the December 1986 issue of the *Liverpool Quarterly Economic Bulletin* his team opined that, despite 'all the "noise" surrounding the monetary scene' (notably the acceleration in M3 growth), 'the Government's strategy has remained basically unaltered'. It saw the suggestion that M0 'needs to be controlled by a rise in interest rates' as 'perhaps exaggerated'. Minford's views were significant in public debate, not least because he was routinely described in the media as 'monetarist'. His focus on M0 (narrow money) diverted attention from the new trend in the growth of broad money.

The problem with M0 is that, on common-sense grounds, it clearly cannot affect anything important in the economy. M0 consists only of notes and coins in circulation, and of bankers' balances at the Bank of England. To suggest that vital decisions by industrial companies or financial institutions are determined by the level of their petty cash is preposterous. Even private individuals with low incomes, who do have to think about the adequacy of their cash resources for day-to-day transactions, normally adjust their cash to their spending behaviour, rather than their spending behaviour to their cash. (It is easy to deposit funds in banks and building societies and easy to withdraw them. Indeed, it is the facility of transfers between cash and other monetary assets which explains the closeness of the relationship between M0 and nominal national income. The econometric demonstration of this close relationship should have come as no surprise and was uninteresting.) Because of these points – which account for the City's original contempt for M0 – M0's supporters had to concede that their pet aggregate was not a determinant of economic activity or inflation, but was instead an indicator of current economic conditions.

Some vital conclusions follow. If M0 has any role in combating inflation, it can be only as a signal of existing inflation

rather than of future inflation. Moreover, M0 is unsatisfactory even as a guide to existing inflation. It fails to pick up two kinds of inflationary pressure which may be very strong. The first is inflation in the prices of assets (shares, land, houses) which are never exchanged for notes or coin. Since virtually all the major assets of a modern economy are bought and sold by transfers via the banking system, M0 would fail to respond to large increases in such asset prices. But rampant inflation in asset prices certainly does affect the behaviour of businessmen and consumers, and is often the precursor of higher inflation in goods and services. The second is inflationary pressure which is being restrained by an overvalued exchange rate and the consequent diversion of domestic demand into imports. These two kinds of inflationary pressure proved of major importance in 1987 and 1988.

Election euphoria

In early 1987 the debate about the monetary aggregates was overshadowed by the greater excitement of an imminent general election. The Chancellor, and his advisers and colleagues at the Treasury and the Bank of England, were reassured by the continuance of moderate inflation. Indeed, the fall in the price of oil during 1986 had helped bring inflation down to the lowest level since the 1960s. This achievement appeared to endorse the shift in policy emphasis away from credit and broad money to narrow money and the exchange rate.

Although the reorientation of policy towards the exchange rate had begun in 1985, it had not been taken much further in 1986. The pound's weakness in the summer and autumn had been countered by an increase in interest rates, with base rates being raised by 1 per cent to 11 per cent on 14 October, but this move was a mild reaction to the events on the foreign exchanges. The authorities' reluctance to do more stemmed from a view that the fall in the oil price justified some devaluation of the pound. Meanwhile intervention in foreign exchange was modest. Over 1986 as a whole it increased M3 by only £181m., a trivial number not very different from those experienced in the earlier 1980s when a floating exchange rate had been deliberate policy.

But early in 1987 policy and attitudes changed radically.

When Nigel Lawson attended the Louvre meeting of G5 finance ministers on 21 February, he was far readier to intervene on the foreign exchanges than he had been at the Plaza meeting. He thought that sterling was slightly beneath the appropriate level and, according the well-informed Japanese financial journalist, Y. Funabashi, bargained with the other finance ministers that the mid-point of the pound's 'range' should be 'a bit above where it was'.[8] It was implicit here that the pound did have an officially-recognised range. It was also clear from other remarks made by Nigel Lawson at this time that, in his opinion, the key currency for Britain was the deutschemark.

The logical next step was an attempt to keep the pound stable in a range against the deutschemark, at a somewhat higher level than the DM2.80 level which prevailed in mid-February. The Chancellor soon engineered precisely this outcome. Sterling rose strongly in late February and early March. It reached DM2.9482 on 9 March, with the foreign exchanges hopeful that the Budget (on 17 March) would stimulate more international interest in Britain. Instead the rate dipped briefly towards the end of the month, but then stayed between DM2.95 and DM3.00 continuously until March 1988. Over this period the fixed exchange rate with the deutschemark dominated major decisions about monetary policy. In substance, Britain had joined the European Monetary System. Surprisingly, no official announcement was ever made about this very important development. It was left to the markets and the media to read between the foreign exchange quotations.

Neglect of broad money was complete between March 1987 and the general election in June. The 1987 budget speech did include a reference to broad money, but it was dismissive. Nigel Lawson noted:-

> For broad money, as the Governor of the Bank of England cogently argued in his Loughborough lecture last October, it is probably better to eschew an explicit target altogether.

The Treasury forecast published with the Budget documents clearly implied that the fast growth in broad money would have no significant effects on the economy. It expected 3 per cent growth in GDP in 1987, not much above the average

of the previous five years and definitely not the full-scale boom which an old-style monetarist was bound to predict in view of recent monetary trends. The official conviction that the growth of output would probably slow down, and that large tax cuts would not cause excess demand, was derived from the Treasury's macro-econometric model. With the old monetarist rules discarded, macro-forecasting became more prominent in decision taking.

Meanwhile, foreign enthusiasm for Britain waxed on the prospect of the Government's reelection, and heavy capital inflows threatened to force the pound above the precious target of DM3. Nigel Lawson reacted by instructing the Bank of England to intervene to prevent sterling rising. This intervention added £946m. to M3 growth in March, £1,750m. in April and £2,861m. in May. Suddenly, after more than thirty years of scepticism, Nigel Lawson seemed to have become an ardent believer in foreign exchange intervention 'as a way of life'. He certainly could no longer claim – as he had in his speech to the Newspaper Society on 30 January 1985 – that 'We have no target for the exchange rate'.

He also agreed to a sequence of cuts in interest rate, with base rates down to 9 per cent by 11 May. These cuts could again be rationalised by an appeal to external considerations, since they had some effect in discouraging capital inflows from abroad. But they made no sense in relation to domestic monetary conditions or the state of the economy. Helped by lower interest rates, the tax cuts in the Budget, and a surge in consumer confidence, the mortgage boom became particularly frenzied.

Mortgage advances by the banking system in the second quarter of 1987 (£2,419m.) were more than twice as high as in the second quarter of 1986 (£1,183m.), while house prices by mid-year were nearly 14 per cent higher than a year earlier. The ready availability of mortgage credit, together with lower taxes, fuelled another strong gain in consumers' expenditure, which rose at an annualised rate of 4.9 per cent in the first half of 1987.

Ahead of the general election, it was hardly surprising that no disquiet about these trends was expressed from within the Government or the Conservative Party. Rumour had it that some Bank of England officials worried that the economy was growing too quickly. But none of them resigned in protest and the Bank

of England's *Quarterly Bulletin* echoed the Treasury line. Indeed, the May issue of the *Bulletin* judged:-

> It has become increasingly apparent that movements in broad monetary aggregates...do not, in an environment of financial innovation, necessarily portend movements in money GDP or inflation.

4

During the Boom:

after the general election

Prosperity was undoubtedly a major reason for the Conservatives' election victory on 11 June 1987. Indeed, the Government's critics claimed that stable economic management had once again been surrendered to the pressures of the electoral cycle, just as in the heyday of the stop-go era. But this was unfair. If the charge had been correct, deflationary action would have been taken shortly after the election and the economy would have slowed down in the next few quarters. Instead, the boom was to prove stronger in the year after the general election than in the year before it. The buoyancy of the economy was the result of mistakes in policy which reflected mistakes in analysis. In this chapter three particular errors are discussed. They are the Government's over-estimate of the contractionary effects of the October 1987 stock market collapse, its confidence that a stable exchange rate between the pound and the deutschemark would prevent higher inflation and its failure to see that, in the circumstances of early 1988, M0 had become a misleading monetary indicator. These three errors were part of a more general misunderstanding, with the Chancellor and his advisers consistently under-estimating the dangers inherent in the rapid growth of credit and broad money.

Mistakes in late '87

A rather haphazard sequence of policy decisions were taken in late 1987. It is most unlikely that, on 12 June, Nigel Lawson and his Treasury colleagues had the slightest notion that over the next few months events would unfold in the way they did. Immediately after the election the main concern was the pace of economic growth. An active debate in the media about the dangers of 'overheating' was focused on unprecedented levels of bank lending to the private sector in June (£4,009m.) and July (£4,486m.), which were respectively 32 per cent and 63 per cent higher than in the same months a year earlier.

When the authorities learned of the scale of the July lending

surge, they were surprised and worried. On 7 August the Bank of England nudged up its seven-day dealing rate in the money markets, giving a signal for a rise in base rates of the clearing banks from 9 to 10 per cent. Nigel Lawson thought that this would be enough to moderate the pace of growth and insisted in a radio interview on 2 September that no further rise in interest rates would be needed. He continued to hold this view over the next few weeks, despite the announcement on 24 September that the trade deficit in August had been £1,424m., the largest ever, and other evidence of rampant excess demand throughout the economy. Later statistics showed that GDP had grown during the third quarter at an annualised rate of about 8 per cent – far faster than had been forecast in the Budget.

The drift of economic commentary and of official statements until mid-October 1987 was still to highlight overheating as the problem of the moment, but one that was likely to abate without further corrective measures. In his speech to the Conservative Party conference in early October Nigel Lawson forecast that 4 per cent growth of GDP in 1987 would be followed by a more moderate 3 per cent figure in 1988. There was a persisting debate with the small group of economists who thought that the credit and money trends would lead to continued high output growth in 1988, but the debate was not particularly acrimonious, and the official view was representative of majority opinion. Most private forecasts concurred with the Chancellor that, at the interest rates then prevailing, the economy would slow down in 1988.

This assessment was overtaken by the stock market collapse on 19 and 20 October, when share prices fell in London by 30 per cent in two days. Economists' views changed abruptly, with widespread fears of a slump in activity because of the adverse 'wealth effect' of lower share prices on consumption*. Parallels were drawn with the disintegration of business confidence in the USA following the Great Crash of October 1929. On 4 November 1987, in the Autumn Statement, the Treasury

* 'Wealth effects' refer to the effect of changes in the valuation of wealth on economic behaviour. A 'negative wealth effect' occurs when, because of a decline in wealth, spending is discouraged.

accordingly reduced its forecast of growth in GDP in 1988 to 2.7 per cent. Again, this coincided with the consensus of private forecasts. To mitigate the expected contractionary effects of the fall in share prices, the Government directed three successive cuts of ½ per cent in clearing bank base rates on 26 October, 5 November and 4 December, bringing the rates down to 8½ per cent, the lowest level since early 1984.

Eventually it became clear that all the scare-mongering about a recession was wrong. There undoubtedly were adverse 'wealth effects' from lower share prices, but they were overwhelmed by positive wealth effects from rises in other assets. The most conspicuous of these was the surge in house prices. In October 1987 most of the available house prices series indicated gains on a year earlier of about 20 per cent, with virtually half of the increase occurring in the four months since the election. But also relevant were sharp rises in the value of industrial and commercial property, and of small independent businesses such as pubs, hotels and restaurants. Total returns on property investment typically exceeded 30 per cent in 1987, while according to figures prepared by the valuers, Christie & Co., the price of independent businesses went up by 24½ per cent. The interest rate cuts of the final quarter accelerated the appreciation of asset prices in the housing, commercial property and small business sectors. Consumption continued to grow. In the first quarter of 1988 it went up by ½ per cent (i.e., at an annualised rate of 4.8 per cent), and in the second quarter was 5.3 per cent higher than year earlier.

Why were the majority of economists so badly wrong? The obvious answer is that they concentrated on price falls in the most newsworthy and glamorous asset market, the Stock Exchange, and neglected the message coming from price rises in more humdrum asset markets. The mistake was understandable, because share prices are undoubtedly easier to follow on a day-to-day basis, and high proportion of influential economists are employed in the City. But the excuses should not be pressed too far. Readily available data on the composition of national wealth showed that directly-owned shares (as distinct from those owned indirectly, via the institutions) were worth only one-fifth as much as the owner-occupied housing stock. The boom in house prices therefore wholly outweighed the crash

in share prices. In any case, the October fall in share prices only cancelled the massive gains earlier in the year. Share prices in November 1987 still stood higher than in November 1986.

The over-estimate of the impact of the collapse in share prices on personal wealth was bad economics. Even more malign an influence on policy was that the stock market collapse encouraged the Treasury and the Bank of England to disregard the continuing rapid pace of growth in credit. Monthly bank lending of over £4b. in June and July 1987 had made officials nervous about future inflation and provoked the surprise jump of 1 per cent in base rates on 7 August. By contrast, the official response to yet higher lending figures of £5,000m. in December and £5,598m. in January 1988 was perfunctory. A ½ per cent rise in base rates on 2 February merely caused puzzlement in financial markets, since it was so difficult to reconcile with other developments in policy. It was also at odds with the continuing, almost unanimous verdict of the economic forecasters that 1988 would see a pronounced slowdown in growth.[1]

These forecasters evidently thought that the lending boom would have no significant consequences for the economy. If there had been any residual trace of monetarism in their models, they would not have been so casual about the acceleration in growth of M3 which soon emerged. At an annualised rate, it grew at 21½ per cent in the third quarter of 1987, and 23.8 per cent in the fourth quarter. In March 1988 M3 was 20.8 per cent higher than in March 1987. If Friedman's theory still had any validity, the pace of economic growth was likely to increase, not slow down. This conclusion – so sharply at variance with the forecasting consensus – was reinforced by the effect of the interest rate cuts of late 1987 in stimulating mortgage credit.

Policy disagreements in spring 1988

Official indifference to rapid growth in broad money was associated, as it had been in the spring of 1987, with a casual attitude towards the monetary effects of foreign exchange intervention. In the last two weeks of February 1988 the pound strengthened appreciably. On 29 February it touched DM2.9940, threatening to breach the DM2.95 – 3.00 band within which it had remained for almost a year. The first week of March saw heavy intervention to hold the pound down. The underlying

increase in foreign reserves during March was $2,225m., which was bound to have a major adverse effect on the monetary aggregates. Not surprisingly, M3 rose in March by 2.4 per cent.

At this point a debate developed within the Government about the wisdom of heavy intervention in foreign exchange markets. Although the precise details of their disagreement are to some extent a matter of conjecture, it is clear that the Prime Minister had become more concerned than the Chancellor about the credit boom and less prepared to 'buck the market' in foreign exchange. On her instructions the Bank of England stopped intervening on 7 March. The pound quickly broke through DM3. Britain's informal affiliation to the EMS had come to an end.

Afterwards the year-long pegging of the pound in the DM2.95 – 3.00 band came to be regarded as a serious mistake. Its consequences included reductions in interest rates to inappropriately low levels, and foreign exchange intervention that added to broad money growth just when that growth ought to have been slowed down. Supporters of full EMS membership believed that, by keeping the pound stable against the DM, the inflation rate in Britain would converge with that in West Germany. Their view, based on the purchasing-power-parity theory of exchange rates, is undoubtedly correct in the long run. But its application in the particular circumstances of 1987 and early 1988 overlooked three severe medium-term problems.

The first is that a fixed exchange rate promotes convergence of inflation rates only if the exchange rate is not overvalued or undervalued when it is first set. Thus, if British prices had been broadly in line with those in West Germany at the pegged rate of about DM3 which prevailed between March 1987 and March 1988, joining the EMS would have implied an early equalisation of inflation rates, since there would have been no tendency for British prices to 'catch up' with those in West Germany. In fact, the pound had depreciated heavily in the two years before 1987. A sense of perspective is given by recalling that it stood at over DM4 in July 1985. So it was probably under-valued at DM3; and there was scope for inflation to be higher in Britain than in West Germany, at any rate for a few years.

This conclusion seems to be substantiated by the sequel to the freeing of the pound in March 1988. The pound appreciated to average almost DM3.17 in May and DM3.21 in December. But

inflation in 1988 and 1989 rose more quickly in Britain than in West Germany. Secondly, experience in the 1980s shows that – although purchasing power parity does hold in the long run – departures from it can be substantial and last for several years. It is notorious that in early 1985 the dollar was over-valued by between 30 and 50 per cent against other major currencies. Since over-valuation can arise not just from exchange rate movements but also because of wide divergences of inflation, a fixed exchange rate does not give a cast-iron guarantee that inflation will always be the same in the two countries involved. Inflation divergences can therefore persist even if the exchange rate is initially set at an appropriate level.

Inflation is most likely to run at higher levels in one member of a fixed-exchange-rate system than another if the price level is strongly influenced by domestic monetary pressures as well as by external competitive forces. In Britain's case substantial areas of the economy are remote from international competition. For example, most of the public sector, many private sector services such as retailing, transport and telecommunications, and virtually all the building industry need pay little attention to the relationship between their prices and those in other countries. The pound's stability against the deutschemark therefore could not prevent prices in these sectors being bid up by excess demand. With so rapid a growth of credit and money in 1987 and early 1988, inflation could accelerate despite the fixed pound/deutschemark rate.

This logic is particularly compelling in the market for residential property. Of course it makes no sense to uproot houses from, say, the West Midlands, transport them intact to West Germany and relocate them in the Ruhr. House prices, and house price inflation, can be very different in Britain and West Germany. In the event, UK net mortgage advances in the second quarter of 1988 were over 50 per cent higher than a year earlier and gave further impetus to the house price explosion. By June 1988 the annual rate of increase in house prices – which, as we have seen, was nearly 15 per cent in mid-1987 and about 20 per cent in late 1987 – had climbed to almost 30 per cent. At the same time the prices of West German houses rose by under 5 per cent.

Thirdly, and most fundamentally, by linking the pound to

the deutschemark and letting the foreign exchange markets think that the new arrangement was meant to last, Nigel Lawson denied himself the option to tighten domestic monetary policy. If a fixed exchange rate is expected to be maintained, interest rates have to be roughly the same in the two currencies concerned. (If not, it is possible to make effortless profits by borrowing in one currency and redepositing the proceeds in another.) With interest rates higher in Britain than elsewhere in Europe and an apparently emphatic official opposition to depreciation beneath the DM2.95 figure, currency operators thought they were certain to make a profit by buying sterling. If in this situation the Bank of England had raised interest rates for domestic reasons, the inflows across the exchanges would have increased still further and appreciation of the pound could have been checked only by yet more massive foreign exchange intervention. But such intervention would have led to further acceleration in broad money growth.

More generally, the pound's informal association with the EMS disrupted domestic monetary control. The only way that the Government could restore control over credit and broad money, and dampen the overheating in the property markets, was to break the link with the deutschemark. (In technical terms, it had to increase interest rates and allow the pound to rise to a level from which the foreign exchange markets would expect an annual rate of depreciation against the deutschemark equal to the interest rate differential between Britain and West Germany.)

Towards 'total pragmatism'

The liberation of the pound from the DM2.95 - 3.00 band came only a few days before the Budget on 15 March 1988. As in the previous year, the Budget speech said almost nothing about credit and broad money, and contained a complacent economic forecast. A modest slowdown in output growth to 3 per cent was expected to be accompanied by no change in inflation and only a slight deterioration in the balance of payments. This forecast was made even though consumption would be boosted by about £4b. worth of cuts in income tax. There was a clear implication that without the tax cuts the economy would have been very sluggish. Apparently, none of the several hundred

equations in the Treasury's econometric model was able to identify any inflationary danger in the credit boom of the previous three years. By cutting taxes, Nigel Lawson declared his faith in the forecast. His willingness to take the econometrics on trust and ignore the money numbers showed that policy was no longer based on monetary rules, as it had been in the late 1970s and early 1980s. Instead, fiscal changes were determined by macroeconomic forecasts, and interest rate decisions had become a lucky dip between external and domestic pressures. In David Smith's words, policy had evolved to a 'total pragmatism'*.

This 'total pragmatism' was evident in the official attitude towards M0. As already explained, there is much wrong with M0 as a target aggregate. But it does have the virtue that, because it is a reasonably reliable coincident indicator for spending in the economy, a government which keeps it under control should be able to maintain some sort of check on excess demand. The check may be administered too late and may not be easily calibrated to the strength of future demand, but it should be a check nevertheless. For this reason Nigel Lawson and the Treasury had insisted back in 1984 and 1985, as they systematically snubbed broad money, that the M0 target would be respected through thick and thin.

However, the *Financial Statement and Budget Report* which was published with the 1988 Budget announced that M0 was expected to move above its target range in the early months of the 1988/89 financial year 'before coming back within it'. It was clearly implied that no special action would be taken to correct the overshoot. The Treasury's conviction that M0 would nevertheless come back within target was based on its forecast of weaker economic growth and on the view that, since the economy would soon slow down, the growth of M0 would slow down as well. In effect, macro-econometric forecasting had completely supplanted money supply targets in policy making. Moreover, the Government appeared to believe that money adjusts to the economy rather than the economy to money, a view on the pattern of causation wholly at variance with the 'monetarism' it had espoused in the early 1980s.

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* See pp. 16-17 above.

As foreshadowed, M0 soon did move above its target band, which was for growth of between 1 and 5 per cent. Indeed, when the money supply figures for February 1988 were published shortly after the Budget, they indicated that the twelve-month increase in M0 had reached 5.3 per cent. This rose to 6.4 per cent in March, 7.7 per cent in June and 8.1 per cent in September. Later the Chancellor and the Treasury were to repent the decision to disregard the excess growth of M0. Thus, Sir Geoffrey Littler, who had retired as Second Permanent Secretary to the Treasury in 1988, told a European Community committee on 15 February 1989 that, 'if you look back at British monetary policy during the past 15 months, something has gone slightly wrong, monetary expansion has been faster than intended or wanted'.[2] Since the only measure of money which had started to misbehave 15 months earlier was M0, it must have been this aggregate which Sir Geoffrey had in mind. Of course, the growth of the broad money measures had accelerated earlier and much more dramatically. It would caricature the mandarin gift for under-statement to presume that Sir Geoffrey had M3 growth rates of over 20 per cent in mind when he talked of policy going 'slightly wrong'.

But it would be strange if Treasury civil servants were altogether convinced, on due reflection, that the lapse on M0 in early 1988 accounted for later events in the economy. The 2 per cent overshoot of M0 in the second quarter of 1988 and the 3 per cent overshoot in the third quarter involved trivial amounts of an aggregate which was widely recognised to have no causal role in the economy. By the time that M0 growth reached 8 per cent the official Budget-time forecast had already proved hopelessly inaccurate. Its estimate of the growth of domestic demand in 1988 had turned out to be too low by about 5 per cent of GDP, equivalent to about £20b. By contrast, 2 per cent of M0 amounts to only £300m. In view of the difference in scale between this £300m. and the £20b. unpredicted surge in aggregate demand, it is surely ludicrous to attach much less significance to the M0 indiscretion.[3] Nigel Lawson was more realistic when, in an attempt to rebut criticism that his £4b. tax cuts had been too large, he pointed to £40b. of lending by banks and building societies as the main cause of excessive consumer demand.

In truth, M0 had been a thorough disappointment to policy-makers. It failed to register the strength of the forces driving economic growth in 1987, largely because it was unaffected by the inflation of asset prices which was such an obvious feature of the economy. It also failed to transmit any precautionary message about the steady deterioration in the balance of payments throughout 1987 or to anticipate the abrupt lurch into massive external deficit in mid-1988. Both these weaknesses of M0 reflected its essential character, that it is a measure of money determined by current economic conditions, particularly spending by individuals in the shops. Nigel Lawson and his Treasury advisers had been given ample warning about M0's inadequacies by City economists in 1983 and 1984. They had no right to be surprised when these inadequacies spoilt monetary policy-making in 1987 and 1988.

Post-Budget humiliation

Earlier attention to M0 would certainly not have saved the Chancellor and the Treasury from the humiliation they suffered in the months following the 1988 Budget. Nearly every statistic to appear in March, April and May was at variance with the official forecast of a slowdown in growth. On Friday 18 March the Building Societies Association's monthly press release indicated that in February the societies' net new commitments to lend were £4,350m., a startling 73.9 per cent up on February 1987. On Wednesday 23 March Department of Environment figures showed that construction orders in January had been higher than in any previous month except for July 1987 when they had been artificially inflated by the Channel Tunnel. On Monday 28 March a CBI survey reported that no fewer than 37 per cent of companies planned to raise output in the next four months, almost the same as the highest figures (37 per cent in June, 38 per cent in August) in the boom year of 1987. And so it went on.

Economists in the official machine were reluctant to change their minds. They remained loyal to the forecasts produced by their econometric models for many weeks after the forecasts were shown by new data to have been patently and grossly implausible. By early May it was known that lending by bank and building societies in the first quarter had been £18,001m.,

65.8 per cent up on a year earlier. Despite this Nigel Lawson told the *Wall Street Journal* on 11 May that the recent rise in the exchange rate had 'tightened up monetary conditions'. He also dismissed growing anxieties about overheating and inflation by remarking that 'inflation fluctuates a bit, but I don't believe there are any signs of resurgence'. The *Bank of England Quarterly Bulletin* published on 12 May chimed in with the Chancellor by claiming that in the previous three months there had been a 'net tightening' of policy.

It took this view because, in the Bank's opinion, two ½ per cent interest rate cuts to 8 per cent base rates (on 17 March and 11 April) had only partly offset the restrictive effect of exchange rate appreciation since the floating of the pound on 7 March. Apparently, policy was being decided with the help of some sort of composite measure of interest rates and the exchange rate. The data on lending and broad money simply did not enter into the calculation at all. It was consistent with the Bank's reasoning that the Chancellor should endorse a further cut in base rates, to 7½ per cent, on 18 May.

To characterise the stance of monetary policy with scant reference to credit or the money supply is surprising in any circumstances. But it was particularly peculiar for the Bank to do this when serving a government whose anti-inflationary successes had been based on the resolute pursuit of monetary targets.

At any rate, neither the Bank nor its masters in Whitehall were able to indulge for much longer in such idiosyncrasies. The new-fangled measures of monetary policy were soon rendered irrelevant by a worsening in the balance of payments, the classic and old-fashioned symptom of British monetary mismanagement. The May trade figures, released on 25 June 1988 showed a current account deficit of almost £1.1b., the second highest figure ever. It was plain that the official forecast in the Budget, of a current account deficit of only £4b.for the whole year, would be exceeded by a very wide margin. A complete reappraisal of policy was necessary.

Clearing bank base rates began to move higher on 3 June, with a ½ per cent rise to 8 per cent. As the evidence of rapid growth and excess demand accumulated from week to week, the Government frog-marched interest rates upwards in six

consecutive steps of ½ per cent. By early August clearing bank base rates had risen to 11 per cent. On 25 August the July trade figures showed a current account deficit of almost £2b., by far the largest ever, which prompted another increase in base rates to 12 per cent. The October deficit, announced on 25 November, of over £2.3b. was met with a further rise to 13 per cent. This large and sudden increase, which almost doubled base rates in only six months, signalled the end of the boom which had begun in mid-1986. The associated jump in mortgage costs contributed to a surge in inflation. The twelve-month increase in the retail price index reached 6.4 per cent in December and nearly 8 per cent in early 1989. It was the worst inflation for six years.

Officialdom became reluctant to discuss why forecasts and policies had been so badly misjudged. The August 1988 *Bank of England Quarterly Bulletin* made no apologies. It noted that policy had been tightened during the summer, a shift which had 'been necessary in the light of the emerging inflationary pressures', and attributed these pressures to the 'continued buoyancy of domestic demand'. Its 'General assessment' contained a couple of sentences on M0, but said nothing about broad money and did not analyse why the inflationary pressures had developed. Although Nigel Lawson conceded in a television interview on 9 September that his five years as Chancellor had seen no progress on inflation, his sixth Mansion House speech on 20 October was silent on the reasons for failure. In sharp contrast to its five predecessors, it included no references to the monetary aggregates.

At least the raising of bank rates to 13 per cent showed that the Government was in earnest about curbing the credit boom. Nigel Lawson's remarks on the stimulatory power of £40b. of personal borrowing tacitly conceded to his critics that credit had grown too fast. He also said on a number of occasions, echoing his speeches as Financial Secretary and in his first two years as Chancellor, that inflation was the result of irresponsible monetary policy. But official speeches, whether from Nigel Lawson himself, his colleagues in the Treasury or his civil service advisers, neglected to mention broad money. Policy makers had forgotten their zeal in 1980 for a strategy which 'is essentially monetary – or, if you like, monetarist', 'a medium-term monetary target, to which we are committed' and the like.

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How to avoid stop-go cycles in the future

The boom of mid-1986 to mid-1988 was not the result of politically-motivated electioneering, but of technical mistakes in macroeconomic management. The continuation of the boom for so long after the general election of 1987, and the Chancellor's evident surprise at the economy's refusal to slow down in the predicted manner in 1988, strongly suggest that the boom was not deliberate. The technical mistakes were of several kinds and each can be discussed as if it were distinct from the others. But their cumulative impact was to end the stability conferred on the economy by the medium-term financial strategy and to restore a degree of macroeconomic muddle which was pretty average by post-war British standards.

The first section of this chapter highlights two intellectual errors which lay behind the policy mistakes. The second section makes proposals for improving macroeconomic policy in the future; it argues for a revival of the emphasis on credit and broad money which was part of the Government's original medium-term financial strategy.

The two basic errors

Two basic intellectual errors lay behind the policy mistakes of 1985, 1986 and 1987. The first was to believe that the amount of money is determined by the behaviour of the economy and so has no independent power as a determinant of economic activity or inflation. This belief surfaced most obviously in March 1988, in the official Budget-time forecast that the prospective above-target growth of M0 would be followed by a return to within-target figures when the economy as a whole slowed down. The implied direction of causation, from the economy to money rather than from money to the economy, was clear.

As a matter of fact, this view was correct for M0 and goes a long way to explaining why M0 was (and is) an inappropriate aggregate for targeting purposes. But it was not correct for broader measures of money. Whereas people and companies

can adjust their individual and aggregate holdings of narrow money to the level of their transactions, they cannot do this with the aggregate quantity of broad money. The reason is that, in a modern economy, the level of bank deposits is determined by the amount of bank credit. An individual with excess bank deposits (i.e. excess broad money) can try to run them down by spending more on goods and services (or assets). But, as he writes out a cheque to someone else, that other person's bank deposit goes up; and, as a result, the total of bank deposits in the whole economy does not change. The argument can be extended. If the other person now also has a larger sum in his bank than he thinks appropriate, he can reduce it only by writing out cheques which boost other people's bank accounts. Again, the aggregate total of bank deposits does not change. And so on.

It follows that a large number of *individual* decisions to change the nominal quantity of broad money balances are futile, because the *aggregate* level of bank deposits is already fixed. But individual decisions do affect the aggregate amount of expenditure. (Expenditure in this context could be on either goods and services or assets.) The direction of causation is from money to the economy, not from the economy to money.[1]

Since the real quantity of goods and services cannot increase by more than the rate by which productive capacity is growing, a rise in aggregate expenditure of this kind is potentially inflationary. Indeed, on the assumption that the long-run growth trend of real output is unaffected by changes in the rate of monetary expansion, an increase in the broad money growth rate will ultimately affect only the inflation rate.

The Treasury's mistaken conviction that broad money growth is not a determinant of economic behaviour may have stemmed from its macro-econometric model. This model had its roots in Keynesian thinking, where expenditure is determined by income and other non-monetary variables. In the early years of the Thatcher Government, partly under pressure from self-consciously 'monetarist' junior ministers, it had been doctored to give the impression that it had 'more money' in it. It had a monetary section and equations for determining gilt yields, international capital flows and the like. But this did not mean that the model assigned broad money a powerful role in the economy. On the contrary, the procedure was to forecast the

main components of demand (consumption, investment, exports and so on) and then to estimate the quantity of broad money consistent with the resulting levels of spending, interest rates and so on. In short, the model continued to work as if the direction of causation was from the economy to money, not the other way round. It was this characteristic which was responsible for the Treasury's failure in March 1988 to appreciate the inflationary dangers latent in three years of fast growth of credit and broad money. Economists who based their forecasts on the money supply and crude Friedmanite lags were much more successful in sensing what was about to happen.

The second basic error was to move from believing that the relationship between broad money and the economy had changed to denying that there was any relationship at all. When stated so baldly, this was a leap from plausible observation to untenable exaggeration which smacked of intellectual laziness. But in 1985 and 1986 most policy makers did make a conceptual leap in the dark of just this kind. In the words of Professor Charles Goodhart:-

> The capacity of the present Conservative Government, and of the Treasury, to move from an (invalid) viewpoint that the growth of broad money is an exact determinant of the growth of nominal incomes to the (invalid) viewpoint that the growth of broad money has no relationship at all with the growth of nominal incomes is staggering with respect both to its speed and the comprehensive nature of the intellectual somersault involved.[2]

The Governor of the Bank of England's speech at Loughborough in October 1986 was largely responsible for the new sloppiness in official thinking. As Nigel Lawson himself noted in his 1987 Budget speech, it provided a set of arguments for 'eschewing' an explicit broad money target or, in other words, for doing nothing about the acceleration in broad money growth. The irony is that the Loughborough speech was actually a model of tight argument and technical rigour, and should not have been an excuse for either intellectual laziness or indifference to the dangerous monetary trends. Indeed, its careful investigation of

complex institutional influences on the demand for and supply of broad money could have become the basis for a more scientific approach to broad money targets.

Two points need emphasis here. First, institutional changes in the financial system do not invalidate the setting of broad money targets. Instead the right procedure is to calculate the probable effect of such changes on the demand for money and to adjust the target accordingly. Second, although it may be difficult to estimate how much any particular institutional change alters desired money balances, it is inconceivable that institutional change can cause the demand for money to become infinite. In any given period there will still be a limit to the amount of money people and companies want to hold and excess monetary growth will still be inflationary.

The arguments of the last few paragraphs, like much of monetary economics, have been quite difficult. Readers may even come to think that policy makers can be forgiven for a certain amount of intellectual confusion. The complexity of the monetarist policy framework may have been one of the basic reasons for its downfall. By comparison with an exchange rate target (of the kind associated with the EMS), money supply targets appeared technically bewildering. Samuel Brittan of *The Financial Times* complained frequently in his column about 'monetarist mumbo-jumbo' and preferred the relative simplicity of a fixed exchange rate for the pound and the deutschemark. Mr. Lawson may have favoured the EMS option on the grounds that monetary targets were too arcane for his high-spending Cabinet colleagues, whereas a sterling crisis quickly brought them to heel.

The end of overfunding, the adoption of M0 as the principal target variable and the stabilisation of the pound/deutschemark exchange rate were honest errors. If policy makers believed that there was no relationship between broad money and the price level, they were right not to worry when broad money exploded. If they thought that the price level determined broad money rather than that broad money determined the price level, they had a sound case for trying to fix the pound/deutschemark exchange rate as an anti-inflationary anchor. But there are still unanswered questions. How could the ministers and advisers who had placed such emphasis on the need for broad money

targets in 1979 and 1980 have come to believe, a mere five years later, there was no identifiable relationship between broad money and prices? And why, if they thought that inflation determined money growth and must therefore itself be determined by other variables, did they continue to regard inflation as essentially a 'monetary phenomenon'? Had they changed their minds? Or had they perhaps, just possibly, got themselves into a frightful technical muddle?

The remedy

One of the advantages of concluding that the mistakes of the 1985-88 period were technical, not political, in origin is that they can be remedied by technically undemanding and politically straightforward adjustments to policy. There is no need for a radical upheaval in the way policy is conducted. Indeed, the policy message of this study is unambitious. By arguing that the breakdown of the monetarist system of financial control in 1985 was followed by serious deterioration in economic policy, it implicitly recommends a return to the pre-1985 system. The focus of policy should once again be a target for the growth of broad money, with the intention (as before) of reducing and stabilising the growth of nominal GDP and the inflation rate. If the growth of broad money is reasonably stable over time, the economy also should be reasonably stable and there will be an end to the stop-go cycle.

This study has concentrated on the M3 measure of broad money. M3 can be regarded as more or less equivalent to bank deposits, since bank deposits constitute about 94 per cent of it. Because bank deposits (on the liabilities side of bank balance sheets) grow with new lending (on the assets side), the control of M3 is achieved by regulating the expansion of bank lending. (This was the point of the arithmetic of credit counterparts which has been discussed in previous chapters.) In theory, adjustments to interest rates were the main instrument by which lending by banks were controlled. It would be perfectly legitimate to restore M3 as the main target aggregate. The system with M3 targets and constant attention to the credit counterparts produced a fairly stable economy between 1981 and 1985, whereas the subsequent pragmatism led to the return of the stop-go cycle.

However, there is a good case for switching to a somewhat

broader aggregate, called M4. M4 includes all assets already in M3 *plus building society deposits*. Nowadays these deposits are increasingly used for transactions, and many people regard their building society deposits in the same light as bank deposits. Moreover, the growth of M4 has been steadier than that of M3 in recent years, because M3 has been buffeted about by erratic shifts in market share between banks and building societies. It should be emphasised that a preference for M4 over M3 as the main target aggregate involves no major issue of principle. M4 is worth following precisely because building society deposits have become more like bank deposits and, in any case, bank deposits are still the largest single element (58 per cent) of M4.

Monitoring M4, however, leads to a slightly different approach to policy from monitoring M3. Whereas bank lending was the dominant credit counterpart to M3, building society lending becomes almost equally important with M4. The new relevance of lending by building societies might actually improve the smooth functioning of the system. Before 1985 bank lending did not respond in a predictable way to interest rate changes, making it difficult to calibrate interest rate changes to the exact attainment of M3 targets. But building society credit has always had the reputation of being sensitive to the level of interest rates, and it appears to have been particularly so in the last few years. It may therefore be easier to set interest rates at levels appropriate for a M4 target than it was for a M3 target.

What target would be correct in current circumstances? The Government's minimum objective at present must be to stop inflation remaining above 5 per cent. In the early and mid-1980s the ratio of M4 to GDP rose on average by 5 to 6 per cent a year, but for two reasons it would be unwise to rely on this in future. First, people may have wanted to hold more money (in relation to income) because of rising real interest rates and institutional changes in the financial system. But real interest rates cannot rise forever and institutional change may not continue at its recent pace. Secondly, excess money balances were clearly being accumulated throughout the economy in this period and abundant liquidity became one of the driving forces behind the boom. Policy should instead try to keep money balances growing at a pace which is neither excessive nor deficient in relation to the prevailing rate of growth of nominal

GDP. If money balances are always just about right in relation to spending patterns and asset holdings, there will be no monetary pressure for either boom or recession, and the economy will avoid stop-go cycles.

A safe starting assumption would be that, if the ratio of M4 to GDP is allowed to rise by 2 per cent a year, the economy will have neither grossly excessive nor seriously deficient liquidity. If the economy's trend rate of growth is 3 per cent and the target rate of inflation is 5 per cent, the indicated target for M4 growth is a bit more than 10 per cent. This is markedly less than the 18 per cent growth recorded in the year to January 1989 and implies quite a sharp correction to monetary growth. If policy makers are troubled by such a prospect, the sensible approach would be to set a target band of, say, 9 to 13 per cent M4 growth over the next twelve months. The width of the band would be the same as with the M3 targets before 1985 and gives policy-makers some freedom to respond to circumstances. In line with the Government's long-term objective of price stability, the M4 target band would be reduced by 1 per cent a year until it had reached a level at which inflationary pressures were overcome. On the assumptions about underlying growth performance and the behaviour of money demand used here, that would be with an M4 target band of, say, 4 to 7 per cent growth and suggests a five-year timetable to eliminate inflation. (Broad money growth at the end of the process would be similar to that currently found in West Germany, where inflation is minimal. In fact, the Bundesbank's approach to setting broad money targets is similar to that recommended here for Britain.)

The techniques for bringing M4 within its target band and keeping it there would be broadly the same as with the M3 targets before 1985, except that policy makers would watch lending by building societies as well as by banks. When the growth of both forms of credit was too high relative to the monetary target, interest rates would be raised; when it was too low, they would be reduced. An active approach to funding policy would be resumed, with the deliberate aim of adjusting official gilt purchases and sales in order to target M4 more closely.[3] Indeed, the existence of a large budget surplus gives the monetary authorities considerable scope not only to withdraw liquidity from the economy, but to fine-tune the rate

at which it is withdrawn.

There should not be any great difficulty in keeping M4 within its target band. (Contrary to common belief, M3 growth ended up close to target in every year when it was targeted, except for 1977/78, when there was heavy and unjustified foreign exchange intervention, and 1980/81, when the corset was removed.)

One possible analytical headache, of some topical importance, should be mentioned. At present new lending to the private sector by banks and building societies is significantly larger in amount than the increase in M4, the gap between them being largely explained so-called 'external and foreign currency counterparts' in the money supply arithmetic. These heavily negative external and foreign currency counterparts are the monetary expression of the large current account deficit in the balance of payments. By targeting M4 rather than the growth of domestic credit, the authorities would be indicating tacit acceptance of a continuing external deficit equal to over 3 per cent of GDP. If a deficit on this scale were at some future date judged to be inappropriate, targets for credit growth might be needed to complement the M4 target. (This would imitate the approach in late 1976 and 1977, when a target for 'domestic credit expansion' was an integral part of the official programme to improve the balance of payments.)

These proposals have not presented a glossy new model of monetary machinery. On the contrary, their purpose has been to salvage some policy equipment (broad money targets, overfunding, close attention to lending by banks and building societies) which had been subjected to a battering by the media in the early 1980s, and was thrown out by the Government, on the grounds of obsolescence and inefficiency, in 1985. In retrospect, it seems very odd that this equipment had such a bad reputation. The truth is that the early and mid-1980s saw both substantial progress in reducing inflation and a more stable economy than in any other period in the twentieth century (except, perhaps, the 1950s)[4] In early 1985 the Government could have claimed, without obvious presumption, that the stop-go cycle had been eliminated. This success was the result of following its original monetarist programme, and stabilising the growth of credit and broad money. By contrast, the muddled

pragmatism of 1985-88 led to another stop-go cycle. If the Government wants to prevent yet another stop-go cycle in the early 1990s, it has only to return to the system which once served it so well.

References

Chapter 1

1 These figures are based on the output-based estimate of gross domestic product. The expenditure-based estimate gives somewhat lower figures, but the output-based estimate is regarded as the more reliable.

Chapter 2

1 M3 was the aggregate Mr. Healey had in mind when he referred to 'the money supply'.

2 It should be noticed that 'monetarism' does not have the same meaning in British public debate as in academic circles. In a paper by T. G. Congdon on 'British and American monetarism compared', to be published in R. Hill (ed.) *Keynes and Monetarism*, London and Basingstoke; Macmillan,(forthcoming), the author differentiates the 'monetarism' of British public debate in the early 1980s from the (American) 'monetarism' of academic economics.

3 M. Holmes, *The First Thatcher Government*, 1979-83, Brighton: Wheatsheaf, 1985, pp.50 and 52.

4 The quotation is from D. Smith *The Rise and Fall of Monetarism*, Harmondsworth: Penguin Books, 1987, p.106.

5 An impressive econometric study by R. B. Johnston on 'The demand for non-interest-bearing money in the United Kingdom', published in 1984 in the *Treasury Working Papers* series, demonstrated the stability of the demand for M0.

Chapter 3

1 The City warnings were made by Tim Congdon and his colleagues, Peter Warburton and Christopher Wickham, at L. Messel & Co. and later at Shearson Lehman Hutton; Roger Nightingale and Paul Turnbull at Smith New Court; and David Smith at Williams de Broe. Gordon Pepper of Greenwell Montagu also became critical of excessive credit and money growth in mid-1987.

2 These figures are taken from the September 1988 issue of

Financial Statistics. Some small revisions may be made to the numbers.

3 'Memorandum by H. M. Treasury', pp. 8 - 16, Treasury and Civil Service Committee of the House of Commons *Memoranda on Monetary Policy*, London: HMSO, 1980. The quotation is from p.11.

4 'Memorandum by Professor M. Friedman', Treasury Committee *Memoranda*, pp. 55 - 61. The quotation is from p.59.

5 The recent discussion of 'equity withdrawal' began in an L. Messel & Co. paper, 'The coming boom in housing credit' (June 1982), by T. G. Congdon and P. Turnbull. The ideas in this paper originated in remarks made by David Lomax, economic adviser to National Westminster Bank, in presenting the case against official restrictions on bank mortgage lending.

6 S. Brittan, *Restatement of Economic Liberalism*, London: Macmillan, 1988, p.277.

7 J. Bruce-Gardyne and others *Whither Monetarism?*, London: Centre for Policy Studies, December 1985, p.43. Professor Minford also warned that slow M0 growth in 1985 indicated that 'we now have the tightest monetary policy we have ever had' and maintained that 'a stalling in the growth rate, unless immediate action is taken to reduce interest rates, is now increasingly likely' (p.45). These remarks, on the eve of the strongest boom for 15 years, suggest that M0 was not giving the right signals.

8 Y. Funabashi, *Managing the Dollar: from the Plaza to the Louvre*, Washington: Institute for International Economics, 1988, p. 78.

Chapter 4

1 As in late 1986, the Shearson Lehman Hutton forecast, prepared by Tim Congdon and his team, was an exception.

2 T. Dickson, '"Wrong turn" of monetary policy in UK', *The Financial Times*, 16 February 1989.

3 It could be argued that the accelerated growth of bank credit depended on a sufficiently large monetary base (i.e. a high M0 growth rate). But that is to concede the primary importance of the credit numbers themselves as a direct influence on spending. In any case, the arrangements in Britain are such that the growth of the monetary base responds to the growth of bank balance sheets rather than the other way round.

Chapter 5

1 This argument is developed in more detail in T. G. Congdon 'Money, credit and the economy', a paper to be published in D. Llewellyn (ed.) *Money*, London and Basingstoke: Macmillan, for the Economic Research Council, (forthcoming).

2 C. Goodhart 'What happens now?: policy after the election', *Gerrard & National 'Economic Viewpoint'*, 12 June 1987.

3 There has recently been some support for a return to overfunding from other City economists, notably Roger Bootle of Greenwell Montagu.

4 This point is made by Sir Terence Burns, the Government's Chief Economic Adviser, in 'The UK Government's financial strategy', W. Eltis and P. Sinclair (eds.), *Keynes and Economic Policy*, London and Basingstoke: Macmillan, for the National Economic Development Office, 1988, pp.428 - 47.

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