Monetarism

An Essay in Definition

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Foreword by William Rees-Mogg

Centre for Policy Studies

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London 1978

First published 1978
by Centre for Policy Studies
Wilfred Street, London SW1

ISBN 0 905880 09 9 (softback)
0 905880 10 2 (hardback)

IBM typeset and printed by
Pentagon Printing Group, Soho Square, London W1

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Foreword

Monetarism is both a new and a traditional doctrine. Early in the last century it became the orthodox political tradition of British economic policy. During the Napoleonic War the House of Commons appointed a Select Committee to inquire into the causes of the high price of gold bullion, that is to say into the causes of the devaluation of paper currency.

The principal finding of the Select Committee (which reported in 1810) was:

> An increase in the quantity of the local currency of a particular country will raise prices in that country exactly in the same manner as an increase in in the general supply of precious metals raises prices all over the world. By means of the increase of quantity, the value of a given portion of that circulating medium, in exchange for other commodities, is lowered; in other words, the money prices of all other commodities are raised, and that of Bullion with the rest.
>
> In this manner, an excess of the local currency of a particular country will occasion a rise of the market price of Gold above its Mint price. It is no less evident that, in the event of the prices of commodities being raised in one country by an augmentation of its circulating medium, while no similar augmentation in the circulating medium of a neighbouring country has led to a similar rise of prices, the currencies of these two countries will no longer continue to bear the same relative value to each other as before. The intrinsic value of a given portion of the one currency being lessened, while that of the other remains unaltered, the Exchange will be computed between those two countries to the disadvantage of the former.
>
> In this manner, a general rise of all prices, a rise in the market price of Gold, and a fall of the Foreign Exchanges, will be the effect of an excessive quantity of circulating medium...

That doctrine was the basis of British monetary policy between the end of the Napoleonic War and the outbreak of the First World War. In the period of full convertibility between 1821 and 1914, the cost of living fell by 10 per cent. In the period since the final suspension of gold convertibility in 1931, the cost of living has risen by 1,000 per cent. That rise has followed the steady expansion of the money supply.

The old doctrine of monetarism was developed mainly by British economists, though French economists were reaching similar conclusions at the same period. The modern doctrines of monetarism have been developed mainly in the United States. It is most important that these doctrines should be widely understood.

They do not offer a cure for all economic ills. Monetary policy can be claimed to remove those ills which are consequent on monetary failures, but cannot remove economic deficiencies which arise from other reasons.

If a country has no factories or too little fertile ground, or no oil, or if its people do not work hard, or if its management is incompetent, then no adjustment of the money supply is going to remove the disadvantages that flow from these economic realities. On the other the supply of money does determine the purchasing power of money; the habits of mind which are associated with the tradition of stability in the purchasing power of money are very favourable to economic development. Equally, the habitual expectation of inflation tends to reduce the wealth of any nation.

Mr Congdon's essay on monetarism provides a clear and informative account of the present state of development of monetary theory. It will be noticed that there is one major difference between modern monetary theory and the traditional theory as it was formulated by the classical British economists. The classical economists were concerned with maintaining the stability of the foreign exchange value of currency by adopting an external standard which determined the rate of issue of the currency. Throughout the Nineteenth century, that standard was gold, but an external standard could either be another metal or another currency.

The modern monetarists, whom Mr Congdon at this point very firmly supports, are concerned with the internal purchasing power of the currency and are prepared to allow the external value to vary. This follows the work of Keynes, particularly his early work on Indian currency reform; and it also follows the work of Professor Friedman. The Bullion Committee and Ricardo took the view that the requirement of convertibility into an external standard was a necessary limit on the issue of currency. Professor Friedman considers that an automatic arithmetic limit will protect the internal purchasing power.

At present this is not a matter of practical controversy; different countries manage their currencies in such different ways that it is inevitable that there should be floating rates of exchange between them. There does not exist a true international currency with a stable rate of issue – such as gold provided – and there is no willingness to bring gold back into its central international role.

Nevertheless, when reading Mr Congdon's admirable account of the present state of monetary theories, it would be wrong to assume that the question of fixed as against floating exchange rates is a closed issue. Historic experience is that internal as well as external prices have been most stable during periods of fixed exchange rates; it should be true that if all countries were to stabilize their internal price level, they would be in a position to operate on fixed external rates as well.

This is not, however, the crucial question which now has to be determined. Governments have to make up their minds whether money is an independent or a dependent variable. There are only two views; one is that the issue of money must be limited to the quantity which is compatible with stable prices, whether internal or external. The other view is that the issue of money should be determined by the requirements of trade and that as much money should be issued as will bring trade to the maximum.

All opinions on this matter, in a controversy that has lasted for at least 300 years, come down to one view or the other. Mr Congdon provides powerful support for the view that it is the issue of money which determines the level of prices, and that trade has to come to terms with a constant rate of issue of money rather than the other way round. His argument is certainly cogent and it is in my view correct.

Introduction

The term "monetarism" has been much used in the last three or four years – sometimes as a clarion call for action to improve economic policy, but often as an epithet of abuse. The present essay, which has been written mainly in response to quite recent events and, therefore, has a necessarily journalistic flavour, tries to define the monetarist school of thought more precisely. With luck it may dispel some of the illusions and misunderstandings which surround it.

Monetarism originates in America and, more specifically, in the "Chicago school" of economics associated with Milton Friedman. However, this essay is intended to place monetarism in the British context. The first chapter is therefore addressed to the question of why monetarism became a contender for influence on policy in Britain in the 1970s. This serves as a background to chapter two – on the theories, arguments and policy proposals which form the essence of monetarism – and to chapter three – on how Britain's situation has modified these theories, arguments and proposals in their application to its economic problems. The fourth chapter is more reflective and relates monetarism to broader philosophical movements much as conservatism and liberalism; or, if one prefers the terminology, it is an attempt to explain why monetarists tend to be "right-wing" and "reactionary". The essay is nevertheless intended to refute the unsubtle but rather common insinuation that monetarism is a kind of economic Blimpishness; it argues that monetarism has an historical continuity and theoretical completeness which few other systems of economic thought can match. The essay contains no original themes of any significance, although a special emphasis is placed on the fact that money is private rather than public property and that monetary policy consequently has implications for the balance between the public and private sectors.

The reader may wonder whether the author is a "monetarist". I have to say that, for most purposes, I am. Certainly in the continuing debate on British economic policy mentioned in chapter three and four my sympathies are entirely with the monetarists. The *soi-disant* "Keynesians" of Cambridge and the National Institute are, in my opinion, completely misguided. In my dislike of their policy recommendations, and my belief that "money matters", that the authorities should adopt a monetary rule, that the exchange rate should be allowed to float, that income policies should be abandoned and so on, I am obviously a monetarist. However, this is not to say that I think that monetarism, as described in this essay, is the last word in economic theory. There is a great deal we do not understand.

In writing this essay I owe a special debt of gratitude to Peter Jay and William Rees-Mogg. I became familiar with most of the ideas and arguments presented here while working as an economic journalist for *The Times* and am most grateful to them for the opportunities I was given to write articles on monetary subjects. More recently, as an economic adviser to the stock-broking firm of L. Messel & Co., my understanding has been sharpened by many discussions with the partners on financial topics. I have also benefited from discussions with Samuel Brittan of *The Financial Times* and Terry Burns and Alan Budd of the London Business School, and from a brief visit to the Manchester Inflation Workshop in 1975. Geoffrey Wood read the typescript and I am grateful to him for many helpful comments. Finally, frequent exchanges with other City economists may be mentioned as influencing my approach to monetarism, but considerations of space (and commercial rivalry!) prevent me from going into details. Fleet Street and the City have been an exciting locale for in an economist in the mid-1970s. None of those mentioned necessarily agrees with all the views expressed here.

I. The Political Setting

"Monetarism" has entered the vocabulary of public debate. Some politicians, economists and journalists categorize themselves as monetarists and, with every expectation of being understood, refer to a particular argument or concept as monetarist. Others say that they are opposed to monetarism and propose alternative arguments and concepts to contradict it. Given the salience of the term in political discussion it is surprising that no attempt has been made to define its meaning more precisely and completely. The purpose of this essay is to provide a definition.

Monetarism is a set of beliefs about the way an economy functions and about the best economic policies for a country to follow. It may be provisionally described as resting on two essential ideas, that "money matters" and that the government should control money supply growth to keep it in line with productive capacity. Before amplifying these ideas some explanation of the rise of monetarism in Britain is necessary; and this will be the subject of the present chapter.

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Monetarism is the contemporary incarnation of an economic doctrine, the quantity theory of money, which has been understood in rudimentary terms for several centuries and has been widely propounded in textbooks since it was first formalized by Professor Irving Fisher in his 1911 *The Purchasing Power of Money*.[1] The quantity theory has influenced British economic policy intermittently in recent decades, notably in the mid-1950s when Mr Peter (now Lord) Thorneycroft, as Chancellor of the

Exchequer, attached priority to restricting the level of bank deposits as part of an attempt to contain inflation.

However, the influence of monetarism on economic opinion only became particularly powerful in the early 1970s, when it received unintended impetus from the economic policies pursued by the Conservative government under Edward Heath. The Conservatives came to office in 1970 after three years in which the preceding Labour administration had achieved a healthy balance of payments position by restrictive demand management. In 1970 and 1971 the economy was suffering from the after-effects of the monetary squeeze of 1969. Economic growth was disappointing and unemployment rose sharply. By the end of 1971 the economic record of the new government could at best be described as unexciting.

Edward Heath and Anthony Barber, the Chancellor of the Exchequer, decided to change direction and the stance of fiscal and monetary policy soon became extremely lax.[2] The public sector borrowing requirement, which amounted to £1,019m in the 1971/72 financial year, climbed to £2,516m in 1972/73 and to £4,458m in 1973/74. But, although the change in the budget deficit was striking, it was the behaviour of the money supply which captured the imagination of economic commentators. In the two twelve month periods to September 1972 and September 1973 the money supply grew by 25.8 per cent and 28.8 per cent respectively.[3]

Money supply growth of this magnitude had never before been experienced in peacetime, but comment remained fairly muted until late 1972 when it became clear that the monetary explosion, and the accompanying "Barber boom", were not temporary aberrations. Attitudes began to polarize and, by early 1973, two distinct camps could be identified.

The first, which may be called "Keynesian", gave its blessing to the government's economic programme.[4] Denying the significance of the money supply as an economic variable, it foresaw the successful containment of inflation by the ambitious prices and incomes policy which the government had enforced since late 1972. Great confidence was expressed about the prospects for maintaining economic expansion, which was unusually rapid in 1972 and 1973, with a high level of employment. This enthusiasm for both the short-term and medium-term

outlook was reinforced by optimism about the potential for export growth, based on the competitiveness of British goods after the depreciation of the pound in mid-1972 and on forecasts of a buoyant world economy. The most outspoken "Keynesian" economists belonged to the National Institute of Economic and Social Research. Its *Economic Review* was quoted extensively by supporters of the government's policy. In May 1973, for example, the *Economic Review* claimed 'that there is no reason why the present boom should either bust or have to be busted.'

Majority opinion in the Treasury shared the "Keynesian" assessment. There is no doubt that most of the official economic advice given to Heath and Barber commended them for the course of action they had taken.

The second school came to be known as "monetarist". Its central prediction was that fast money supply growth would undermine the prices and incomes policy and eventually destroy it, leading to a serious acceleration in inflation and a collapse in the international value of the pound. Still more grave, in the monetarists' view, would be the decline in output and increase in unemployment which would succeed any meaningful government steps to restore price stability. The case was outlined in a *Memorial to the Prime Minister*, signed by a number of academic economists, in November 1972. The *Memorial* may be regarded as a sort of charter of incorporation of the new school.[5] It steadily gathered support. Peter Jay, economics editor of *The Times*, who in the late 1960s had scoffed at the quantity theory and been an eloquent advocate of incomes policies, wrote an article on 7th May 1973 entitled "The boom that must go bust".[6] In the next three years *The Times* became openly committed to monetarism and its position was instrumental in acquainting informed opinion with the doctrine.

For most of 1973 the debate between the two views remained unfocused, as the progress of the economy gave no sign of which was right. But late in the year two events gave a clear indication. The first, and most important, was the announcement on 13th November of a very large trade deficit for October. The Bank of England, afraid of the consequences for sterling, promptly raised Minimum Lending Rate from 11¾ to 13 per cent.[7] The move initiated a regime of high interest rates which remained in force until early 1977. The immediate result was a collapse in share prices, with the *Financial Times* index of industrial ordinary shares dropping from an average of 434.7 in October to 329.9 in December. Property values soon moved downwards in step and, as much of the bank lending of 1972 and early 1973 had been directed to the property sector, a number of financial institutions were badly bruised. The financial crisis intensified throughout 1974 and, as always, was the prelude to a more general downturn in economic activity. As one gilt-edged dealer remarked tersely at the time, the 13th November 1973 was "not a great day in the history of the British Empire".

The second event gave more opportunities for political showmanship and Heath, with his economic policy crumbling around him, exploited them to the full. In October the National Union of Mineworkers organized an overtime ban to force the acceptance of a pay demand which violated stage three of the government's incomes policy. It began on 12th November and, by December, it was obvious that the threat to the nation's energy supplies, and ultimately the economy's capacity to produce, was grave. Heath, with the unanimous backing of the Cabinet and, indeed, of the Conservative party in the country at large, interpreted the miners' militancy as a direct challenge to its inflation objectives. "Confrontation" was inevitable.

The outcome of the conflict – which Heath did his best to represent as a Punch and Judy show between the nation and the miners – was unfavourable to the government. Despite the introduction of a three-day working week between January and March to keep up energy reserves, the NUM persevered with its industrial action and called a full-scale strike. Heath responded by calling a general election. The Conservatives lost by a narrow margin.

The generous award which was shortly afterwards granted to the miners proved to be the harbinger of a "wage explosion", presided over with apparent unconcern and, no doubt, some hidden glee by Michael Foot, the Secretary of State for Employment in the new Labour government. By the end of 1974 earnings were rising at an annual rate of over 30 per cent. Similar rates of price inflation followed. The retail prices index rose by 16.1 per cent in 1974 and by 24.2 per cent in 1975.

The monetarist predictions of early 1973 had, by late 1975, been completely validated. But more had been at stake than

intellectual rivalry between the monetarist and "Keynesian" academic factions. The basic error of Heath's approach, the incompatibility between his government's monetary and incomes policies, had resulted in electoral defeat for the Conservative party. The circumstances of this defeat were little less than disastrous. Indeed, the increasingly blatant antagonism between the union movement and the Conservative government provoked alarmism about the viability of the British political system. Only the Labour party, it was argued, could co-operate with the unions, a qualification which made it the "natural governing party".

This sequence of events had an extremely unsettling effect on attitudes in the Conservative party. A growing number of MPs and party supporters saw the "Barber boom" as the root cause of their misfortunes and, as a reflex response to their own and the economy's dificulties, advocated certain measures which were the precise opposite of those followed by the Heath government in 1972 and 1973. They favoured vigorous deflation of the economy, through "massive" cuts in public spending and a sharp check to money supply growth; they conceded that unemployment would rise, but that was seen as the unavoidable cost of restoring balance to the economy; and they denounced increasing government intervention in private enterprise. These views came to be regarded in public debate as distinctively monetarist.

The adoption of this label by a group of active and practising politicians gave wider recognition to a set of beliefs which, until then, had been largely confined to the universities. But the common view that monetarism entailed deflation and more unemployment did a serious disservice to the new creed. The connotation of monetarism with a vaguely disreputable "extreme" political position originates in the disarray of the Conservative party in early 1974. The allegation of "extremism" – which it is one of the aims of this pamphlet to dispel – has unnecessarily restricted the audience for monetarist ideas. In fact, prominent monetarist economists, particularly Professor David Laidler (then of Manchester University), were the earliest and most emphatic critics of the severity of the monetary squeeze which the Bank of England began to operate in late 1973. The ground of their criticism was that the squeeze would cause an excessive increase in unemployment at some point in 1975.[3]

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Despite the tension between the political and academic supporters of monetarism in 1974 the successful infiltration of its leading ideas into the mainstream of fashionable opinion would not have been possible without the existence of a large body of academic studies, both theoretical and empirical, which substantiated its case. The home of this work is the University of Chicago in the United States and its most celebrated protagonist is Professor Milton Friedman, winner of the 1976 Nobel prize in economics.

However, Friedman is not the founder of the Chicago school. Professor Irving Fisher popularized the quantity equation $MV = PT$, which is the starting point of all monetarist thinking. But he did not teach at Chicago, being Professor of Political Economy at Yale from 1898 to 1935. The accolade for establishing the school must instead be awarded to Henry Simons, who was Professor of Economics in the Law Faculty at Chicago in the 1930s. A fair measure of continuity can be detected between the monetary analysis of Simons and Friedman. Although Friedman has greatly refined and hardened the monetarist argument there can be no doubt that, when he joined the Chicago faculty in 1946, its tradition of monetary thought was robust.[9]

Simons' most influential article, on "Rules versus authorities in monetary policy", was published in the 1936 *Journal of Political Economy*. It emphasized the need for an automatic, rule-governed method of monetary policy determination, and envisaged a "new 'religion of money', around which might be regimented strong sentiments against tinkering with the currency". Simons' two proposals for banking reform were that demand-deposit banking be put on a 100 per cent reserve basis and, "more tentatively", that there be an "eventual fixing of the total quantity of circulating media". These proposals reflected the environment of world slump in which their author was writing. The "100 per cent system" was intended to prevent the collapse of related banking institutions through the "domino effect" in the financial system, which was identified as one of the principal defects of the capitalist economy. Like Keynes in England at the same time, Simons' main anxiety was fluctuations in both output and price levels. Unlike Keynes, who favoured "a somewhat comprehensive socialization of investment" to enable the government to regulate investment demand directly, Simons recommended an institutional reform in the banking system to curb the inherent instability of its lending operations.[10]

The "100 per cent system" was regarded as the "Chicago Plan" in the 1930s and 1940s. It would lead to control of the money supply, but neither its advocates nor its critics thought that such control was the unique or pre-eminent contribution of the Chicago school to monetary debate.[11] Friedman's first important article on these themes, "A monetary and fiscal framework for economic stability", published in the 1948 *American Economic Review*, shared Simons' preoccupation with stabilizing output and employment and borrowed some of his recommendations. It was a mix of two ideas – the 100 per cent reserve proposal, which Friedman approved as eliminating the private creation of money, and the "hypothetical income" budgetary policy. Friedman said that the government should not adjust its expenditure to cyclical variations in the economy. As long as the government kept tax rates and transfer payment schedules constant, these variations would themselves cause changes in the budgetary balance. If national income were above a particular "hypothetical level", there would be a budget surplus and, because of the 100 per cent system, there would be a corresponding contraction in the money supply. National income would decline, returning to the stable hypothetical level. And vice versa if national income, for some reason, dropped beneath the hypothetical level.[12]

Simons' articles and Friedman's early policy proposals are more than historical curiosities. It is evident that in the 1930s and 1940s Chicago economists were deeply interested in fiscal, as well as monetary, policy, and that they had an acute awareness of the interaction between the two. Moreover, they did not consider either that capitalism possessed innate stability or that government policy should be directed exclusively towards the maintenance of a constant price level. They distrusted political and discretionary management of demand, but they advanced schemes for automatic policy changes which, in their view, were desirable because of the consequent mitigation of output fluctuations.

A perceptible shift in Chicago school thinking occurred in the

1950s. The significance of fiscal measures began to be questioned and the school's commitment to price stability as the overriding aim of economic policy became more pure. The shift was probably attributable to the empirical investigations undertaken by Friedman and Anna Schwartz.[13]

This work seems to have made Friedman sceptical about economists' understanding of the link between changes in government policy and subsequent economic developments.

> In the present state of our knowledge we cannot hope to use monetary policy as a precision instrument to offset other short-run forces making for instability. The attempt to do so is likely to introduce additional instability into the economy, to make the economy less rather than more stable.[14]

Friedman's doubts could easily have led to agnosticism about the policy-making authorities' right course of action, but he was rescued from this by the statistical confirmation of a durable and trustworthy relationship between the money supply and money national income. The answer was clear.

> In order to attain a reasonably stable price level over the long pull, we must adopt measures that will lead to a growth in the stock of money at a fairly steady rate roughly equal to or slightly higher than the average rate of growth of output.[15]

This prescription had the important merit of simplicity. Unlike the 100 per cent reserve proposal, which in any case was of doubtful feasibility, it could be easily propagandized. In the 1960s interest in monetary economics became increasingly widespread and growing numbers of economists accepted the Chicago school conclusions. Friedman, who had by now acquired a world-wide reputation, termed the change in opinion "the monetary counter-revolution". He thought of it as a reaction to the Keynesian revolution of the 1940s.[16]

Professor Harry Johnson, a remarkably prolific Canadian who held two simultaneous professorships, one at Chicago and the other at the London School of Economics, was an influential follower and developer of the doctrine. His position at the LSE was extremely valuable in enabling monetarism to obtain a foothold in Britain. In 1969 he played a leading role in setting up the Money Study Group, which soon became a forum for monetary debate. In the same year the Social Science Research Council agreed to finance a new research project on inflation, under the

directorship of Professors David Laidler and Michael Parkin, at Manchester University. It began work on a three-year programme in July 1971.[1]

At first its work was not channelled in any particular direction Parkin, for example, has said that he began as "a self-confessed Keynesian". However, a major branch of the programme was the examination of the monetary evidence in Britain which, until then, had been rather neglected. Empirical inquiry seems to have had the same effect on the researchers as it had had on Friedman and Schwartz in the 1950s. The focus of their work was, of course, somewhat different, since their main concern was an explanation of price level variations as such, not of price and output movements considered together. But the evidence pointed towards a monetary, not a political or sociological, interpretation of inflation and this put the Manchester Inflation Workshop firmly in the monetarist camp.

The result of this academic activity was that, throughout 1972 and 1973, while the "Barber boom" was in full swing, opponents of the loose monetary policies chosen by the government could appeal to a mass of reasoned and detailed theoretical argument, backed up by statistical analysis, to fortify their position. The "Keynesians" lacked intellectual artillery of the same range or penetration.

iii

The weight of scholarship on the monetarists' side would not, however, have been sufficient to guarantee their recognition in the wider debate on economic policy. In Britain this debate proceeds mainly in the quality newspapers, particularly *The Times*, *The Financial Times* and *The Guardian*. Its participants are concentrated geographically in the centre of London and include journalists, civil servants, economists working in the City, some politicians and a few academics. Their purpose is to influence government and their hope is that, in doing so, economic policy will be made better and wiser. It is certainly true that the financial press is taken seriously in government circles, far more so than in most other countries. This may be largely a reflection of the fact that public awareness of Britain's economic misfortunes in the last fifteen years has been created by newspaper coverage which has become almost tedious in its gloom. But it is also probably due to the excellence of much of that has been written by the leading economic commentators – notably Samuel Brittan and Anthony Harris in *The Financial Times*, Peter Jay in *The Times* and Miss Frances Cairncross in *The Guardian*. It is ironic, but not perhaps surprising, that a country with such obdurate economic problems should have such a well-informed and thoughtful financial press.

Contacts between economic journalists and academics are close. Brittan, for example, is a Visiting Fellow of Nuffield College, Oxford, and, apart from his regular pieces in *The Financial Times*, has made a number of contributions to academic works. These contacts meant that the commentators had been familiarized with the essentials of monetarism by the early 1970s. By the end of 1973 most of them had, with varying degrees of conviction, decided that the economic policy of the Heath government was doomed and there was also some measure of agreement that its main weakness had been the failure to contain money supply growth. As events unfolded the soundness of the monetarist predictions of 1973 became less controversial and eventually indisputable. The monetarist message was repeated at regular intervals in the quality newspapers in 1974 and 1975. The virtual unanimity of the financial press – and, more especially, the stand taken by *The Times* – that the money supply must be brought under control was possibly the most important single cause of the progress made by monetarism in public debate in those years.

But it would be superficial to end our account with a tribute to journalists, however justified that might be. The acceptance of monetarism by many people occupying prominent positions in British political life may be interpreted as part of a more general reaction against certain trends in social policy. In a later chapter it will be argued that monetarism is not politically neutral, but may be regarded as an economic accompaniment to the liberal-conservatism associated with such thinkers as Hayek and Oakeshott. Its rise may have been conditioned by anxiety about the increasing role of government in the economy and society. Such anxiety has been remarked on by several observers in the 1970s and has led to a resurgence of interest in the philosophy of economic liberalism. Books such as Professor James Meade's *The Intelligent Radical's Guide to Economic Policy* and Brittan's *Capitalism and the Permissive Society* may be cited as examples of these tendencies. "The monetarists" and "the economic liberals" are phrases used almost interchangeably in certain contexts. The group to which they refer has been compared in influence to a "new Fabianism" – although it is perhaps paradoxical that the Fabianism of the 1920s is now establishment orthodoxy and that some monetarists would feel happier in the political climate of the 19th century than in today's.[17]

Notes

1 I. Fisher *The Purchasing Power of Money* Macmillan: New York p.25. Fisher refers to "an algebraic statement of the equation of exchange" by Simon Newcomb in the "able but little appreciated" *Principles of Political Economy* Harper: New York 1885 p.346. (*The Purchasing Power of Money* is dedicated to the memory of Simon Newcomb, "pioneer in the study of 'societary circulation' ".) But Fisher says that Ricardo "probably deserves most credit for launching the theory", although not giving it mathematical expression.

2 The money supply had been growing quite quickly for some time before the budget of 1972 publicly committed the government to reflation. In 1970 the money supply rose by 9.5 per cent and in 1971 by 13.2 per cent, compared to 3.1 per cent in 1969. The economy was, in fact, recovering satisfactorily when the "Barber boom" was inaugurated. That observers at the time did not recognize this reflected the widespread ignorance of the deflationary and reflationary force of money supply movements.

3 The money supply concept under discussion here is M3 – notes and coin in circulation with the public; current accounts; and deposit accounts, including certificates of deposit.

4 There is little, if any, sympathy between Keynes' own writings and those of the "Keynesians" – it is an outrage on Keynes that those economists who favour reflation in almost any circumstances should have appropriated his name. I have protested against this usage elsewhere (see "Are we really all Keynesians now?" by T. Congdon in *Encounter* April 1975) and will discuss it in more detail below (in ch.4). However, the use of the term "Keynesianism" to describe the brand of economics practised at the Treasury and National Institute is so well-established that one will have to abide by it as a convention.

5 *Memorial to the Prime Minister*, Economic Radicals: London 1972.

6 Peter Jay has pointed out to me that debate about the importance of the money supply had been fairly active in Whitehall and the City before the "Barber boom" and that it is somewhat misleading to relate the rise of monetarism too closely to the monetary mismanagement of 1972-73. Indeed, his own articles show how attitudes had begun to change shortly after the devaluation of the pound in 1967. Particularly fascinating is the following passage from an article by him in *The Times* of 31st May 1968 with the title "Inflation: is the money supply crucial?":

> Just as every schoolboy knows about the perils of 'assignats', so every schoolboy of recent vintage knows that Peter Thorneycroft 'forgot' the velocity of circulation of money when he tried to stop the inflation of 1957 (the highest in the last twelve years) by limiting the money supply.
>
> That mistake, or at least the failure of Mr Thorneycroft's policies which caused high unemployment without stopping inflation, really brought to an end for ten years significant political discussion of the money supply as a major factor in economic management. Cognoscenti pointed out that the equation was MV = PT, not
> $P = \frac{M}{T}$

(In fact, the Thorneycroft monetary restraint did stop inflation – in 1959 and 1960, after the usual two year lag – but even in 1968 the notion of lags in response to monetary policy was not widely understood.) Mr Jay received a number of letters from American monetarists in 1968 and 1969 criticizing his remarks in this and other articles. *The Times* carried the first ever money supply story (that is, a story about the increase in the money supply in a recent period according to official statistics) on 24th September 1968, remarking on the 9.9 per cent growth at an annual rate in the second quarter. The continuous reporting of money supply figures followed and was, of course, indispensable in creating public awareness of monetary policy. A leader in *The Times* of 15th October 1968, on "Understanding the role of the money supply", was symptomatic of a gradual shift in attitudes.

7 It could be argued that the increase in MLR on 13th November made the severe recession of 1975 and 1976 inevitable. Money supply growth was soon checked and a fall in output followed with the usual nine to eighteen month lag. It might have been better, in retrospect, to have allowed the pound to depreciate by about 5 or 10 per cent after

the October trade figures and to have managed interest rates with a more gradual money supply decelaration in view.

8 Evidence by Professor D. Laidler. p.59 *Ninth Report from the Expenditure Committee 1974 Session* HMSO: London 1974

9 Friedman was, however, well-known at Chicago in the 1930s. His name appears as an editor of a collection of essays on *The Ethics of Competition* George Allen & Unwin: London 1935. The essays were written by Professor F.H. Knight, another of the founding members of the "Chicago school", although he did not write on monetary economics to any significant extent.

Friedman has written an assessment of Simons. See "The monetary theory and policy of Henry Simons" in M. Friedman *The Optimum Quantity of Money* Macmillan: London 1969 pp.81-94.

10 H.C. Simons "Rules versus authorities in monetary policy" in *Readings in Monetary Theory* American Economic Association Series: George Allen & Unwin: London 1952 pp.337-368, reprinted from *The Journal of Political Economy* 1936 pp.1-30.

11 See A.G. Hart "The Chicago plan of banking reform" in *Readings in Monetary Theory* (ibid.) pp.437-456, especially p.441.

12 M. Friedman "A monetary and fiscal framework for economic stability" in *Readings in Monetary Theory* pp.369-393, reprinted from *The American Economic Review* 1948 pp.245-264.

13 M. Friedman and A.J. Schwartz *A Monetary History of the United States 1867-1960* Princeton University Press 1963.

14 M. Friedman "Monetary Theory and Policy" (p.144) in R.J. Ball and P. Doyle (eds.) *Inflation* Penguin: Harmondsworth 1969 pp.136-145.

15 M. Friedman *ibid* p.144.

16 The phrase "the counter-revolution" is used in Friedman's essay on "Post-War trends in monetary theory and policy" in *The Optimum Quantity of Money* pp.69-80. It may be noted that Friedman himself does not like the word "monetarist".

17 I have been surprised by the number of confessed monetarists who have objected to being associated with "the right-wing" and "conservative" philosophy. But it seems to me to be quite inescapable that monetarists do tend to favour policies in other contexts which are connected with right-wing political attitudes. This needs to be explained and

discussed. There are, of course, wider questions on the viability of the right-left dichotomy. See S. Brittan *Left or Right: the Bogus Dilemma* Secker & Warburg: London 1968.

On the other hand, I have yet to meet a monetarist who dislikes being called a "liberal". Why do people get so upset about being called "conservative" and why are they content to be called "liberal"?

II. The Economic Content

Monetary theory is one of the more complicated areas in economics; and its difficulty has unfortunately impeded the spread of understanding about the *modus operandi* of monetary policy. However, the essential notions are quite simple. It is only the less fundamental theoretical embellishments that are hard to grasp. The purpose of this chapter is to outline the background thinking behind monetarism, emphasizing the important ideas and referring only incidentally to the qualifications.

i

In any economy, money has a variety of functions, such as being a store of value and a standard for deferred payments. But its unique attribute, and that on which economists concentrate, is that it serves as an acceptable medium of exchange, as an instrument for completing transactions and settling debts. It removes the need for barter and helps minimize the inconvenience of buying and selling.

However, unlike shares or bonds, it yields no pecuniary return to its owner: it is an unrewarding way of holding wealth. Consequently, most individuals do not have an unlimited demand for money because there are more effective dispositions of their assets. Money is useful mainly because it facilitates transactions and the demand for money is determined primarily by the extent of the transactions to be undertaken.

This reasoning explains the central monetarist principle that the demand for money bears a stable relationship to money national income.[1] There is one particular ratio between the money supply and national income at which companies and persons are satisfied; if, by some mischance, the actual ratio exceeds this particular ratio it must be worthwhile for them to spend more on goods or invest in bonds to bring their asset dispositions and preferences more into line; if the actual ratio is less it must be expedient to cut down on their expenditure because otherwise there would be undue inconvenience in their business arrangements. The same proposition can be expressed with the help of the MV = PT identity. Monetarists say that economic agents are only content if the velocity of circulation takes one value, its equilibrium value. The velocity of circulation may depart from this temporarily, but forces will then be set up to make it return to its unique equilibrium level.

Empirical investigations of the relationship between the quantity of money and money national income have been carried out in many countries and over long historical periods to test these arguments. The evidence is that the demand for money exhibits considerable stability through time and the results have, therefore, generally been reassuring for the monetarist case. The nature of the evidence should not be misunderstood. It does not show that the velocity of circulation never changes; but it does show that such changes are around a fairly constant trend value. The trend value may itself alter because of technical progress in the financial system or changes in the community's "taste" for money compared to other things. But the velocity of circulation never swings wildly upwards or downwards without apparent cause.

Although the demand for money is stable, the supply of money may not be. The money supply is determined by a number of factors, such as the budget deficit and the balance of payments position, which vary from month to month and year to year. Indeed, if the money supply (the quantity of notes and coin, and bank deposits, *actually* held in a country) differs from the demand for money (the quantity that economic agents *would like* to hold) the steps taken by companies and individuals to restore equilibrium result in fluctuations in output, employment and the price level. It follows logically that monetarists consider economic instability to be due principally to instability in the money supply. For example, Friedman has said that the depression of the early 1930s was due to unnecessarily restrictive policies by the Federal Reserve in the United States, not to other possible

causes such as over-investment in the 1920s or the collapse of confidence.[2] If monetary instability is the main culprit for cyclical problems it follows that the surest method of steadying the economy is to keep the money supply growing at a constant rate; and the only rate which is compatible with zero inflation is one related to growth in the underlying capacity of the economy.[3]

It should be noticed that this case for the "monetary rule" is a positive one: the rule is recommended because of its likely success in eliminating cyclical fluctuations. But the argument Friedman originally advanced to support it is less ambitious. It emphasized that in the past the monetary authorities had failed to move the economy onto a desired path by discretionary adjustment of interest rates and credit availability. The justification for stable monetary expansion is not that it will definitely lead to more even economic expansion, but that varying the rate of money supply increase will not help towards that end and may aggravate instability.[4]

This negative and sceptical case for the monetary rule is an accommodation to policy-makers' lack of understanding of the world in which they live, but it is not particularly convincing in debate and has achieved most of its force over a period of years from growing disillusionment with "fine-tuning" in practice. Most monetarists, including Friedman, oscillate between the positive and negative arguments for stable money supply growth, depending on the purpose and context of the discussion in which they are engaged. But both arguments have a weakness. They are vulnerable to the charge that they give no policy guidance in a situation of serious inflationary disturbance. In such an extremity it is perhaps of purely academic interest that more moderate money supply growth would lead to price stability in the long run. It is no use telling a finance minister confronted by a 40 per cent inflation rate that, if prices were steady, 3 per cent money supply increases every year would keep them steady. The critical problems are immediate and demand a prompt clarification. Putting the difficulty in more general terms, the monetarists, although possibly successful in specifying a necessary condition for macroeconomic equilibrium, appear to have nothing relevant to say about appropriate policies in disequilibrium or about the passage from disequilibrium to equilibrium.

The monetarist school has responded to this challenge, but the answer has been complex. The pivotal concept is that of inflationary expectations – the rate of price increases expected by the economic system in the immediate future. Business plans and consumer spending patterns are based on such expectations. If they are disappointed there is likely to be a mismatch between intended and achieved levels of income and expenditure. Adjustments to serious planning failures result in changes in business activity and employment, which are undesirable and to be avoided. Monetarists agree that the disappointment of inflationary expectations is most probable if the rate of money supply growth changes abruptly in a short space of time. For example suppose that an economy, such as Britain's at the end of 1973, has experienced two years of money supply growth in excess of 20 per cent, producing inflationary expectations at 15 per cent or above. According to one characteristic monetarist argument, to check money supply growth to 5 or 10 per cent in such circumstances would be unwise because the conflict between the system's expectations and its ability to accommodate those expectations can only be resolved by a severe recession. More prudent would be a gradual decelaration in money supply growth to prevent the conflict, which is inevitable in some form, becoming too pointed.

This doctrine of "gradualism", associated with the Manchester Inflation Workshop, is monetarism's main reply to the problems of inflationary disequilibrium.[5] But there is another escape-route. Instead of operating exclusively on the money supply the authorities can attempt to influence inflationary expectations as well. If expectations of the annual rate of price increase can be brought down to the 5 or 10 per cent range a reduction in money supply growth to the same sort of figure would not be damaging. On this approach the best policy may be a shock to the system, with powerful monetary and fiscal measures accompanied by the announcement of low inflation targets and by a firm official commitment to restore price stability. A package of this kind could be compared to a "virtuous confidence trick", which, once believed, is also self-fulfilling. It is one of the rare instances in political economy when noisy government is more benign than quiet inactivity.

The choice between gradualist and shock therapy is not easy: monetarists often differ in their views on the appropriate severity of treatment. Much depends on the seriousness of the inflationary situation and on the credibility of the government in office. Clearly, in a hyperinflation, when prices are rising at fifty per cent or more a month, gradualism is inadequate and shock measures can do no harm. On the other hand, when inflation is running at less than 5 per cent a year, it may be counter-productive to administer unpleasant medicine where the side-effects are worse than the disease. But, between these two limiting cases, there is a spectrum of more or less bad inflations where the right action has to be judged in relation to prevailing economic and political opinion. It is essential, if a shock package is to work, that the people believe the politicans.

A discussion of monetarist attitudes towards economic disturbance would not be complete without referring to the other main form of macro-economic disequilibirum, heavy unemployment associated with falling prices, the situation which troubled Keynes in the early 1930s. It is sometimes argued against the monetarist position that, when resources are unemployed, raising the money supply at a faster rate than the long-run rate of economic growth would be innocuous because the result would be lower unemployment, not inflation. In recent years this criticism has been rather off-beam because high unemployment and fast inflation have occurred simultaneously: a policy able to influence one and not the other has not been devised or implemented.

But it is nevertheless fair to ask a monetarist what he would do in a severe and prolonged depression of the 1929-33 type. Would he adhere to an automatic rule? Or would he concede that discretionary stimulatory action might be applicable in certain conditions? It is not possible to speak of a well-defined monetarist standpoint on these questions, but a tentative answer can be given. The monetarist would probably attribute the depression to an incorrect financial policy which left the economy with too small a money supply in relation to its needs. If a discretionary stimulus were to be given he would estimate its required size by calculating the degree of shortage, perhaps by comparing the equilibrium velocity of circulation with actual velocity. But if the result indicated the need for a violent change in monetary policy he might hesitate and favour a more temperate course.

He would certainly accord a prominent role to innate or "natural" mechanisms in the economy tending to restore full employment. Such mechanisms would include wage and price changes to bring demand and supply more into balance. Institutional impediments to wage and price flexibility would be condemned because they interfere with the smooth functioning of market mechanisms and impair the economy's adjustment performance. Concern about wage and price flexibility has been a recurring theme in monetarist writings. Simons, in his seminal "Rules vs. authorities in monetary policy" article, bracketed "the establishment of highly competitive conditions in industry and the narrow limitation of political control over relative prices" with rule-governed monetary policy as desirable objectives.[6] Similarly, Friedman's early proposals for a stable economic framework were punctuated by reservations about price rigidities.

> The brute fact is that a rational economic programme for a free enterprise system. . .must have flexibility of prices (including wages) as one of its cornerstones.[7]

The same anxieties are frequently expressed by monetarists today.

In short, the monetarist response to mass unemployment *and a stable or falling price* level would have two elements – a discretionary monetary stimulus to offset previous unwarranted stringency; and the encouragement of wage and price flexibility. The "cheap money" experiment in Britain in 1932 – which led to money supply growth of 15 per cent in a year – might well receive the monetarist blessing.

On the other hand, if unemployment is associated with rising prices the monetarist would not favour an acceleration of money supply growth, but would instead counsel caution and restraint, to permit the economy's in-built equilibrating mechanisms to do their work. Time and government indifference are the only cures for the most vicious outbreaks of "stagflation".

ii

So far this chapter has examined the analytical foundations of the Friedman rule and discussed the rationale for possible exceptions to it. But this is only one half of the monetarist approach to economic policy. The other half is a distrust of

attempts to regulate the economy by managing the level of aggregate demand. In no country has such demand management, by means of "Keynesian fine-tuning", been adopted so completely by the authorities as in Britain and it is perhaps fair to say that in no country has disquiet about the authorities' methods been more frequently articulated.

In the monetarists' eyes there are two fatal weaknesses in Keynesian fine-tuning of the type which has been conventional in the Treasury since about 1960.[8] First, it is organized with three policy goals in mind – full employment, balance-of-payments equilibrium and price stability. This trio of objectives, sometimes supplemented by economic growth, are accepted as appropriate by the great majority of professional economists in Britain and, indeed, they have been sanctified by a generation of textbook writers. A standard examination answer at university level to the question "what are the aims of macro-economic policy?" will mention them as a matter of course. But the pure monetarist does not acknowledge their validity. To him only price stability should be pursued by the government and the other two objectives cannot properly be policy considerations.[9] In his view, it is very difficult to specify the desired position of an economy when three (or four) of its characteristics are at stake. Such an approach is, he feels, too enterprising and is likely to terminate in confusion, uncertainty and, most dangerously, frequent policy adjustments as one or the other objective is not attained. If, on the other hand, policy is directed towards only one objective it can have the consistency and lucidity necessary for success.

The second weakness is more technical. In its demand management capacity the Treasury has, since about 1970, been dependent on a large econometric forecasting exercise. The exercise is performed with the aid of a powerful electronic computer three times a year. Its theoretical function is obvious: as long as the government knows where the economy is going to be in a year or eighteen months' time, policies can be changed to move it closer to the desired position, whatever that may be. But, of course, the forecasts must be accurate. The trouble is that they have in practice generally been wrong, with unhappy consequences in mistaken policies and predictions.

The economists involved in the forecasts seem to be uncertain about the reasons for this failure, but it has been argued that the basic flaw is the Keynesian lineage of the Treasury's econometric model. The Keynesian origins mean that it is framed in real terms and that it gives only a slight role to balance sheet influences, including that of the money supply, on behaviour.[10] These attributes and their significance are appreciated by those responsible for formulating and constructing the model. It is, they say,

> . . .built round the income and expenditure flows leading up to an estimate of aggregate demand and output. In particular, the approach adopted reflects such initial presumptions as a 'full-cost' approach to pricing, the absence of sharply defined constraints on the supply side and demand relationships in which the dominant role is played by income-expenditure rather than portfolio considerations.[11]

They describe themselves as "perfectly open-minded" about these emphases and observe that "different preconceptions on these matters might have led to a differently constructed model".

To the monetarists this is not good enough. The exclusion of "portfolio considerations" implies that changes in the liquidity position of companies and individuals have no measurable economic effects. Such a position is at variance with the cardinal principle of monetarism, that asset preferences are stable and predictable. The Keynesian forecasters usually defend their stand by claiming that there is no comprehensive monetarist model of the economy in existence and that, therefore, no alternative to neglecting portfolio effects has been offered. The monetarist reply that a big model is needed only because the government is seeking undue exactitude in its handling of the economy. It would be more wise not to expect so much precision from the forecast.

This plea for humility appeared particularly judicious in 1975 when the government was hopelessly incorrect in its forecasts of the scale and timing of the recession, largely because of the innate structural inability of the Treasury model to capture the effects of the slowdown in money supply growth in late 1973. The model, with its hundreds of equations and dozens of dependent variables, proved to be precisely wrong. It would be better, the monetarists say, to be roughly right.[12]

These objections to Keynesian fine-tuning relate to the particular style of economic policy operated in Britain in the last twenty years. However, there are deeper and more fundamental criticisms of the whole philosophy of demand management which

raise a host of difficult issues. The gravamen of these criticisms is almost cruel: the government can do nothing to improve levels of output and employment without causing inflation. The best advice an economist can give to a finance minister or Chancellor of the Exchequer is the quietist injunction, "do nothing, except control the money supply".

iii

Perhaps the starkest case against an active employment policy was presented by Friedman in his 1967 address to the American Economic Association on "The role of monetary policy". It regards unemployment as performing the same function in the economy as stocks of raw materials or "hoarded labour" in a firm.[13] Unemployment constitutes a pool of unused labour which can be augmented or reduced to meet supply-demand imbalances in particular industries. Indeed, there is one level of unemployment, "the natural rate", at which there is neither excess demand nor supply in the labour market. It is therefore compatible with a stable rate of wage increases. In Friedman's words, the natural rate is

> . . .the level that would be ground out by the Walrasian system of general equilibrium equations, provided that there is embedded in them the actual structural characteristics of the labour and commodity markets, including market imperfections, stochastic variability in demands and supplies, the cost of gathering information about job vacancies and labour availabilities, the costs of mobility, and so on.

If the government, in search of an arbitrarily defined full employment goal, stimulates demand and drives unemployment beneath the natural rate, money wage rises increase. In due course, this is reflected in price inflation and, subsequently, in the system's inflationary expectations. If the government perseveres with its employment policy even the higher rate of inflation cannot be stable and price rises accelerate further. More concisely, a "full employment" target in conflict with the "natural" forces in the economy can be attained only at the expense of progressive currency debasement and, finally, hyper-inflation and the collapse of political life.

The argument has another wrinkle. If unemployment drops beneath the natural rate, even for a very short period of time, the upsurge in inflation affects beliefs about future price movements. The system's expectations have been permanently contaminated. To remove the contamination and restore price stability it is not sufficient to have unemployment at its natural rate, because in such circumstances that rate is consistent only with the positive and higher inflation already established. Instead, unemployment must be allowed to rise above the natural rate as a sort of deliberate convalescence from the inflationary fever. The implications are grim. An active employment policy is not merely futile or self-defeating, but downright harmful. The only realistic course is to abandon the full employment objective and confine monetary policy to its proper role of maintaining the real value of the currency.

The "natural rate" argument is, unlike most economic theories, extremely simple. Some surprise might be expressed that opponents of active employment policies took so long to think of it. It has close ties with one of the 'leitmotivs' of "classical", pre-Keynesian economics, that the amount of money cannot change real variables. Friedman himself has pointed out the resemblance between his discussion of unemployment and Wicksell's analysis of interest rates in the 1890s. Perhaps the reluctance to put forward the concept of a natural unemployment rate was due to its faintly mystical ring. What does "natural" mean? How should it be measured? Friedman confessed ignorance.

> What if the monetary authority chose the "natural" rate – either of interest or unemployment – as its target? One problem is that it cannot know what the "natural" rate is. Unfortunately, we have as yet devised no method to estimate accurately and readily the natural rate of either interest or unemployment. And the natural rate will itself change from time to time.

In other words, it is the lack of knowledge, the very elusiveness of the natural rate, that is the true refutation of the demand management approach. Similar misgivings about the authorities' understanding of the economy were, it may be remembered, the background to the negative and sceptical case for the monetary rule which Friedman advanced in the late 1950s.[14]

Like the natural rate critique of the manipulation of unemployment, the monetarist objection to the manipulation of demand and output has deep historical roots. The crux of the objection is that any attempt to stimulate the economy by raising public

spending is nugatory because a fall in private spending will offset the higher public demand. The modern term for this phenomenon is "crowding out", which, although somewhat ungainly, expresses very clearly the notion of jostling between different bundles of expenditure.[15] Crowding out has been much debated in the last two or three years, but the process was understood in Britain in the 1920s and 1930s. The Treasury had found, from experience, that small public works schemes were only temporary palliatives for unemployment. Once ended, the initial and genuine problem, the lack of authentic job opportunities in the private sector, was renewed. More fundamentally, the borrowing necessary to finance public works schemes pre-empted borrowing by industry and may, therefore, have exaggerated the underlying weakness in the demand for labour. This body of ideas, which was the standard government response to Keynes' call for an expansionary fiscal policy in the inter-war period, was known as "the Treasury view". The Treasury view and crowding out are, in essentials, very similar.

Clearly, the widespread acceptance of the crowding out argument in the 1970s was not a breakthrough in economic understanding. Moreover, the success of the argument may have owed as much to its historical setting as to its theoretical content. Government spending rose rapidly in Britain in 1974 and 1975, for reasons which still remain somewhat obscure.[16] But the rise in spending did not stave off a severe downturn, as an increase in the savings ratio counterbalanced the extra public sector expenditure.[17] In the early 1930s, by contrast, the Treasury view seemed misplaced because companies in the private sector did not take on new employees when government expenditure was curbed.[18] The intellectual initiative lay with the Treasury's critics, such as Keynes and Mr Richard (now Lord) Kahn, who put forward the idea of a "multiplier" process whereby an increase in public spending not only constituted an addition to national income in itself, but also vitalized private spending and caused consequential further rises in demand. The multiplier, which is taught as the fulcrum of a typical macro-economics course in universities, was a persuasive theoretical construct in 1933. By 1975 circumstances had changed and so, too, had the comparative plausibility of the multiplier and crowding out arguments.

But the conditions under which one or the other argument is valid are still hotly disputed among economists. Two distinct sequences of events have been said to constitute crowding out. The first, which may be termed "resources crowding out", emphasizes that, when the government places orders for more goods and services, the demand for labour and capital increases and their prices (wage rates; rentals for machinery; etc.) rise. The private sector is unable to meet the higher bills and resources are shifted into the public sector. There is no net benefit to the community, merely a change in the balance between the public and private sectors. The second, known as "financial crowding out", is more intricate and raises quite complicated issues in economic theory. The crucial point is that crowding out takes place when certain techniques of financing additional public expenditure are chosen. If higher expenditure is financed from the banking system, the money supply increases, possibly leading to downward pressure on interest rates and higher private spending. If it is financed by sales of debt to the general public, the money supply is unchanged and the public's demand for (relatively illiquid) financial assets has been more fully satisfied. Should companies and individuals persist with the same borrowing plans that they had before the government debt sales, interest rates are forced to rise. Eventually higher interest rates reduce the private sector's willingness to incur debt, restrain its expenditure and counteract the stimulative effects of higher public spending. Financial crowding out ends in resources crowding out, but it provides a more thorough account of the processes involved and, more particularly, shows how important is interest rate behaviour to the outcome.[19]

The debate on crowding out is, in the final analysis, a debate on interest rate determination and on the effect of interest rates on the real economy. It is unlikely to be resolved until economics has provided a more satisfactory theory in this area.[20] However, what is quite clear is that the size of the budget deficit has effects – and possibly big effects – on interest rates in an economy where the government has committed itself to a money supply target. In Britain the market in government debt, most of it taking the form of gilt-edged securities, the prices of which vary inversely with interest rates, is highly sophisticated and the behaviour of the public finances is monitored with some care.

In 1974 and 1975, when the public sector borrowing requirement went haywire and soared wildly from an annual rate of £4,000m to £10,000m, one of the financial analyst's chores was to predict the likely outturn. The higher was the prospective borrowing requirement, the more gilt-edged securities the authorites would need to sell and the higher would interest rates have to be.

The turmoil in government finances resulted, therefore, in an entertaining guessing game, in which both the quality financial press and leading stockbroking firms participated. With the gilt-edged market frequently capturing the headlines some of these firms grew in reputation (and prosperity). They found that investor curiosity in monetary research, with its obvious bearing on interest rate developments, was exceptionally keen and the recruitments of economists with the appropriate background proceeded apace. These economists tended to be monetarists, either in the full Chicago school sense or in the milder version of believing that "money matters". The City has become the spiritual centre of British monetarism – particularly after the emigration of some academic monetarists, such as Laidler and Parkin, associated with Manchester University, in 1976. This outcome is not perhaps all that surprising since the City, far more than other industry, is concerned that monetary policy be conducted on the right lines.

Most stockbroker research has focused on the links between public sector finances on the one hand and the money supply and gilt-edged sales by the authorities on the other. But there has been another branch of enquiry, known as "flow of funds analysis", which can be used as an aid to conventional forecasting methods. Flow of funds analysis starts from a truism, that any sector of the economy which is a net issuer of financial liabilities must be matched by another sector which, on balance, acquires financial assets. It follows that the sum of the financial surpluses and deficits of the four main sectors (public, overseas, personal and company) must be zero; and that, if the public sector is running a deficit, the other three sectors taken together must have a surplus.

At first blush these relationships might seem to be no more than logical identities devoid of economic interest. However, it has been claimed that the financial behaviour of certain sectors is governed by definite principles. More specifically, it has been asserted that the private sector's acquisition of financial assets is small and stable over time, amounting to about 4 per cent of private disposable income.[21] Consequently, if the public sector deficit exceeds the equilibrium level of private sector asset acquisition a balance of payments deficit must be incurred.

The implication is rather similar to that of crowding out. If the private sector is in portfolio balance (a condition in which it is satisfied with the quantity of financial assets it holds), extra government spending adds to the trade deficit and does not support domestic demand. The reasoning is straightforward. Since portfolio balance obtains, infusions of public debt are unwelcome to private savers. Even if savers can be temporarily induced to take up the debt they possess more assets than they want and should try to reduce their holdings. Equilibrium is restored when foreigners have acquired a large part or all of the new debt, but this can only be mediated through a payments' deficit. It can be shown that, in a world where all goods are tradable and exchange rates are fixed, "the correct income multiplier for government expenditure increases or tax reduction is precisely zero".[22]

This indictment of discretionary demand management is as radical as the crowding out and natural rate of unemployment doctrines, and, as with them, there has been an energetic dispute about the conditions needed for the result. The effectiveness of fiscal policy depends on the size of the economy relative to the rest of the world, and on whether it is open to international trade or closed; it is partly related to the importance of the traded goods sector compared to the domestic economy; and it is influenced by the exchange rate system the economy has adopted. Similarly, several routes to the same destination can be followed. One approach is to say that there is a unique price level for internationally traded manufactured goods; if the government stimulates demand the price level rises, making exports uncompetitive and imports cheap; exports fall and imports rise, withdrawing demand, until equilibrium is restored with the domestic and world price levels once again in line. Another approach is to point out that, with considerable capital mobility between financial centres, there is a common interest rate for all countries; if the government runs an enlarged deficit and finances it by debt sales to the public, it needs to offer an attractive interest

rate above that currently in force, but this cannot be done because any interest rate disparity is followed by an inflow of capital and restoration of the initial common interest rate; and the counterpart to a capital account surplus is a current account deficit.

Clearly, this part of economic theory opens up many opportunities for intellectual exhibitionism; some of the contributions to it have been of mind-bending difficulty. But the underlying conceptual basis is uncomplicated and has an obvious dependence on the monetarist principle of stable asset preferences. Unlike the natural rate of unemployment and crowding out ideas, the argument has not been given a distinctive label. The "new Cambridge school" has affinities to it, but doubts might be expressed about giving it this name. Publicists of the new Cambridge school doctrine – that, beyond a certain point, increases in the public sector financial deficit lead to increases in the balance of payments deficit – do not seem to be aware that their result is a special instance of a more general set of relationships. Moreover, they have not provided convincing behavioural underpinnings for their conclusions and, still more seriously, they have not seen that such underpinnings are to be sought in monetary economics. Instead, the right generic term for the body of ideas is the rather clumsy "monetary approach to the balance of payments". A lecture, with this title, was given by Professor Harry Johnson to the Graduate Institute of International Studies in Switzerland in 1971 and summarizes the approach.[23] But the roots of the theory can be traced back to David Hume in the eighteenth century while much of the more notable work was performed in the late 1950s. Professor Robert Mundell, at that time on the staff of the International Monetary Fund, wrote many of the path-breaking articles. He subsequently became a member of the University of Chicago economics faculty.[24]

Although there are many strands in monetarist theory they share a certain unity of theme and are, for that reason, quite easy to understand. The main policy recommendation, that money supply expansion be steady through time and related to the growth rate of output, is almost artless in its simplicity; and the bedrock theoretical assumptions, that asset preferences are stable and that monetary variables cannot (in the long run) change real magnitudes, are among the oldest ideas in economics.

But, despite their antiquity, these ideas continue to be disputed. Monetarist economists have had to attempt to demonstrate their empirical worth by elaborate statistical testing; and it is a fair generalization that the effect of the enquiries has been to induce considerable scepticism about the policy-makers' capacity to regulate the economy with much precision. Such scepticism, perhaps best exemplified by Friedman himself, is a fitting accompaniment to an anti-interventionist attitude towards economic policy as a whole. The three main constructs used to support and justify this attitude – the natural rate of unemployment, crowding out and the monetary theory of the balance of payments – have tended to resist direct statistical verification, but the last two are corollaries of stable asset preferences. Those who are persuaded by the monetarist evidence on the stability of the demand for money can also be persuaded, without much difficulty, that excessive budget deficits lead to inflation, less private spending, trade disequilibrium or a combination of the three.

Notes

1 This statement is a crude description of monetarist theory, chosen for its heúristic value. It would be more correct to say that monetarists believe the demand for money function to be stable. The arguments in the function may include money national income or they may not. In his "The quantity theory of money: a restatement" (in M. Friedman (ed.) *Studies in the Quantity Theory of Money* Chicago University Press 1956), Friedman said that "the demand for money is a special topic in the theory of capital" and "that the demand for money depends on three sets of factors: a) the total wealth to be held in various forms. . .b) the price and return on this form of wealth and alternative forms; and c) the tastes and preferences of the wealth-owning units".

This 1956 paper was the theoretical launching-pad for the monetary counter-revolution, its importance being that it broke away from naive constant velocity of circulation formulations which had preceded it. But it is interesting that Friedman tends to revert to such formulations when he has to explain ideas at a popular level. (See, for example, *The Counter-Revolution in Monetary Theory* Institute of Economic Affairs: London 1970 pp. 9-10). The much simplified exposition given in the present text is, therefore just about excusable. But readers should bear in mind that monetarist theory is considerably more profound than is being suggested here.

It should also be noticed that interest is paid on deposit accounts which form part of M3, the broadly-defined money supply measure. The sentence saying that money "yields no pecuniary return to its owners" is, therefore, not quite right. Bank deposits nevertheless remain an unattractive asset-holding in yield terms.

2 M. Friedman *The Optimum Quantity of Money* Macmillan: London 1969 p. 218. The events of the 1930s have been interpreted in contradictory ways. A survey of the debate is given in D. Laidler "The influence of money on economic activity" on pp. 101-105 of G. Clayton, J.C. Gilbert and R. Sedgwick (eds) *Monetary Theory and Monetary Policy in the 1970s* Oxford University Press 1971.

3 Irving Fisher clearly hinted at this policy proposal on p. 329 of *The Purchasing Power of Power* Macmillan: New York 1911, but rejected it on the grounds that it would not survive the pressures of political expediency.

4 See, for example, pp. 20-27 of M. Friedman *The Counter-Revolution in Monetary Theory* Institute of Economic Affairs: London 1970. Friedman, in addition to defending the monetary rule in a rather cautious way, does not, like the monetary cranks to whom he is so often compared, consider it an all-embracing panacea. On p. 28 of the IEA pamphlet he says, "It will not produce perfect stability; it will not produce heaven on earth; but it can make an important contribution to a stable economic society."

5 See D. Laidler's evidence on p. 59 of the *Ninth Report of the Expenditure Committee*, cited in the previous chapter. Laidler's remarks in a commentary to M. Friedman *Unemployment versus Inflation?* Institute of Economic Affairs: London 1975 (p. 41) are also interesting. He suggests that inflationary expectations are so "deeply embedded" in the economy that inflation can only be eliminated at the price of unemployment over the million mark "for five years or more". It would be desirable, therefore, to move over to a system of indexation in order to live with the inflation as an ongoing phenomenon, instead of trying to remove it too quickly.

Friedman has discussed "gradualism" in *From Galbraith to Economic Freedom* Institute of Economic Affairs: London 1977 p. 44.

6 See p. 342 and p. 351 of *Readings in Monetary Theory* American Economic Association: George Allen & Unwin: London 1952, where Simons' article is reprinted.

7 See p. 380 of the same *Readings in Monetary Theory* volume.

8 The Treasury's short-term forecasting model has been operational since 1970, when it had about 40 equations. Certain statistical relationships were in use, however, from the early 1960s. Before this, the Treasury relied very little on economists and statisticians. Indeed, it is a moot point whether the British economy was managed on "Keynesian" lines in the 1950s, perhaps the most stable decade in its history. A reader of Sir Herbert Brittain *The British Budgetary System* George Allen & Unwin: London 1959 could be forgiven for thinking that the Treasury then believed rather strongly in balanced budgets and "sound finance". However, this is not the place to elaborate historical points.

9 This is a strong statement to which many monetarists will object. Laidler and Parkin consider that full employment should be a policy goal. See, for example, p. 47 of M. Friedman *Unemployment versus Inflation?* Institute of Economic Affairs: London 1975 with Laidler's commentary on "The end of 'demand management' ", where he claims that "Monetarist analysis suggests that it is the tools of high employment policy, rather than its goals, which must be changed." This seems to me to be in flat contradiction to several of Friedman's statements. Again, Friedman thinks that the abolition of price controls and other government restrictions raises an economy's growth rate and can be defended on that ground. For example, he has forecast that denationalization and a programme of economic liberalization could raise Britain's growth rate to 10 per cent a year. Friedman would appear to accept economic growth as a policy objective.

I would argue that it is one thing to favour liberalization because it enhances freedom and another because it raises economic efficiency; and that it is inconsistent to regard price stability, full employment and economic growth all as subjects of government policy. I hope in another essay to show that the maintenance of price stability is the only objective government should have in the economic field. Like the preservation of law and order it is an acceptable part of the minimal state.

10 It should again be emphasized that the exclusion of portfolio considerations is completely at variance with the thrust of Keynes' work and that to label such a model "Keynesian" is an abuse of language.

11 J. R. Shepherd, H. P. Evans and C. J. Riley *The Treasury Short-term Forecasting Model* Her Majesty's Stationery Office: London 1974 p.6.

12 A close approach to a full-scale monetarist model is contained in a paper on *Inflation in the United Kingdom: Causes and Transmission Mechanisms* (mimeo) by M. R. Gray, M. Parkin and K. T. Sumner given at a conference on "The Monetary Mechanism in Open Economies" in Helsinki in August 1975. The most recent versions of the London Business School model also have markedly monetarist features.

It should be said that the Treasury has responded to outside criticism and amended the model gradually towards a more monetary approach. For example, a real balance effect was incorporated in the consumption equation in 1977. A full-scale monetary model has also recently been annexed to the conventional expenditure equations. However, the additions are principally useful for analysing the behaviour of the banking system and relating such behaviour to the sectoral flow-of-funds. It is more than questionable if these changes meet the monetarist points.

13 M. Friedman *The Optimum Quantity of Money* Macmillan: London 1969 pp. 95-110, where the presidential address to the American Economic Association on "The role of monetary policy" is reprinted. The following quotes come from p. 102 and p. 104. See also J. Taylor *Unemployment and wage inflation* Longman: London 1974 *passim* for a discussion of labour hoarding and an estimate of the effect of a change in labour market institutions (higher rates of unemployment benefit) on unemployment.

14 See p. 16 above.

15 Premonitions of the crowding out controversy can be traced back to the Napoleonic War when observers had difficulty in accounting for the visible prosperity of most industries while "unproductive" expenditure on the war effort was high. Some argued that military spending stimulated the economy, while others claimed that it displaced "productive" expenditure.

See J. S. Mill *The Principles of Political Economy* Longmans: London 1885 p. 48-49 for more details.

16 At least one of the reasons for the explosion of public expenditure was the failure of the Public Expenditure Survey Committee (or PESC) system of control which monitored programmes and real output, rather than sums of money spent. The PESC system dated back to the late 1960s. Mr Healey, as Chancellor of the Exchequer from 1974, decided to bring back a control mechanism based on actual money expenditure which was christened "the cash limits

system", The Expenditure Committee of the House of Commons approved this change in its Ninth Report of the 1974/75 session but not before some left-wing Labour MPs had proposed an amendment to the report which began, "We are very concerned about the implications of this development. Cash limits have become the Pavlovian cry of monetarist theorists and others who wish to see public expenditure slashed". Perhaps it should be said that cash limits have no connection with monetarism.

17 The conjunction of a large rise in public expenditure and a deepening recession created a serious intellectual crisis for the "Keynesians". One response was to blame the rise in the public sector borrowing requirement on the recession, because of the impact of lower activity on tax revenues and social security payments. See R. Neild and T. Ward *The Budgetary Situation: an Appraisal* Department of Applied Economics: Cambridge 1976, especially p. 28. The weakness of this approach is that it lacks an independent cause of the recession. The possibility that monetary policy was responsible for the drop in demand is excluded by assumption.

18 The sentence is not historically accurate. Employment rose quite strongly in the 1930s, but unemployment did not fall because of demographic factors.

19 For a survey of crowding out see K. M. Carlson and R. W. Spencer "Crowding out and its critics" pp. 2-22 *Bulletin of the Federal Reserve Bank of St. Louis* December 1975. There has not been a good academic discussion of the problems in Britain, but *The Times* has carried a number of articles on the issue. See, for example, P. Jay "Ask a reasonable question. . ." in *The Times* of 11th November 1976, where it is argued, against Mr Michael Posner, a former adviser to the Treasury, that government spending cuts are not deflationary because they leave more room for private sector spending.

20 That the outcome of the crowding out debate should depend on how interest rates are determined is particularly interesting. Notice that Fisher's theory – that interest rates depend on the productivity of capital and the rate of inflation – is no help to the monetarists.

21 See memorandum from the Department of Applied Economics, University of Cambridge, to the House of Commons Expenditure Committee on pp. 2-4 of the *Ninth Report of the Expenditure Committee*, cited above, and also p. xvi.

22 R. I. McKinnon "The limited role of fiscal policy in an open economy" in *Banco Nazionale del Lavoro Review* August 1976 pp. 98-99

23 H. G. Johnson "The monetary approach to balance-of payments theory" in *Further Essays in Monetary Economics* George Allen & Unwin: London 1972 pp. 229-249.

24 Mundell's articles are collected in *International Economics* Macmillan: London 1968.

III. The British Context

Monetarism, as described in the previous chapter, is largely a product of American economic culture. The importation of monetarist ideas into Britain required adaptation and redesign to make them suitable to local conditions. Indeed, it is not an exaggeration to say that a distinctive brand of monetarism has evolved, differentiated from the Chicago school original by emphases appropriate to the British economic environment. This chapter discusses the differences and similarities, and relates them to particular characteristics of the British economy.

i

Until the late 1960s a consensus about the role of monetary policy prevailed in Treasury and Bank of England circles.[1] It had three elements. Firstly, the money supply was not regarded as a significant economic variable in its own right; secondly, interest rates mattered because of their bearing on investment decisions, although this was not deemed to be very strong; and, thirdly and most vitally, interest rates were recognized as determining the attractiveness of London as a home for volatile international financial flows. The consensus has been described by Dr. Charles Goodhart, who became an adviser to the Bank of England towards the end of this period, in his *Money, Information and Uncertainty*:

> Throughout most of the 1960s. . .interest rates were varied mainly in response to external conditions, being raised whenever there was a need to support the fixed exchange rate, which was often under pressure, and lowered in a spirit of general benevolence towards investment – as each balance-of-payments crisis temporarily receded. With interest rate policy mainly determined by external considerations, the money supply was allowed to vary passively.[2]

Although more attention was paid to interest rates than to monetary aggregates as conduits of monetary policy influence on the economy, Bank of England officials were diffident about frequent and sizeable interest rate changes because of their impact on gilt-edged security prices and, indirectly, on equity and property values. Stable interest rates were perceived as essential to the stability of the financial system as a whole. If interest rates had to be raised Bank officials needed a pretext, an excuse for the damage that would be done to the portfolios of City institutions. Until 1967 that excuse was provided by a fixed sterling exchange rate. While the $2.80 pound remained intact parity adjustments were looked on with strong disfavour in the City.

In the early 1970s two changes occurred in the organization of monetary policy. First, in the summer of 1971 the Bank of England published a series of consultative documents on "Competition and Credit Control" which formed the basis for a new system of financial regulation introduced in September of that year. Under the new system greater scope for interest rate changes was envisaged as part of the official attempt to control official gilt-edged sales, the quantity of credit and the money supply. The Bank had shifted towards this position from dislike of the quantitative restrictions on bank lending it had had to police for much of the 1960s. (Such restrictions had been the only method for abating monetary expansion, given the self-denying ordinance on interest rates.)

The second change was even more of an upheaval. In June 1972, following several days of intense speculative pressure against the pound, the authorities abandoned the fixed exchange rate and inaugurated a policy of "managed floating".[3]

The implications of the more permissive exchange rate regime for monetary policy were not widely appreciated. Before 1967 and, to a lesser extent, between 1967 and 1972, the tendency to think of interest rates primarily as guardians of the sterling parity often caused their other and equally important functions to pass unnoticed. The general level of interest rates had been – throughout the 1950s and 1960s – a critical factor in money supply growth. When interest rates were high, the money supply had increased slowly; and, when they were low, money supply growth had accelerated. Through this well-established, but neglected, relationship interest rate changes prompted by external factors had powerful internal effects. Britain's adherence to a fixed exchange rate against foreign currencies prevented the authorities from misbehaving at home. Excessive and undue financial laxity quickly led to payments deficits and capital outflows, giving a clear signal that a change of course was necessary. But, with a floating rate, the authorities had the option to meet pressure on the pound by currency depreciation and not by tightening monetary policy. The "early warning system" given by the foreign exchanges could be ignored.

Evidently, therefore, the introduction of Competition and Credit Control in 1971 and the departure from the fixed exchange rate system in 1972 placed the authorities in a quite different situation. It might be said that the real problems were the same as before, but there is no doubt that they took on a new guise; and if the solutions had to have similar impact, they could not be administered in the customary manner. In particular, there was no longer a clear-cut rule for deciding on interest rate policy. The authorities were obliged to take account of the behaviour of the money supply and the progress of official sales of gilt-edged stock, but they continued to be susceptible to the speed and scale of the decline in the sterling exchange rate. The dual concern was reflected in a policy statement accompanying the 1975 Letter of Application to the International Monetary Fund that interest rates were determined by both "external and internal factors".[4]

This schizophrenia meant that the official approach to interest rate policy had little intellectual coherence. Perhaps not surprisingly its practical results tended to be unfortunate. Financial markets in the City had no way of knowing whether external or internal factors were uppermost in the government's mind at any moment in time; and the opacity of its intentions generated considerable interest rate uncertainty.[5]

The problems caused by this uncertainty were exacerbated by the Bank of England's methods of gilt-edged market management. In principle, Competition and Credit Control heralded a new era in the official attitude towards the market. Instead of supporting prices when demand was weak (as the authorities had done particularly conspicuously in 1968) it would be the Bank's responsibility henceforth to ensure that the take-up of new issues by the non-bank public was sufficient to keep money supply growth within reasonable bounds. According to the theory, if this involved sales of stock by the government broker on a falling market, so be it. It might be unpleasant if prices plummeted and interest rates soared but this would be preferable to losing control over the money supply.

But the Bank of England has never liked selling stock on a falling market. The reason is partly moral and partly practical. Suppose that the Bank – via its market agent, the government broker – sells £50m of government stock at a price of £96 per £100 nominal and that this £50m is considered to be not enough to meet a money supply target. Suppose that the government broker lowers the price to £95 to encourage sales. What happens? First, life assurance companies and pension funds which bought stock at £96 have incurred losses *inflicted deliberately by the authorities*. Understandably, they feel aggrieved. Secondly, other financial institutions are shy about making purchases at £95 because they know that the government broker will reduce the price again if he cannot make sufficient sales at the new level. The inevitable vacillation in committing funds is not cussedness, but simple financial prudence, and the authorities respect the motive behind it.

Because of these drawbacks to selling gilts on a gradually falling market the authorities can either sell stock on a gradually rising market (the ideal method, usually involving small upward "tap" price movements of 1/16, 1/8 or ¼ point) or by delivering a hammer-blow to prices, with sharp increases in interest rates and probably 3 to 5 point losses throughout the list. The "big bang" falling market method may be effective as long as the institutions believe that the authorities have pushed prices low enough to leave room for selling stock in the required amounts on a subsequent rise in the market.[6]

These somewhat elaborate price gyrations are necessitated by the system of selling stock by "tap", that is, by having an issue of government securities continuously available at a particular price to meet spontaneous market demand.[7] It should be emphasized that neither the "tap" system nor the authorities' tactics of market manipulation were much affected by Competition and Credit Control. It is true that, since September 1971, the authorities have bought stock on a falling market (to stabilize interest rates) less frequently than before and that they have administered "big bang" treatment for money supply control reasons on at least two occasions.[8] But it is not true that they systematically attempt to sell stock on a gradually falling market or that they move interest rates exclusively in response to money supply indicators.

This discussion of the financial situation in Britain between 1971 and 1976 suggests that there were three main questions for the monetarists to consider: "should priority be given to money supply control or interest rate stability?"; "what methods of selling gilt-edged stock should the authorities adopt to attain monetary objectives?"; and "what relative weight should be given in interest rate policy to internal (i.e. money supply) and external (i.e. exchange rate) factors?". The first two questions form the subject matter of the following section; the third is analysed in the section after that.

ii

Whatever the official lack of confidence on the appropriate interest rate prescription, the monetarists had no doubts. The overriding imperative to them was control over the money supply. In their view, interest rates had to be totally subordinated to that end; if the result was high and fluctuating interest rates, that misfortune would just have to be tolerated. The monetarist *insouciance* towards interest rates can be explained both by contemporary events and by a more long-standing theoretical disposition.

Recent hostility towards interest rate stability as the prime *desideratum* of monetary policy owes much to disillusionment with developments in the late 1960s. As mentioned earlier, the Bank of England was, given its hesitation over interest rate rises in that period, able to retain control over the money supply only by direct restrictions on bank lending. These controls hindered competition by preventing the fast-growing and efficient banks from capturing the business of their slow-growing and inefficient counterparts; they also penalized the commercial banks in their

rivalry with other financial institutions. As Professor Johnson put it,

> Credit discrimination against particular classes of borrower or of loan-financed activity may involve short-run disruption of established financial relations and in the longer run distort the growth of the economy and reduce its efficiency. From the point of view of structural efficiency. . .the most relevant consideration is that by imposing an implicit tax on commercial banking, these techniques of control restrict the scale of the cheque-payment system provided by the commercial banks to something below the social optimum.[9]

If controls had adverse repercussions on banks' efficiency and profitability they also not surprisingly had effects on banks' attitudes towards financial regulation. Clearing bank executives and managers thoroughly disliked the artificial clamp-down on lending and expressed a preference for greater freedom. A majority of financial opinion could, therefore, be mobilized for allowing interest rates to fluctuate, a quite remarkable situation in view of the conventional bias towards interest rate stability in banking circles.

As administrators in the Bank of England shared the aversion to lending ceilings pressure within the financial community for a freer system was difficult to resist. The monetarists, who tend to be believers in the price mechanism and the virtues of competition, were definite supporters of a change and applauded Competition and Credit Control from the outset.

Monetarists' enthusiasm for greater flexibility in financial regulation was reinforced by their interpretation of politicians' motives in avoiding the appropriately high level of interest rates in the late 1960s. Interest rates have little obvious connexion with the budget of the "man in the street" – apart from their effect on mortgage payments. But mortgage payments can be a heavy burden and they impinge particularly on young married couples who, rightly or wrongly, are regarded as among the most fickle of floating voters. On this view, improperly low interest rates were being enforced by the government for partisan political ends. The monetarists and, indeed, many other economists and non-economists of no special denomination, considered that this favouritism distorted the housing market because the attractions of owner-occupation were made too great. The honest course was to allow interest rates to rise to their true level.

The call for more frequent interest rate adjustments received much of its justification in the early 1970s, therefore, from certain unsatisfactory results of the authorities' earlier preoccupation with interest rate stability. But it would wrong to think that the monetarist attitude had no more profound rationale. Indeed, the roots of this attitude are to be found in the running battle in abstract economic theory between the "Keynesians" and their opponents which has remained undecided since the publication of *The General Theory of Employment, Interest and Money* in 1936.

In *The General Theory* Keynes said that the demand for money cannot be separated from the rate of interest. His reasoning was that, if the rate of interest is above a certain "normal" level, investors expect the rate to fall which will lead to capital gains on stocks and shares. Hence, they wish to hold less money (or "liquidity") than if the rate of interest is low. In general, the demand for money must be related not solely to the level of transactions, as the monetarists are inclined to emphasize, but also, and less predictably, to interest rates, asset values and investor attitudes. The rate of interest can be regarded as the result of the interaction of the supply and demand for money and is a "a highly psychological phenomenon".[10]

By putting interest rates at the centre of monetary debate Keynes upset the conclusions of orthodox theory and, in particular, he advanced a quite basic argument for thinking that the velocity of circulation might change from time to time. The monetarist response has been to examine the evidence, with the intention of estimating the interest-elasticity of the demand for money and also of seeing whether this interest-elasticity is stable.[11] According to Friedman, the evidence demonstrates that the rate of interest does have a "systematic effect on the amount of money held", but "the effect is rather small". On the other hand, another variable, the rate at which prices in the economy are moving, has "a clearly discernible and major effect when price change is rapid and long continued, as during extreme inflations and deflations". A positive rate of inflation alters the value of money compared to other goods and it is only logical that it should enter significantly into people's choice about how large money balances they want to maintain.

Friedman's appeal to the rate of price change in his work on the money demand function harks back to the theory of interest rate determination proposed by Irving Fisher in his 1896 *Appreciation and Interest*. Fisher distinguished between the nominal and real rate of interest and argued that savers would ensure that the nominal rate be increased *pari passu* with an expected rise in the price level – or borrowers that it be reduced with an expected fall. In other words, interest rates depend on whether and how quickly prices are going up or down.[12] Monetary forces play a part in this because they set the rate of price change, but, in Fisher's view, they do not decide the level of real interest rates to which the adjustment for inflation or deflation has to be made. Real interest rates are instead fixed, in the long run, by the marginal productivity of capital; they are a "natural" attribute of the economy, one of its underlying technological characteristics, not a plaything of speculative psychology.

The conflict between the Keynesian and monetarist approaches has not yet been fully resolved. Friedman has suggested that both approaches are correct, but for different time periods.

> . . .a change in monetary growth affects interest rates in one direction at first but in the opposite direction later on. More rapid monetary growth at first tends to lower interest rates. But later on, as it raises spending and stimulates price inflation, it also produces a rise in the demand for loans which will tend to raise interest rates. That is why world-wide interest rates are highest in the countries that have had the most rapid rise in the quantity of money and also in prices – countries like Brazil, Chile and Korea.[13]

But, despite the concession in this passage that an injection of liquidity can temporarily reduce interest rates, the inference is clear. In any real-world situation it is difficult to interpret the direction of monetary policy from interest rates. Friedman concluded that, "the two-edged relation between money and interest rates explains why monetarists insist that interest rates are a highly misleading guide to monetary policy".

In Britain the inadequacy of interest rates as guides to monetary action became apparent in the early 1970s in two ways. First, the upsurge in money supply growth in 1972 and 1973 was soon reflected in rising inflation and, more ominously, in rising inflationary expectations. The drop in interest rates which Keynesians would normally predict in such circumstances was brief and, from early 1972, interest rates were edging upwards. In late 1973, when most individuals and companies were flush with liquidity, interest rates jumped sharply, totally contradicting the simple-minded Keynesian theory. Secondly, although the prices of gilt-edged securities (i.e. fixed-interest bonds, the asset in relation to which interest rates are expressed) declined almost without intermission during the Barber boom, the prices of other assets, notably property, increased spectacularly. Although the monetary explosion did boost asset values it was not the rate of interest on bonds which fell, but the yield on a number of assets conventionally regarded as good hedges against inflation. The pattern of asset values and yields was not the result of uncomplicated "liquidity preference" in *The General Theory* sense, but of topsy-turvy (and ultimately false) speculative expectations. It is understandable that one of the most scathing indictments of the Keynesians made by a British economist described their interest rate theory as "extremely unrealistic" and that it isolated the root of the trouble as "Keynes' simplification in *The General Theory* that money and bonds are the only portfolio assets".[14]

The monetarists have no reservations, then, about disregarding interest rates. This belief is crucial in determining their approach to the gilt-edged market and techniques of monetary control. Since they do not think interest rate volatility is a high price to pay for an effective system of money supply regulation, they are quite willing to contemplate sharp movements in gilt prices.

Some monetarists consider that, if a money supply target is being exceeded, the authorities should have no embarassment about lowering "tap" prices in small steps, despite the acknowledged drawbacks of this method. They feel that, in due course, a price must be reached at which the demand for stock will be of the required strength. It is right that financial institutions be obliged to out-guess each other about what that price is. After all, whatever the market's distrust of the belligerence of the government broker, there must be some price at which it is profitable to buy. Other monetarists would prefer a different system of selling government debt, through a regular auction rather than "taps". The auction method is found in the United States, where the Federal Reserve Board has been relatively successful in keeping the money supply on a pre-determined path.

However, it does have weaknesses. The most important is that, because the market cannot know the outcome of an auction in advance, considerable uncertainty prevails in the intervals between auctions and this deters transactions in existing stocks. In the practitioners' jargon, the auction method weakens "the secondary market".[15] No altogether satisfactory approach to official gilt-edged sales has, therefore, been agreed by the monetarists or, for that matter, by anyone else. A blend of the accuracy of control given by the auction method and the high marketability of stock given by the "tap" method is clearly desirable. Perhaps it would be possible to conduct auctions in short-dated stocks (with, say, one to three years to maturity) and "tap" sales simultaneously.[16] It should also be said that the defects of the "tap" system have become glaring in the last three years, principally because of the enormous size of the government's funding problem. If the funding problem is eased, financing patterns may be more stable and the need for more reform may not appear so insistent.[17]

Although there is a lack of accord among monetarists on gilt-edged market management they are unanimous that another aspect of monetary control – the specification of the banking system's reserve asset ratio – needs improvement. At present a variety of debt instruments, most of them held in sizeable quantities outside the banking system, qualify in the ratio. Consequently, the Bank of England cannot safely ensure control of bank lending totals by influencing the amount of reserve assets in existence because banks can remedy any officially induced shortage by obtaining them from the public. A superior institutional arrangement, according to the monetarists, would be for the Bank to operate on a more restricted ratio – that between cash (plus banks' deposits with the central bank) and total assets. The case for a more restricted ratio can also be based on certain risks entailed by too broad a definition of reserve assets. At present some of the instruments included in the ratio, notably Treasury bills, are used to finance that residue of the government's borrowing needs not met by sales of long-term debt. As we have seen above, such sales can fluctuate erratically and unpredictably, with dangerous implications for the money supply. In Laidler's words,

> When you are operating a cash ratio form of monetary control, that separates the reserve base of the banking system from the financing of

the government deficit. But we now have a reserve ratio arrangement which puts Treasury bills into the reserve base. That seems to me . . .to result in our having abandoned one of our great advantages, which is sufficiently deep short term capital markets to enable deficits to be financed without monetary expansion. Countries without such a market frequently are driven into printing money for just this reason.[18]

iii

Britain is comparatively "open" to world economic forces. The proportion of industrial production sent to foreign markets is high by international standards; and the importance of Britain's external assets and liabilities in its total national wealth leave it vulnerable to economic fluctuations in other countries and to changes in confidence in sterling. The contrast with the American economy, which is exceptionally self-contained, has often been remarked. There is little doubt that the "openness" of the British economy has affected the development of monetarism in this country and it seems probable that the main effect has, for a variety of reasons, been to retard the assimilation of monetarist ideas.

In the previous chapter it was shown that the scope for discretionary demand management in a small, open economy is limited. The constraints on the government's freedom of maneouvre in such an economy are most severe if the exchange rate is fixed. Extra government spending may then benefit foreign suppliers, not domestic industry, while action on the monetary front may be negated by international capital flows or changes on the current account. These difficulties have been most commonly described as undermining the intellectual basis of Keynesian demand management. However, they also trouble the monetarists. The problem is that, unless certain freak conditions are satisfied, a fixed exchange rate or, indeed, any active exchange rate management is incompatible with a money supply rule.

The point needs emphasis. Throughout the mid-1970s the Treasury has pursued, if with a rather hazy idea of what it is doing, both exchange rate and monetary targets: in principle, the pound's value against other currencies has been manipulated by the requirement of constant export competitiveness and the money supply has been regulated either by a qualitative rule or

by a quantitative growth band.[19] Politicians and government economists seem to have no comprehension of the inconsistency between these objectives. It may be helpful to provide a short explanation of why an exchange rate and money supply target are almost certain to come into conflict.

Suppose that Britain has a money supply target of 5 per cent, that world money supply growth is 10 per cent and that the growth rates of output are the same in Britain and other countries. Suppose also that the British monetary authorities want to maintain an exhange rate of $1.72 or less to the pound and that at $1.72 the British and world price levels are in line.

The slower money supply growth in Britain will tend to cause a divergence between inflation rates, with the price level falling beneath that elsewhere. However, disparities in price levels are unsustainable. If the British price level is only slightly beneath that elsewhere British consumers buy fewer foreign goods because they are relatively dear and foreign consumers buy more British goods because they are relatively cheap. The slower rate of money supply growth will soon cause a payments surplus. But the surplus acts to increase bank deposits, pushing up the money supply and British prices. Ultimately, exports are depressed to their former level, while the excess monetary expansion abroad has been drawn into and absorbed by the British financial system.

If the authorities try to keep exports up by driving the exchange rate beneath $1.72 the problem is exacerbated. British goods may be made artificially cheap, but a payments surplus will quickly emerge. Through the usual processes, this will impact on bank deposits, the money supply and prices until British goods are once again neither cheap nor dear relative to goods made in other countries. But it is not just that the authorities are unable to force the rate beneath $1.72. They cannot even maintain this rate and achieve their 5 per cent money supply target because, as we have seen, the $1.72 parity only survives if Britain absorbs some of the money supply growth in other countries.

In this example, it is clear that the 5 per cent money supply target and the $1.72 exchange rate cannot be combined and that an attempt to force the rate beneath $1.72 is certain to fail. The argument is quite general. Exchange rate movements depend on comparative money supply growth rates in different countries. A fixed exchange rate – or any particular exchange rate figure – can be sustained only if central banks throughout the world have co-ordinated their money supply objectives sufficiently for the price levels of goods entering world trade to be the same for all countries.[20] Such co-ordination destroys the autonomy of monetary policy: it hinders a central bank from administering monetary policy actions in the manner most suited to the needs of its own economy. The choice of any exchange rate level as the goal of policy subjects an economy to monetary influences from the rest of the world and makes money supply targets impossible to fulfil. A fixed exchange rate serves as an anchor, keeping an economy in line with world inflation and preventing it from following its own independent course in fiscal and monetary policy.[21]

But the monetarist wants the authorities to retain control over the domestic money supply. He has, therefore, to be an opponent of fixed exchange rates and the practice of manipulating the exchange rate for reasons of export competitiveness; he favours floating rates to preserve the autonomy of monetary policy. In his ideal world, exchange rates should be allowed to change without let or hindrance from central bank intervention.

At the behest of the Treasury, the Bank of England has continued to perform such intervention in recent years. Moreover, as an inheritance from the $2.80 parity era, the Bank still on occasions raises interest rates as a reflex response to sterling weakness. The motives for the authorities' behaviour are often very difficult to unravel, since on one day they try to push the exchange rate down to make exports cheap and on another they put interest rates up so that the exchange rate will not fall too far too fast. Inevitably, the monetarists have been extremely critical of the Bank's refusal to accommodate to market forces in the foreign exchanges and of the authorities' apparent confusion about their own intentions.[22]

It is difficult to find substantive reasons for the reluctance to embrace the monetarist recommendation of floating exchange rates. However, opponents of floating rates have sometimes appealed to two commonplace, but spurious, objections. The duet of fallacies only made sense in the rather forlorn context of Britain in 1974 to 1976, because they are not really criticisms

of exchange rate flexibility but of exchange rate depreciation. The first objection says that a drop in the world value of the pound adds to inflation; the second that, because of the effect on the retail price index, it reduces living standards.

The usual chain of thought runs like this. A fall in the exchange rate increases the price of imported goods. In particular, raw materials and fuel become more expensive because they are mostly purchased from abroad. After a lag of a few months, the increase in import costs is transmitted to prices in the shops. There may then be a secondary effect, through the aggravation of collective wage bargaining. The Treasury has given its blessing to this vignette by claiming that a 10 per cent depreciation of the pound causes a 2.9 per cent rise in the retail price index after a year.[23]

To the monetarists (and to many economists who are not monetarists), the assertion that there is a causal link of this kind stems from a theoretical confusion. The point is that an increase in imported goods' prices is only incremental to inflation *if the prices of domestically-produced goods are unchanged*. But, on the assumption that the money supply is held constant, the amount of expenditure in nominal terms that companies and individuals wish to make is also constant. It follows that the higher prices paid for certain imported commodities must be offset by lower prices for domestically-produced commodities. A currency devaluation or depreciation may affect relative prices, but it can have no ultimate effect on the absolute price level. But this is not the only defect of the devaluation-causes-inflation argument. It is perhaps even more fundamental that the argument lacks a prior explanation of the fall in the exchange rate. If this explanation consists in invoking the disparity between domestically-generated inflation rates in different countries, the exchange rate is not a truly independent influence on the price level. Indeed, if inflation disparities mirror divergent monetary trends, the money supply remains the prime causative agent in the inflationary process.[24]

Similarly, a country's exchange rate cannot of itself affect living standards. Living standards must depend, in the last resort, on what is produced, on the real productivity of the economy. The exchange rate is a monetary phenomenon and cannot change real variables.[25]

Although, as should be clear from these paragraphs, the objections to depreciation are not cogent, they have received much publicity from the press and elsewhere. As such, they have certainly coloured official attitudes and discouraged the whole-hearted endorsement of exchange rate flexibility. The plausibility of the two fallacies has been increased by the high weight of imported goods, notably food, in the consumption pattern of the typical British household. The temptation to journalists on television and radio news to say that the latest fall in the pound will aggravate inflation and lower living standards is, therefore, rather strong. Politicians also on occasion find the devaluation-causes-inflation doctrine convenient because it enables them to blame foreigners and "speculators" for higher prices.

It should be noted, as a matter of historical interest, that Keynes was himself one of the earliest and most forthright critics of the Bank of England's practice of determining monetary policy in relation to external factors. In his *A Tract on Monetary Reform*, first published in 1923, he remarked that

> . . .the rate of exchange of a country's currency with the currency of the rest of the world. . .depends on the relation between the internal price level and the external price level. . .It follows that the exchange cannot be stable unless both internal and external price levels remain stable. If, therefore, the external price level lies outside our control, we must submit either to our own price level or to our exchange being pulled about by external influences. If the external price level is unstable we cannot keep *both* our own price level *and* our exchanges stable. And we are compelled to choose.[26]

He also referred, with evident approval and sympathy, to "the pioneer of price stability as against exchange stability, Irving Fisher". These themes of *A Tract on Monetary Reform* remained with Keynes throughout his life and were not at all amended or qualified as a result of his theoretical innovations in *The General Theory*. In a speech to the House of Lords in May 1943 he observed that

> We are determined that, in future, the external value of sterling shall conform to its internal value, as set by our own domestic policies, and not the other way round. Secondly, we intend to keep control of our domestic rate of interest. Thirdly, while we intend to prevent inflation at home, we will not accept deflation at the dicate of influences from outside. In other words, we abjure the instruments of bank rate and credit contraction operating through the increase of unemployment as a means of forcing our domestic economy into line with external factors.
>
> . . .I hope your Lordships will trust me not to have turned my back on all I have fought for. To establish these three principles which I have just stated has been my main task for the last twenty years.[27]

In this respect, as in many other, Keynes was a monetarist before it became fashionable.

iv

In answer to the questions posed at the end of the second section we may say, therefore, that monetarists consider control of the money supply, not interest rates, to be truly important; that they are unhappy about present techniques of monetary control, but are not sure what would constitute the most satisfactory improvements; and that they think floating exchange rates are essential to insulate domestic monetary policy from external interference.

Discussion of these topics has been particularly lively among British monetarists because of the disarray of monetary policy since 1971. However, they have often been overshadowed by a still more contentious issue, that of the economic power of the trade unions. A related problem has been the effectiveness of prices and incomes controls.

The pure monetarist position is that trade unions cannot alter the inflation rate, because inflation is determined by monetary expansion. But this is not to say that unions and their role in wage bargaining may be neglected. By exerting their monopoly power unions disturb the free working of the labour market and raise wages above the level justified by marginal productivity. Consequently, the natural rate of unemployment is increased.[28]

One typical monetarist argument proceeds from here by noting the potential dangers in this situation. If the government is committed to a full employment objective the trade unions have indirectly a lever on the political process which generates inflation. By becoming more militant they can cause a deterioration in labour market efficiency and reduce the level of employment for any given pressure of demand. The government may try to rectify the rise in unemployment by stimulating demand, but this leads to a faster rate of price increases. In other words, if politicians are sufficiently gullible and use monetary policy to achieve ends which monetarists do not believe it can achieve, the trade unions may prompt the money supply growth which causes inflation. It is a largely semantic question whether the unions are or are not ultimately responsible for the whole process.

However, it would be misleading to suggest that this view, to which several monetarists adhere, is representative. There are two counter-arguments. The first is that even in Britain, where unions are exceptionally strong in comparison with other countries, their membership forms less than half the total labour force. On this reckoning they cannot change the general wage level, only the relative wage level between them and the non-unionized sector.[29] The second is that it is not enough to demonstrate the dependence of the natural rate of unemployment on "union pushfulness". For this dependence to be the instigator of an inflationary upheaval it is necessary that there be an increase in union militancy. "It will not follow analytically. . .that. . .strong trade unions are a cause of inflation. . .It is the *change* from one degree of strength to another that has an effect."[30] The monetarists have not, then, reached a consensus about the economic impact of the union movement. But there are usually common strands in their discussions, which tend to revolve around the natural rate of unemployment.

If the monetarist attitude towards trade unions remains uncertain there is no doubt about their view on price and pay controls. All monetarists are convinced that such controls are harmful and should not be adopted by governments to combat inflation or for any other purpose. It is possible to detect contrasting nuances in this general position, depending on which monetarist economist one selects, but the central message is clear. If trade unions are at worst accomplices in currency debasement, politicians who institute direct controls can too easily become the ringleaders. They are inclined to deceive themselves that inflation can be checked by administrative fiat and that it matters not one jot what is happening to government spending and the money supply. In any reasonably free economy such an approach is, according to the monetarists, a recipe for inflationary disaster.

The first, and most decisive, criticism of pay and price controls is that they do not work. Monetarists in Britain, especially those from the Manchester Inflation Workshop, have carried out extensive statistical work on incomes policies. Its usual form has been to incorporate excess demand and incomes policy variables in an equation and to test for their comparative significance. One such exercise, entitled "Incomes policy: a reappraisal" and published in the 1970 *Economica,* was performed by Professors Lipsey and Parkin. It contended that, in the period from 1948 to 1968, incomes policies had been successful in moderating inflation when unemployment was less than 1.6 per cent of the labour force, but had exaggerated the problem when unemployment was higher than this. Other articles have reached less bold and counter-intuitive conclusions. Indeed, some empirical work suggests that controls have occasionally had a favourable effect.[31]

But no research has shown that incomes policies have always and exactly had the results originally intended. The discrepancy between aim and achievement was emphasized by the signatories of the November 1972 *Memorial to the Prime Minister* in a further letter to the Prime Minister in 1974. It was particularly apposite at that moment because the Conservative government's Counter-Inflation Programme had by then proved an ignominious failure. The policy documents envisaged, over the three phases of the policy from November 1972 to July 1974, a rise in pay of 14 per cent. The Department of Employment's earnings index actually increased by 27.6 per cent in the period.

If the sheer ineffectiveness of pay and prices controls were their only demerit monetarists might not be too antipathetic; if they had no other effects they would be irrelevant, but innocuous. The point is that they do have other effects, nearly all thoroughly undesirable. The monetarists argue that any attempt to restrain the rise in the absolute price level by direct controls distorts the structure of relative prices; the distortion of relative prices causes resource misallocation; and resource misallocation causes a consequent welfare loss. Moreover, the resource misallocation is more serious the longer and the more strictly enforced are the controls. The condemnation of incomes policies on allocative criteria should not be separated from the previous criticism that they do not work. It is precisely because they lead to a welfare loss that there is an incentive to break them; and the more permanent and durable incomes policies are, the more irresistible does this incentive become.[32]

Some economists mention a justification of pay and price controls which exploits the monetarist emphasis on expectations. They say that, if the promulgation of an incomes policy can favourably modify the system's inflationary expectations, the cost in unemployment of curbing inflation by monetary deflation is reduced. In technical terms, incomes policies, particularly the pay and price "freeze" version, have beneficial "announcement effects" which shift the short-run Phillips curve to the left. But Laidler has dissociated himself from this suggestion and it is perhaps false to describe it as a monetarist argument for income policies.

> If the government announces its intention of influencing the future rate of inflation by way of an incomes policy, this will change expectations if incomes policy is expected to work. Equally, however, an announced intention to reduce the rate of inflation by reducing the rate of money supply growth will influence expectations if the policy proposal is credible. What is important is that the government's willingness and ability to reduce the rate of inflation should be believed in, and not the means by which this end is to be achieved.[33]

The standard policy tools can ameliorate expectations just as well as direct controls and they can do so without damaging allocative side-effects. The worst possible outcome is for a supine, blustering government to talk strong and act weak.

V

A familiar war-cry of monetarist sympathizers between 1974 and 1976 was the contrasting affluence of the public and private sectors. The public sector grew substantially, in terms of both employment and output, and, according to an influential view in which myth and fact intertwined, exuded a well-being and abundance reflecting the absence of serious financial constraints. The private sector, on the other hand, suffered badly from the recession and was forced to cut back.

Discontent at the expansion of the public sector was focused on two features of the economic scene – the emergence of a disparity between pay in public and private employment; and the transfer of resources from "productive" industry to "unproductive" jobs in government.

Relative pay movements have been much influenced by incomes policies because, while it is far from clear that such policies are successful in the private sector, they tend to be respected (for a

time) in the public sector. A typical sequence of events, therefore, is that the public sector falls behind during "policy-on" periods and catches up in "policy-off" periods.[34] In 1974 and 1975, during the interval between the Conservative government's stage three and the Labour government's £6 a week policy, no control was in force. The breathing-space seems to have been exploited by public sector unions not only to catch up, but to move ahead of the private sector. It was this over-compensation for the restraint of 1972 and 1973 which aroused such widespread comment and hostility.

Factual evidence about the size of the public sector's advantage is difficult to pin down, mainly because of the heterogeneity of job types. One statistical analysis, based on Department of Employment figures, showed that private sector earnings fell by almost 10 per cent relative to public sector between October 1973 and October 1974. In 1975 the divergence was accentuated. Public sector settlements between January and June 1975 registered an average rise of 41.0 per cent compared to 30.3 per cent for the private sector. It is understandable that the analysis concluded that, unless the relative pay of the private sector improved after 1976, "the movement of earnings over 1973-75 will be seen as an unexpected and historic occurrence".[35]

The thesis that the growth of the public sector has encroached on the economy's "productive" industries was advanced by Mr Walter Eltis and Mr Robert Bacon in a series of articles in *The Sunday Times* in November 1974 and later developed in book form in *Britain's Economic Problem: Too Few Producers.*[36] It was given considerable prominence in political discussions, gaining much of the popularity from the public sector pay bonanza. Most economists were nevertheless suspicious of "the Bacon and Eltis thesis", since it implied a hierarchy of "productiveness" for different activities. A hallmark of the economic approach to most problems is that no one has the right to make judgements about the ethical appropriateness of chosen consumption behaviour. For example, Bacon and Eltis venerate manufacturing industry and downgrade service industries, such as hair-dressing and education. But if people want to spend much of their income on hair-cuts and evening classes, that is their business and theirs alone. The services of barbers and evening class instructors are in demand and cannot, as Bacon and Eltis suggest, be deemed "unproductive" because no tangible end-product is created. The same objection does not apply to their division of output into "marketed" and "non-marketed" categories. This valid and interesting distinction is emphasized in the less polemical chapter five of *Britain's Economic Problem: Too Few Producers* on "The underlying economic theory", which is the technical fulcrum of the book.

There is nothing specifically monetarist about the Bacon and Eltis thesis, as it has been presented so far. In the book monetarism is mentioned a few times, with the most significant passage being a version of the proposition that heightened union militancy increases the natural rate of unemployment. However, the most vocal supporters of the thesis have tended also to be advocates of monetarism and an extremely important connexion between the two sets of ideas does, in fact, exist. The clue is provided by the terms "marketed" and "non-marketed"; output is bought and sold with the help of a medium of exchange, that is, of money; non-marketed output is allocated by administrative decision, typically by a civil servant in the public sector. When the distinction is elaborated in this form, the point may be obvious. *The demand for money bears a stable relationship to marketed output (i.e. to all those transactions in which money is required), not to national income as a whole.* The government has no demand for money balances because its sphere of activity is relatively insensitive to market pressures. This principle is a major qualification to the familiar monetarist contention that there is a reliable link between money supply and money national income movements. The link is rather between money supply and the value of transactions in marketed output or, roughly speaking, between money supply and private sector expenditure.[37]

It is possible to imagine two hypothetical economies, polar opposites of each other, one in which all commodites are produced by government order and distributed according to ration book entitlements (or something of the kind); and another in which all goods and services, including health, education and transport, are offered by private suppliers to private consumers and the distribution of income depends on productivity. In the first economy, which is of course the ultimate socialist ideal, there would be no need for money; in the second, which is unadulterated individualistic capitalism, the demand for money is determined by total national income. The mixed economy of the real world is intermediate between these two extremes, with the demand for money depending on the ratio between marketed and non-marketed output.

These observations throw light on certain recent difficulties of the British economy and, more especially, on the process of "de-industrialization" examined by Bacon and Eltis. As indicated above, the three years from 1974 were marked by a restrictive monetary policy and an inordinate growth in public expenditure. The reasoning of the previous paragraph indicates the likely sequel of such a policy mix; and it was the sequel which actually eventuated. The curb in money supply growth affected only marketed output or, in effect, the private sector, while leaving the public sector quite unscathed.

Since industry in Britain is (still) predominantly in private hands, it was industry, and not the public services, which was obliged to shed most labour. By this mechanism the demand management policies adopted by the Labour government simultaneously featherbedded the public sector and penalized industry. The monetary squeeze, combined with the public spending explosion, rendered the "new industrial strategy", designed to shift resources towards industry, quite impossible to achieve. Since the strategy became something of a music hall joke for other reasons this may seem a rather unnecessary debating point. But it deserves mention because the architects of the strategy showed no signs of understanding the basic incompatibility between the different branches of their policy approach or, to adopt a topical antithesis, between their macro-economic and micro-economic measures. The resemblance of de-industrialization to crowding out, and the relevance of monetarist thinking to down-to-earth industrial problems, should also be emphasized. The traumas of the private sector between 1974 and 1976 illustrate most effectively that monetary and real forces on the economy cannot be separated from each other into analytically watertight compartments.

vi

The arrival of monetarism in Britain in 1973 and 1974 was a reaction to dismay at the Barber boom and everything that came with it. For most of the post-War period resistance to monetarist authorities still accustomed to orienting monetary policy on external objectives and, in particular, to buttressing an explicit openness to international commercial influences, the strong trade union movement and the large public sector. These attributes fostered a number of objections, some of them plausible, others quite unjustified, to the implementation of sensible monetary policies. But policy-makers' indifference to monetary policy was relatively innocuous while Britain was on a fixed exchange rate because the misdemeanours of its politicians soon led to payments crises, "speculation" against the pound and appropriate corrective measures.

The decision to float – or, rather, to manage the depreciation – of sterling in 1972 was the watershed between the economically stable 1950s and 1960s and the unstable 1970s. With the external constraint no longer in force, the money supply exploded and the budget deficit widened sharply. For a time officialdom was deceived by the buoyancy of the economy into thinking that the looseness of its economic policies would not suffer retribution from union discontent, inflation and uncontrollable pressure on the pound. But the lag in the effect of monetary policy had passed by early 1974 and it became clear, to even the most stubborn of government economists, that something was badly wrong.

The partial acceptance of monetarist principles by the government probably dates from around this period. It coincides roughly with Mr Healey becoming Chancellor fo the Exchequer in March 1974, although it would be unwise to impute any causal connexion between the two events. But officialdom's conversion was half-hearted and incomplete, and it stemmed from a realization that mistakes had been made, not from a clear perception of what the right policies were. It is still not widely appreciated that the formal announcement of monetary targets in July 1976 and the official blessing they have since received (in the *Bank of England Quarterly Bulletin* of June 1977) is only a beginnning. Monetarist economic policy embraces far more than the explicit publication of monetary targets.

Because the Treasury and the Bank of England did not understand the implications of the new approach, serious inconsistences marred the conduct of economic policy. The main uncertainty was over interest rate determination, with the

ideas – and even to the belief that "money matters" – owed much to certain attributes of the British economy, notably the sterling-dollar parity. Confusion was worse compounded by the notion that the exchange rate should be regulated by the need to maintain "export competitiveness" which, on occasion, pointed to deliberate depreciation of the currency in the foreign exchanges.

Further difficulties arose in blending monetary targets with incomes policies and discretionary monetary policy, the two pet Treasury panaceas of the late 1960s and early 1970s. The monetarists had firm and coherent views on these questions. Direct control over pay and prices should be discarded as a policy instrument and fiscal policy should not be used as a stabilization device. Instead, the commitment to a monetary target, achieved by varying interest rates without regard to external factors, had to be the lynchpin of economic management. Floating exchange rates were a logically necessary counterpart. It was perhaps the most important merit of monetarism in the policy debate that it possessed a comprehensiveness and internal consistency which other schools of thought could not match.

If the government moved in the monetarist direction because of a continuous education by events the monetarists themselves learned much from policy failures and disappointments. Perhaps the best example of this process has been the development of "international monetarism" at the London Business School.[38] The kernel of this system is that, since the price level of a minor economy like Britain must move in step with the world price level, its inflation rate is determined by the world inflation rate and the change in the value of its currency against other currencies. Exchange rate appreciation or depreciation is, in turn, a reflection of comparative rates of money supply growth. Moreover, an attempt to push down the exchange rate for balance of payments reasons is pointless because domestic costs adjust to the devaluation and restore British costs to the international level. International monetarism is a close relative of the monetary theory of the balance of payments, but it is easy to detect the ways in which the British context has affected the growth of its main ideas. The openness of the economy has forced the international monetarists to ascribe great importance to the exchange rate and its evolution through time, while the speedy upward adjustment of wage costs which neutralizes devaluation may be regarded as the result of aggressive, alert trade unionism. In a big economy, such as the United States of America, where the unions are more placid and (for historical reasons) less inflation conscious, the emphases of monetarist economists were naturally somewhat different.

Notes

1 The Treasury and the Bank of England are referred to together as "the authorities". However, the Treasury is ultimately responsible for all policy decisions, since the Bank can be overruled by a Treasury directive.

2 C.A.E. Goodhart *Money, Information and Uncertainty* Macmillan: London 1975 p. 242.

3 Since then the exchange rate has been a policy instrument, although the authorities have made a pretence that one of their objectives is to maintain stable and orderly conditions in foreign exchange markets. It is likely that their actions – particularly the practice of keeping the exchange rate at a specific level, simply because that level has been established for a time, until a large downward step is considered necessary for the sake of export competitiveness – have actually destabilized markets. This was certainly the case in early 1976, notably on the celebrated day (4th March) when the Bank of England sold sterling to prevent the rate going up and started a run on the pound which saw it drop, with few intermissions, from $2 to $1.60. The *Bank of England Quarterly Bulletin* for June 1976 complained somewhat disingenuously that "the authorities' sales of sterling. . .were misinterpreted by the market". (p. 171)

4 Quite apart from the confusion which this statement symptomized it was a useless and fatuous remark even in its own terms. Of course, monetary policy must be determined by external or internal factors. Similarly, one can cross the Atlantic by sea or by air.

5 The rise in Minimum Lending Rate from 9 to 10½ per cent on 30th April 1976 is a good illustration of the market's puzzlement at the authorities' behaviour. The pound had dropped from $2.02 on 4th March to $1.84 on 30th April without any response from the Bank on interest rates and it seemed reasonable to suppose that the external threat to the pound would not meet with such a response in future. But the market's expectations were destroyed by the MLR increases and no one knew how the Bank would react to further pressure against sterling.

6 It should be noted that the mechanism by which a large fall in gilt-edged prices is engineered is extremely clumsy. The one rate which the authorities set directly is Minimum Lending Rate. A rise in yields on long-dated stocks can only be achieved if the market responds sympathetically to a movement in this ultra-short-term rate. Generally it does, but not always by the right amount at the right time.

7 There are, of course, prolonged periods of time when no "tap" stock is operative. But when an issue is on offer it is available at a particular price which is known throughout the market.

8 The two occasions being the rises in Minimum Lending Rate from 11 to 12 per cent on 3rd October 1975 and from 13 to 15 per cent on October 1976.

9 H. G. Johnson "Problems of efficiency in monetary management" in H. G. Johnson (ed) *Readings in British Monetary Economics* Oxford University Press 1972 p. 298.

10 J. M. Keynes *The General Theory of Employment, Interest and Money* Macmillan: London 1936 p. 202.

11 The interest-elasticity is defined as the percentage change in the quantity of money which people wish to hold divided by the percentage change in the rate of interest. It is a measure of the responsiveness of the demand for money to interest rate movements. See M. Friedman *The Optimum Quantity of Money* Macmillan: London 1969 p. 155 and p. 176 for the quotations below.

12 Friedman mentions Fisher at some length on pp. 8-11 of his *The Counter-Revolution in Monetary Theory* Institute of Economic Affairs: London 1970. There is a particularly clear and simple account of Fisher's interest rate theory on these pages.

13 M. Friedman *The Counter-Revolution in Monetary Theory* (ibid) p. 25. Note that there are elements here of another theory of interest rates – that they depend on the supply and demand for loans.

14 W. Eltis "The failure of the Keynesian conventional wisdom" *Lloyds Bank Review* October 1976 p. 11.

15 W. Greenwell & Co., the stockbrokers, have argued this point forcefully in their monthly *Monetary Bulletin*.

16 This is my own suggestion.
The authorities met the problem of fluctuating gilt-edged sales by an imaginative innovation – an instalment plan whereby an investor buys part of an issue at once, but has to pay up for the remainder in two or three months' time – in March 1977. (The £800m Exchequer 12½% 1992 issue was the first to be marketed in this way.) It remains to be seen how far it will succeed, but the immediate effects seemed very favourable.

17 Mr Anthony Harris of *The Financial Times* has written many articles in favour of index-linked gilts, the idea being that, if either the capital redemption or interest payments were linked to the rate of price increases, success in anti-inflation policy would reduce the debt charges on the Exchequer in future years. But this proposal is not specifically directed towards solution of the funding problem.

18 See D. Laidler's evidence on pp. 52-53 of the *Ninth Report of the Expenditure Committee*, cited in chapter 1. Laidler has also criticized the present arrangement in *Inflation: Causes, Consequences, Cures* Institute of Economic Affairs: London 1974 pp. 98-99 The reasons for "the somewhat heterogeneous collection of assets" included in the reserve asset ratio are explained on p. 198 of M. Crockett *Money: Theory, Policy and Institutions* Nelson: London 1973. Professor Brian Griffiths of the City University and Mr Gordon Pepper of W. Greenwell & Co. have also been strong critics of the use of the ratio for purposes of monetary control.

19 It is worth mentioning that most Bank of England intervention in foreign exchanges in the mid-1970s was designed to keep the exchange rate up. The authorities do not seem to have pondered on the inconsistency between this and their aim of ensuring export competitiveness. The fact is that any intervention in the foreign exchanges – unless it is palpably to meet a capital account outflow and only a capital account outflow – is *prima facie* evidence of overvaluation and must mean, therefore, that exports are not competitive.

The qualitative rule governing money supply growth in 1974 and 1975 was that it should be less than the growth rate of money national income. In early 1976 this was changed to a formulation which was that money supply and money national income growth should be more closely aligned in future. In July 1976 a formal "guideline" – later redesignated a "target" – was announced, for 12 per cent growth in conventional M3 between mid-April 1976 and mid-April 1977. In December 1976, at the time of the Letter of Intent to the International Monetary Fund, a new target came into effect, for 9 to 13 per cent growth in sterling M3 between mid-April

1976 and mid-April 1977. This was repeated in the period from mid-April 1977 to mid-April 1978.

20 See R. I. McKinnon "Beyond fixed parities: the analytics of international monetary agreements" pp. 42-56 in R. Z. Aliber (ed) *The Political Economy of Monetary Reform* London: Macmillan 1977.

21 See K. Duck, N. Parkin, D. Rose and G. Zis "The determination of the rate of change of wages and prices in the fixed exchange rate world economy 1956-71" in N. Parkin and G. Zis (eds) *Inflation in the World Economy* Manchester University Press 1976 pp. 113-143 for more details. There is a harsh criticism of this paper by Professor Michael Artis on pp. 143-149 of the book.

22 Monetarism is not necessarily incompatible with exchange market intervention by central banks. In some circumstances, for example, when a country has gone heavily into debt, such intervention is essential to acquire the means of repaying its obligations.

There are more technical details which disturb the relationship between supply, inflation, rates and exchange rates assumed by the monetarists. See B. Brown "Why a stricter monetary policy will not prevent currency crises" *Euromoney* March 1977 pp. 73-78.

The important point is that intervention be governed by quantitative targets for the amount of currency bought or sold and not by a wish to preserve a particular exchange rate. The commitment to a certain price for a currency must involve a willingness to vary this amount of intervention and such variations reverberate on domestic money supply growth.

23 In a parliamentary answer to Mr Norman Lamont MP in April 1976.

24 R. Walters "Importing and Exporting Inflation" on pp. 16-23 of *Dear Prime Minister* Economic Radicals: London 1974.

It should be noted in qualification to the argument in these passages that not all monetarists would agree with the way it is presented here. For example, some monetarists would say that devaluation does raise the price level. By its direct effect on prices it reduces the value of real balances and causes declines in domestic expenditure. This generates a payments surplus and, subsequently, a rise in the money supply which endorses the rise in the price level occasioned by devaluation. This sort of objection is made most strongly by the "international monetarists" at the London Business School.

Much depends on whether one is starting from a position of equilibrium or disequilibrium and what the casue of disequilibrium may be. There is scope – within an agreed conceptual framework – for a rich diversity of descriptions of the inflationary process in a small, open economy. See, for amplification, A. Lindbeck "Approaches to exchange rate analysis: an introduction" pp. 1-13 in J. Herin *et al* (eds.) *Flexible Exchange Rates and Stabilization Policy* London: Macmillan 1977.

25 A floating exchange rate cannot, of course, insulate an economy from the effects of changes in the terms-of-trade. There is a difficult policy problem is deciding how a small economy should respond to a sharp rise in the prices of its imports due to an increase in their relative scarcity, rather than currency depreciation. The problem is ventilated on pp. 79-82 of J. Flemming *Inflation* Oxford University Press 1976. This short book is an excellent introduction to the monetary theory of inflation.

26 J. M. Keynes *A Tract on Monetary Reform* in D. Moggridge and E. Johnson (eds) *The Collected Writings of John Maynard Keynes* Macmillan: London 1971 pp. 125-126.

27 Lord Kahn *On Re-reading Keynes* Oxford University Press 1974 pp. 22-23. The quote is from the official report of the House of Lords debate of 23rd May 1944.

28 Perhaps I may be allowed to say that I disagree with this argument which is based on the fallacy of thinking of the economy as analogous to a firm. "Marginal productivity" is not an operationally meaningful concept at the macro-economic level.

29 See Laidler's comment on p. 35 of *Inflation: Causes, Consequences, Cures* Institute of Economic Affairs: London 1974.

30 Friedman's remark on p. 46 of *Inflation: Causes, Consequences, Cures* ibid.

31 As an example, see F. P. R. Brechling "Some empirical evidence on the effectiveness of prices and incomes policies" in M. Parkin and M. T. Sumner (eds.) *Incomes policy and inflation* Manchester University Press 1972 pp. 30-47.

32 There is not much academic work of the misallocation of resources which follows wage and price controls, perhaps because to the well-trained economist the nature of such misallocation is self-evident. But see J. R. Hicks *Value and Capital* Oxford University Press 2nd ed. 1946 pp. 265-269 for an analysis of the general equilibrium effects of "price rigidities". I have also written a fairly extended critique of the Conservative government's Counter-Inflation Programme of 1972-74 ("The Counter-Inflation Programme: Can it work?" in *The Banker's Magazine* August 1973 pp. 58-63) which concentrates on the micro-economic disadvantages of incomes policies. For a lucid critique of incomes policies see S. Brittan and P. Lilley, *The Delusion of Incomes Policy.* Temple Smith: London 1977.

33 D. Laidler *Essays on Money and Inflation* Manchester University Press 1975 p. 92.

34 See R. Millward "Price restraint, anti-inflation policy and public and private industry in the United Kingdom 1949-73" in *The Economic Journal* June 1976 pp. 226-242.

35 A. J. H. Dean "Earnings in the public and private sectors 1950-75" *National Institute Economic Review* November 1977 pp. 60-70

36 R. Bacon and W. Eltis *Britain's Economic Problem: Too Few Producers* MacMillan: London 1976 *passim.*

37 It has been suggested to me that the true reason why the government does not hold money balances is not that it is insensitive to market pressures, but that it can print money at will. But the fact that it can print money at will is simply the consequence of its ability to command resources by legislative enactment or, in other words, of its insensitivity to market pressures.

It is true, of course, that government expenditure is "paid for" with "money" – in the sense that government employees, contractors to government departments, etc., receive cheques. But bank deposits, not cheques, are money. In principle, it would be possible for bureaucrats (using the state's monopoly of coercive force) to order individuals to transfer goods and services to the government *without payment.* In practice, governments do have some good-will and the writing of a cheque is the recognition of a liability to the private sector. It is institutionally convenient that this liability is registered with the banking system.

It is clear that the bureaucrat faces a budget constraint – he cannot spend more than the entitlement laid down by a higher political authority. But it is also clear that he does not face a liquidity constraint – he does not have to maintain a portfolio of financial assets to meet demands on him as they arise. If expenditure on national health and education is doubled there is no need for the government to increase its money balances – it has none anyway. Similarly, if the share of public health and education expenditure in national income rises the share of marketed output to national income falls and so, too, does the demand for money.

There are some difficulties here. The private sector does have to build up balances ahead of tax payments. Local authorities and public corporations do have some irregularity in their payment and receipt patterns which they cannot always be sure of covering by borrowing from the banks. But the main observation – that the demand for money is a private sector demand and is intended to match transactions in marketed output – still stands.

These themes are developed at more length in chapter 4.

38 See *Economic Outlook 1977-80* January 1977, the first number of a journal to be published by the London Business School Centre for Economic Forecasting. Its authors are Dr A. Budd and Mr T. Burns. Also R. J. Ball, T. Burns and J. S. E. Laury "The role of exchange rate changes in balance of payments adjustment: the United Kingdom case" in *The Economic Journal* March 1977 pp. 1-29.

IV. The Philosophical Implications

It is always a double-edged compliment to characterize an idea as fashionable. The description tends to suggest impermanence and fragility, as if the idea in question could be shrugged off as a topical irrelevance. In the case of monetarism, this danger has been particularly acute. Many of its detractors have found that the sharpest critical approach has been to admit that it has gained widespread support, but to imply that such support fluctuates with the ebb and flow of opinion and has made no real difference to economic knowledge. The previous chapters have attempted to refute this insinuation. Certain propositions which are branded as "monetarist" are not, in fact, distinctive of any school of thought, but form part of the core of received economic theory. Moreover, many of those themes which are distinctively monetarist, far from being an evanescent response to the Barber boom, have been recognized in one form or another for several decades.

As we have seen in the last chapter there are reasons for the apathy or hostility which establishment economists have displayed towards monetary theory and policy in Britain. But there is, nevertheless, a curious irony in the allegation they sometimes make that monetarism is a fashion and nothing else, since the monetary tradition in British economics was at one time full of vitality. Indeed, in the first half of the twentieth century Cambridge was the acknowledged centre of monetary theory, with original contributions from Marshall, Pigou, Robertson and, above all, Keynes. In the 1950s and 1960s this legacy was forgotten. The leading economists at Cambridge, who called themselves "Keynesians" and enjoyed the esteem conferred by

Keynes' name, scoffed at the small and diminishing bands of die-hards in provincial universities who obstinately insisted on the importance of money. It might be claimed that opposition to monetarism, and the lack of intellectual preparedness among establishment economists when confronted by the problems of the Barber boom, was due to the propaganda against money which came from the Keynesians over a period of years. By extension, it could be claimed that the responsibility for Britan's economic difficulties rests with Keynes himself.

i

It is important to examine this charge, because its investigation reveals much about the development of economic thought in Britain; and it must said straightaway that, as is clear from the titles of his three main books, *A Tract on Monetary Reform*, *A Treatise on Money* and *The General Theory of Employment, Interest and Money*, Keynes considered the influence of money on fluctuations in output and employment as fundamental. He thought that the weakness of economics in his day was its inability to reconcile the determination of individual prices by supply and demand with the determination of the aggregate price level by the quantity of money. His aim in *The General Theory* was

> to escape from this double life and to bring the theory of prices as a whole back to close contact with the theory of value. The division of economics between the theory of value and distribution on the one hand and the theory of money on the other hand is, I think, a false division. The right dichotomy is, I suggest, between the theory of the individual industry or firm and the distribution between different uses of a *given* quantity of resources on the one hand, and the theory of output and employment *as a whole* on the other hand. So long as we limit ourselves to the study of the individual industry or firm on the assumption that the aggregate quantity of employed resources is constant. . .it is true that we are not concerned with the significant characteristics of money. But as soon as we pass to the problem of what determines output and employment as a whole, we require the complete theory of a monetary economy.[1]

Keynes devoted twenty years of study to analysing the interaction of the real and financial sides of a capitalist economy. It is true that at the outset he considered money to be a benign or at worst harmless contrivance for facilitating transactions and

that at the end he was convinced it could be the jinx of the free enterprise system. But, whether the existence of money was beneficial or pernicious, he had no doubt that money mattered. That an influential set of academics have been able so easily and successfully to fabricate a "Keynesianism" in which decisions to spend are severed absolutely from liquidity, interest rates and all the other monetary elements in Keynes' theory must be the most extraordinary *volte face* in economics. How did "Keynesianism" emerge? What are its main elements and can they be related, even distantly, to *The General Theory?*

It has to be conceded that the Keynesian approach – even in the much diluted and bastardized form found in the Treasury and the National Institute – is not altogether divorced from Keynes' thinking. The principal Keynesian theoretical construct is the income-expenditure model of aggregate demand determination. Reduced to its essentials this model says that demand depends on how much economic agents decide to spend and that certain categories of spending (such as exports and government expenditure) are "exogenous". That is, they do not depend on the current level of national income, but instead regulate its future value by the multiplier process. The vast Treasury econometric model, adverted to in chapter two, nothing more than an elaboration of this simple insight.

The income-expenditure model is advanced in *The General Theory*, constituting the subject-matter of books two to four. These take up 160 of the 385 pages and are the heart of Keynes' *magnum opus*. The model is expressed in wage-units which may be equated with the wage payment to the average worker. This device is technical and its function is purely pragmatic: if demand is measured in so many wage-units, an increase in demand leads to an identical increase in the number of wage-units and, as long as wages are constant, to an identical increase in the number of men in work. The wage-unit assumption enabled Keynes to proceed quickly from the level of aggregate demand to the level of employment, an undoubted merit in the 1930s when mass unemployment was the obsessive economic problem. But this convenience was obtained at great cost in theoretical completeness because its result was that Keynes had no method of determining the wage-unit.

For this reason book five of *The General Theory* was concerned with "Money-Wages and Prices". It should be noted that the hypothesized effects of changes in the quantity of money are very different in this book from in books two to four. In them an increase in the money supply lowers the rate of interest, stimulates activity and does not change the price level. In book five, however, a rise in the money supply boosts effective demand and "the increase in effective demand will, generally speaking, spend itself partly in increasing the quantity of employment and partly in raising the level of prices".[2] In the extreme case of full employment monetary expansion leads only to inflation. Clearly, the income-expenditure model is outlined in books two to four before the discussion of wages and prices because it is only valid if the wage-unit is constant. Keynes organized the argument of *The General Theory* in full cognizance of the ramifications, and the peculiarities, of the wage-unit assumption.

But the Keynesians have overlooked these qualifications. Their income-expenditure models are invariably constructed in real terms, as if a change in wages could not occur inside the model context. Within the confines of the forecasting exercises carried out by the Treasury and the National Institute, such indifference towards price and wage level changes can be defended. It is a common property of Keynesian forecasting models that an x per cent rise in wages is sooner or later accompanied by an x per cent rise in prices, implying that the real purchasing power of earnings and, hence, consumption and national income are unaffected. But the habit of forecasting the macro-economic aggregates in real terms has had very serious consequences. It has persuaded the economists concerned to believe that real variables and the level of inflation are determined by two separate processes and it has caused them to banish money from their models. The exile of monetary factors to the nether regions of the City and old-fashioned, pre-Keynesian economics faculties is necessary to them because, as Keynes recognized, neither his theory nor any of its rivals has been able to disentangle the effects of a money supply increase on real output and the price level – except, of course, in long-run equilibrium when the monetarist conclusions hold. The Keynesians have to believe not only that national income depends on decisions to spend, but that decisions to spend have no connexion with the economy's balance sheet (the level of the nominal and real money supply, the market value

of stocks and shares, etc.) If they did not believe this they could not trust the income-expenditure model and the whole conceptual edifice of Keynesianism – as the term is understood in Britain's policy-formation establishment–would collapse.

As this account demonstrates, the story of the degeneration of Keynes' pure theory to contemporary Keynesian "orthodoxy" is tortuous and complicated. But it could be argued, as a legitimate generalization, that the theme of this story has been the reinstatement of a dichotomy between two aspects of the economy which, in the real world, are intertwined. One aspect is the determination of national income by the level of demand; and the other is the determination of the rate of inflation by supposing that collective bargaining drives up wage costs (i.e. Keynes' wage-unit) and, in the same proportion, the price level. Here lies the intellectual origin of the Keynesian assertion that effective demand has no bearing on the increase in prices and the theoretical background to the advocacy of incomes policies. If spending changes output and not prices, demand management is a useless instrument for controlling inflation and reliance must instead be placed on direct political and administrative action. That such action may distort the structure of relative prices is a minor drawback to the Keynesian because his income-expenditure model is aggregative and does not stoop to scrutinize the supply-and-demand problems of individual businessmen.

The dichotomy under discussion here can only be generated by an interpretation of economic reality which abolishes money and relative prices by assumption. The "apparatus of mind" which works on such assumptions is, in fact, not economics at all, but a kind of anti-economics. It is the "technique of thinking" of the great majority of economists in the Treasury and the National Institute and has been carried to extreme limits at the Department of Applied Economics in Cambridge. Perhaps more than any other single factor it is this anti-economics which has been responsible for the succession of misguided policies pursued by the British government in the last fifteen years.[3]

Moreover, the dichotomy on which the official anti-economics rests resembles the classical dichotomy rebutted by Keynes. The classical dichotomy said that the output of the individual industry depended on supply-and-demand and the aggregate price level on the quantity of money. Keynes insisted that via the rate of interest, money affected relative prices, output and the aggregate price level and that the economy could not be neatly divided into different departments. The official dichotomy of the 1960s and 1970s has, if anything, been even more dishonest than the classical because it dispenses with money altogether. Keynes, who thought that "as soon as we pass to the problem of what determines output and employment as a whole we require the complete theory of a monetary economy", would have repudiated it totally. It is sometimes said that the income-expenditure models of the Treasury and the National Institute, with their attendant simplifications and misrepresentations, are a "vulgar" version of what "Keynes really said"; but, as we can see, they are not; they are a fake. To talk of the dissipation and destruction of Keynes' endowment to British economics is not overstatement.

The strength of the resistance to monetarism in Britain cannot, therefore, be attributed to the fact that Keynes was an Englishman, rather than an American or European. It is not his fault that, since his death and, more particularly, since about 1965, Cambridge has been a disaster-area for both economic theory and policy. Monetarism is not an assault on Keynes' work, but an attempt to rescue it from his *soi-disant* successors. Friedman has compared Keynes' disillusionment with the stability of capitalist financial markets in the 1930s with similar views held by Henry Simons, and he has described Keynes' monetary theory as "sophisticated and modern".[4] By contrast, one would not have guessed from the sort of statements which emanate from the National Institute or the Department of Applied Economics at Cambridge that Keynes had a monetary theory or, indeed, that such an entity as monetary theory, whether derived from Marshall, Keynes or Friedman, was worth discussing at all.

The lack of sturdy intellectual defences against monetary abuse on the 1972-74 scale is not to be explained by Keynes and the special position he holds in the pantheon of British economists. It is not fantasy to suggest that part of the answer lies instead in the social and political attitudes of the policy-formation establishment in Whitehall and the two "blue-brick" universities. Civil servants and academics – especially Oxbridge academics – like to pretend to a quasi-aristocratic detachment from the materialism of business and commerce: they bridle at the mention of complicated financial mechanisms and operations; and they would prefer not to know how the squalid and grubby business of the City of London is conducted. The result is an ostentatious ignorance of even the most rudimentary ideas in monetary theory. (Professor Harry Johnson is perhaps the only monetarist to have made a fuss about the economic establishment's aloofness from "making money" and to have seen it as an important influence on the thought-habits of the Keynesians).

But there are deeper reasons for the neglect of monetary economics than these sociological considerations. It often seems from the tone of voice in which they refuse even to hear the word mentioned that the intensity of the Keynesians' hostility to "monetarism" stems not from a process of reasoning, but from pure emotion. In fact, this is probably an exaggeration, for the opposition may be more a matter of ideology, with the emotional vehemence merely the by-product of political commitment. As its critics understand, monetarism is not politically neutral. It can readily be an ally of a particular political philosophy or, to be less bold, of a certain disposition towards political problems. This disposition is basically liberal, but, since the need to preserve the *status quo* is emphasized, it also has conservative implications. It is not tendentious to associate it with such thinkers as Hayek and Oakeshott. Perhaps it goes without saying that the Keynesians do not sympathize with this disposition or with these philosophers.

The purpose of the following sections is to outline the affinities between monetarism, liberalism and conservatism.

ii

Money is usually termed "the medium of exchange", but this is perhaps to demean its role. The phrase, "the instrument of choice", brings into stronger relief its significance for a liberal philosophy. Of course, choice exists in a barter economy, but the possibilities for transacting are much more circumscribed. Because it is universally accepted, the introduction of money into an economy reduces the size of the stock of goods needed to engage in trade. It thereby lowers marketing costs and extends the area in which consumers are able to select the combination of products most suited to their needs. This extension of choice is an essential preliminary to widespread specialization. If it is expensive to trade, the market may be too small to allow an individual to concentrate on one form of production. But when commerce is facilitated by a universally accepted instrument of choice the division of labour can begin. The ensuing gains from economies of scale and experience were first described by Adam Smith in *The Wealth of Nations* and they have formed part of the folklore of capitalism ever since. The division of labour can, of course, be taken a long way in a socialist, centrally planned economy, but traditionally it has been a process associated with market freedom and decentralized decision-taking. The reason is clear. The fact that the division of labour generates advances in productivity is an effective illustration of how self-interested individuals, not working at the behest of a single co-ordinating unit under government control, can achieve a harmonious and socially optimal result. It is one component, and perhaps the most persuasive component, of the argument for permitting the "invisible hand" to allocate resources without interference from the state.

Hayek has reinforced this argument by pointing out the dependence of a complicated economy on

> the fragmentation of knowledge, on the fact that each member of society can have only a small fraction of the knowledge possessed by all and that each is therefore ignorant of most of the facts on which the working of society rests.[5]

Here, too, the role of money is crucial. It is a common standard of value, a *numeraire* in which the value of all goods may be expressed. Its presence excuses traders from having to be informed of the price of a good in terms of other goods (e.g. exchange ratio of wheat into coffee, cars, furniture, etc.) since it is instead adequate to know the price of a good in terms of money (how many pounds have to be paid for a bushel of wheat). Since the amount of information required for successful marketing is reduced by this device, energies are released for other tasks and economic efficiency is improved. The advantage conferred by money in this respect is weaker if its quantity and, consequently, its exchange relationship to goods in general (that is, the overall price level) changes too much in a short space of time. The monetarist distrust of sharp increases in the money supply finds here its most basic rationale.

The connexion between money and freedom may be seen to turn on the Smithian theory of the division of labour and the

Hayekian concept of the division of knowledge. One of the characteristics of economists who believe in these ideas is that they respect the relative price structure which arises from free production and exchange. They consider that unfettered market forces set prices which achieve the right equilibrium between consumer wants and scarce resources. It is not surprising, then, that the monetarists recommend a high degree of wage and price flexibility since restrictions on price movements impede the attainment of this equilibrium. Such restrictions may stem from monopoly power, but governments are more usually to blame.

Pay and price controls designed to curb inflation are, of course, the most prominent form of government interference. Although they are commonly formulated as if they were to be impartial in effect (for example, the same percentage pay increase is allowed to the whole labour force), they always discriminate in practice. It is almost part of the definition of a dynamic economy that the relative price structure should come under pressure from different rates of productivity growth in different industries, varying income elasticities of demand and so on. To proclaim the same proportional pay increase for every worker or price increase for every good is to freeze the relative price structure and weaken its allocative power. Monetarists regard these consequences as unacceptable.

It is evident that the monetarists' condemnation of incomes policies stems from their philosophical attitude towards market freedom. Their emphasis on a monetary explanation of inflation supports this attitude. If it can be shown that monetary mis-management is the cause of inflation it is reasonable to claim that monetary responsibility is a sufficient policy response. Direct controls, with the infringment of freedom they entail, are unnecessary. This conclusion cannot be reached by the Keynesians since money is alien to their economic outlook. Their world-view is such that only changes in wages can account for changes in the aggregate price level and only political measures to check the collective greed of the unions can prevent prices from rising.

The divide between monetary and non-monetary approaches to inflation is related to another fundamental divide in economic theory, that between those theories which say the distribution of income is determined by productivity and those which say it is determined by comparative bargaining power. The productivity theories belong to the neo-classical strand in economics and the power theories to the Marxian.[6] The wage-unit assumption places the Keynesians firmly on the Marxian side. Because the assumption implies that wages are not governed by the workings of their income-expenditure model, but are given by forces outside the model, it is open to the Keynesians to attribute pay movements, and the balance between wages and profits, to political factors. The frequent references to union militancy in Keynesian writings are a logical consequence. In the more embroidered versions phrases such as "class conflict" and "revolutionary struggle" may even make an appearance. On this reckoning, inflation is a manifestation of "social crisis", a sign that the system is under threat from tension between selfish workers and profiteering capitalists. Since the problem is political, so must be the solution. Hence, there is a need for the government to become involved and act as a peace-maker by laying down pay and profit limits to be binding on all groups. Keynes' wage-unit assumption culminates in centralized pay negotiations between the "peak organizations" of labour and capital on the one hand and the government on the other. Moreover, in the Keynesians' opinion, these negotiations not only help overcome inflation, but may also contribute to the attainment of "social justice". By permitting larger pay increases to the low-paid than the well-off an incomes policy can reduce inequality. This the Keynesians consider a desirable end, partly because equality is good in itself, but also partly because they feel that the prevailing distribution of income, being determined by power, has no worthwhile economic function.

The monetarists take the opposite view; they sympathize with the neo-classical school of pricing and distribution. Because, in their outlook, the relative price structure bears the imprint of market forces, they believe that wages – which are also prices, the prices of labour – are fixed by supply and demand. A worker is paid for what he produces; if he is paid less employers are induced to compete for his labour services until his wage rises and their surplus is removed; if he is paid more he is either made redundant or obliged to suffer a wage cut. There is a definite, if rough-and-ready, justice in this equating of pay with productivty because it matches reward to effort and skill. Pay controls

disturb this equivalence and, aside from the harmful side-effects in the misallocation of labour, they tend to lead to industrial unrest. The monetarist suspicion of income policies is validated, therefore, not merely by the tenet that inflation is caused by excessive monetary expansion, but also perhaps by moral approval for the pattern of income distribution created by the market.

The monetarists' criticism of income policies can be used as part of a broader defence of economic freedom; and economic freedom is justified by the benefits it yields through the Smithian division of labour and the Hayekian division of knowledge. A trustworthy instrument of choice, in the form of a monetary unit which maintains a constant value through time, is necessary to the smooth operation of the free economy which the monetarists favour.

iii

By its intrinsic nature, money is private, not public, property. Since the state is able to manufacture money at zero (or minimal) cost, it has no need to hold large money balances. In most advanced economies central government expenditure is financed on a continuous overdraft from the banking system. The government's cash resources from day to day are practically nil, but the banks lend it large sums for its ongoing commitments by taking up issues of Treasury bills. Again, local authorities and public corporations can never face bankruptcy, because the government will bail them out however gross their financial incompetence. This immunity to risk means that they do not need to have sizeable balances in the banks. Insofar as they have a demand for money at all it is a demand for relatively minor transactions and is necessarily very small. British money supply statistics confirm these observations. At present, the money supply (notes and coin; plus bank deposits) stands at about £44,000m; of this total, only £1,000m are public sector deposits – or 2½ per cent, compared to the 50 to 60 per cent share of public expenditure in the national income.

No private sector agent can operate with the same financial licence as the government. On the contrary, every transactor in the economy outside the public sector must own some cash or bank deposits; and, as is clear from the figures, the money stock is almost entirely private property. This attribute of money was remarked upon in our discussion of the Bacon and Eltis "de-industrialization" thesis in chapter three, as it had an obvious relevance for the difficulties of the private sector in the mid-1970s. But there are more far-reaching implications for stabilization policy. They illuminate the processes whereby Keynesian economics has damaged the British economy in the post-War period.

The political message of Keynes' macro-economic theory was that, because of the instability of the speculative demand for money, monetary policy was an unsound tool for regulating demand and that greater reliance should be placed on fiscal policy. It might on occasions be necessary to combat recessions by raising public expenditure. Keynes had not noticed that money was only a determinant of private sector fluctuations and that the public sector, which can borrow from the rest of the economy almost at will, cannot have liquidity troubles. One of the major flaws latent in his macro-economic advice was hidden from him.

The flaw has gradually been exposed. The Keynesian predilection for using public expenditure as a demand regulator has aided those politicians and bureaucrats who want, for selfish or ideological reasons, to see the public sector expand without check. It would not matter if a recession was accompanied by spending increases and a boom by equivalent spending cuts. But that is not the way it has worked out. Instead, recessions have induced spending increases and booms have prompted restrictive monetary policy. The private sector is disabled in either situation. When demand is weak the government's inclination to stimulate public expenditure has not been associated with comparable pressures to raise private expeniture; and when demand is strong the resort to higher interest rates in partial in effect and detrimental to the private sector alone.

This asymmetry in resonse, fully endorsed by "Keynesianism", has been reinforced by the characteristics of government employment. Because such employment is not justified by marketed output the government cannot dismiss employees on the grounds that demand has dropped and sales revenue is insufficient. It is quite unlike a private sector company subject to commercial

disciplines which can offer a morally convincing defence for declaring workers redundant if it does not have enough money to pay their wages. Public sector redundancies, the ultimate cause of which is usually monetary restraint, can be attributed to bad business conditions and their rationale, even to those who are forced to go without jobs, appears impeccable.

There is a further, related point. Keynes' unhappiness about the clumsiness and unreliability of monetary policy led him to his plea for the activation of fiscal policy. But he did not stop here. His assessment was that fiscal policy could have the necessary flexibility and impact only if the public sector were sufficiently large. The corollary was, to use Keynes' own phrase, "a somewhat comprehensive socialization of investment". An apparently technical and non-ideological judgement about the efficacy of monetary policy became the background to a frankly socialist proposal.

There is much to be said against Keynes even on his own premises. For example, difficulties in predicting the consequences of monetary policy might be thought a reason for paying more attention to it, not less. There is also the objection – not perhaps apparent to Keynes in the 1930s when the public sector was so unimportant compared to the present situation – that government employment is subject to much more inertia than private, as we explained above, and public expenditure is not, therefore, the sweet and flexible instrument that he thought it to be. But the monetarists' reply to Keynes is based on a yet more profound scepticism about economic policy.

They doubt that the authorities have the wisdom, foresight and political detachment required for the role Keynes hoped would be possible. To them the variability of the lag between money supply and money national income movements does not warrant indifference towards the effect of central bank behaviour on the economy or greater concern about fiscal policy. Instead, it justifies abandoning the discretionary approach to economic policy altogether and the adoption of an automatic money supply rule. The crowding out doctrine toughens the monetarists in their stance because it implies that an activist fiscal policy is futile and pointless. That economists can debate whether a £100m increase in public expenditure adds £200m, £100m or nothing to effective demand in the economy is, in a way, sufficient proof of the policy-makers' ignorance and, hence, of the impropriety of Keynes' call for "comprehensive socialization". The monetarists find his case for an upheaval of established property relationships rash and insubstantial.

The strength of the correlation between monetarist sympathies and a liberal or conservative approach to political problems is not an accident. Money is one of the principal kinds of private property and variations in its quantity have most effect on the private sector. The "Friedman rule" is intended first and foremost as the answer to inflation, but it also performs the function of protecting the private sector from the politicians. It is sometimes said that there is no intellectual consistency between monetarist macro-economics and the aversion towards the public sector and interventionist industrial policy which monetarists commonly display. But we now see that these attitudes can form part of a coherent political outlook. It is, of course, conceivable for a socialist government to have a programme of constant money supply growth while maintaining a high ratio of public expenditure to national income and embarking on schemes for subsidizing or penalizing private industrial ventures. But a high ratio of public expenditure to national income reduces the scope for individually motivated choices and thus makes the management of the money supply less important. In addition, the more obtrusive is the state's determination "to accelerate industrial change", and the more politicians and government officials arbitrate on the allocation of scarce inputs, the more otiose becomes the financial system's role of enforcing market-related priorities according to profitability. The monetarist advocacy of stable money is integral to the defence of private property; and, as Oakeshott has noted, private property is the institution which since it "allows the widest distribution and discourages most effectively great and dangerous concentrations of power", is "most friendly to freedom".[7]

Friedman has tried to give a more exciting appeal to the case for limiting the size of the public sector. In an article in *Encounter* in November 1976 he put forward the notion of a "tipping point" – a particular ratio of public expenditure to national income at which political liberty is in peril and totalitarianism is imminent. For a fairly unsophisticated country, such as Chile, the tipping point is 40 per cent; for a richer country, like Britain, it may be

higher at 60 per cent.[8] Much criticism, notably from such leading monetarist economic commentators as Brittan, has been levelled against these predictions as glib and unscientific. But Friedman's article, even if it could not substantiate the specific figure in contention, was based on some simple and indisputable perceptions about the nature of political democracy. The vital contrast, according to Friedman, is between political and economic markets. The political mechanism has "the fundamental defect" that

> . . .it is a system of highly weighted voting under which the special interests have great incentive to promote their own interests at the expense of the general public. The benefits are concentrated; the costs are diffused; and you have therefore a bias in the political market place which leads to ever greater expansion in the scope of government and ultimately to control over the individual.

The economic market is "very different".

> In the economic market – the market in which individuals buy and sell from one another – each person gets what he pays for. There is a dollar-for-dollar relationship. Therefore, you have an incentive proportionate to the cost to examine what you are getting. If you are paying out of your own pocket for something and not out of somebody else's pocket, then you have a very strong incentive to see whether you are getting your money's worth.[9]

Although in his *Encounter* article Friedman did not join this essentially political argument to his well-known economic prescriptions, it is not difficult to do so. The machinery of the political market is oiled by votes – or, rather, by the interplay between the bargaining tactics of different interest groups and the state's monopoly of coercive force. But the lubricant of the economic market is money; and the advantages of the economic market are most obvious when the monetary system is in good working order. It is the hallmark of societies undergoing a hyperinflationary experience that pressures on the government to act as the guardian of particular sectional intersts are particularly strong; in such circumstances the citizens prefer the political market because the lack of a stable monetary unit leaves the economic market hopelessly inefficient. Only when the value of money is steady and reliable over a period of years can the economic market develop to its full extent.[10]

iv

In the previous two sections it has been shown that sound money furthers the widening of choice found in a free economy and lends support to the institution of private property. Both these themes connect monetarism with liberalism and conservatism, and help to account for the political disposition of monetarist economists. It may not be too fanciful to conclude on a yet more abstract note by suggesting that the sceptical tone of monetarist economics accords with the misgivings about the currently dominant style of rationalist and managerial politics which have been expressed by Hayek and, more particularly, by Oakeshott in his *Rationalism in Politics.*

The starting-point for discussion may again be Keynesianism of the kind practised by Britain's economic establishment. It has several rationalist characteristics. It is highly ambitious in that it asks the state to pursue four goals – full employment, price stability, economic growth and balance-of-payments equilibrium – and to have a precise conception of what these goals are or should be. They are to be sought by means of "demand mangement". We may notice how the word "management" has already crept in, rather as if the state were a business and politicians were its board of directors. The notion of demand management presumes that policy-makers not only have a good grasp of economic common sense, but also that their empirical understanding of detailed economic mechanisms is certain and thorough. It is implicit in this that the more scientific is the approach, the deeper is their understanding. The electronic gadgetry of the Treasury model, with its pretence of giving exact answers to difficult questions, indicates only too clearly the cast of mind involved. More fundamentally, Keynesianism assumes that all the requisite knowledge and wisdom is concentrated in a few minds in Whitehall and may ultimately be assembled at a sort of central committee meeting where the crucial decisions are taken. (Hence, all the attention paid to meetings of the National Economic Development Council or "confrontations" between the Chancellor of the Exchequer and the TUC or CBI.) The committee's decisions have, if some Keynesian accounts are taken to their logical conclusion, a purely technical character, rather as though the problem of steering the economy were like

that of steering a ship on an agreed course. Debate and uncertainty are banished from this view of economic policy: Keynesianism is the embodiment of rationalism in political economy.

Monetarism is in conflict with the rationalist tendency in two main ways. First, it denies that enough is known for policies to be framed with the exactitude needed. As was remarked in chapter 2, Friedman's original case for the monetary rule was negative and sceptical. It was not based on an extravagant boast that he knew more about the economy than the Keynesians, but instead rested on the perhaps less vulnerable foundation of partial ignorance. Because so little was understood, it was sensible, Friedman argued, not to expect too much from monetary policy. A similar admission of incomplete knowledge came with his theory of the natural rate of unemployment. In the 1967 presidential address to the American Economic Association he said quite candidly that, although he thought the natural rate was an empirically valid concept, he could not measure it. This may be branded as obscurantist or applauded as prudent intellectual modesty, but either way it departs abruptly from a rationalist managerial approach to economics such as that associated with the Keynesians.

Secondly, monetarists distrust the political authorities to whom Keynes felt the task of demand management should be granted. To Keynes, and arguably to most of the English upper middle class of his time, it was safe to believe that governments acted as servants of the community as a whole and that their members were basically honest and conscientious. This was a plausible belief forty or fifty years ago because Britain had at that stage been ruled by an exemplary political elite for at least two centuries. The Benthamite and melioristic mood of Keynes and his establishment colleagues reflected this long tradition of fairness and decency: it duped them into thinking that altruism among politicians was the rule rather than the exception. Henry Simons, and other social and economic observers in inter-War America, did not have the same respect for the political process beacuse America had seen the rough-and-tumble of democratic vote-catching since the early nineteenth century. Chicago school economists have tended to take a realistic and cynical view of politicians' motives – as Friedman's antithesis between the economic and political markets demonstrates. The monetarists are inclined to consider that politicians, far from watching over the interests of the community as a whole, put their own interest first: politics may be analysed, not as the maximization of social utility, but as the maximization of politicans' utility. It follows that the government's powers in the economic sphere should be restricted. The monetary rule is perhaps the most effective barrier to political discretion. When consistently applied, it excludes "management" of the exchange rate, "management" of fiscal policy and "management" of prices and incomes. The critique of Keynesianism is absolute; and the reason for the opposition being so diametric is that monetarism and Keynesianism are based on quite different interpretations of democratic politics.

Since 1945 Britain's experience of democracy has been much more like America's, with the two main parties competing for votes by electoral promises in such areas as full employment and price stability. The Barber boom is only the most recent attempt to seek political popularity by over-stimulating the economy. Precedents may be found in 1950s when the Conservatives held a general election in 1955 shortly after a Budget which cut income taxes and again in 1959 when Mr Macmillan's slogan of "you never had it so good" was declared in the midst of an unusually vigorous cyclical upswing.

Keynesianism – with its hope that governments would publicly commit themselves to four recognised economic objectives – has been largely responsible for this version of democratic politics. But managerialism has refuted itself. By becoming embroiled in party politics, demand management has lost its innocence and can no longer claim to be a purely technical item on a committee's agenda. Moreover, as Keynesian economic policy has been exposed as contentious and political in nature, so has the delusion that the political class respects the public interest rather than its own slowly evaporated.

The recent progress of monetarism in public debate may be seen, therefore, as one reflection of the disillusionment with politicians which has marked the 1970s; and this disillusionment may be attributed to a realization that rationalism in political economy has not solved problems, but increased them, and has not made disagreement about policy less heated, but has intensified it. But managerial economics and political democracy are confederates – managerialism gives politicians plenty to say at elections and plenty to do between them. It remains to be seen if monetarism, with its vision of a smaller state and less adventurous economic policy, can be reconciled with the competitive, adversary style of contemporary British politics.

Notes

1 J. M. Keynes *The General Theory of Employment, Interest and Money* Macmillan: London 1936 p. 293.

2 J. M. Keynes *ibid* p. 296.

3 The phrases in quotation marks are taken from Keynes' famous introduction to the Cambridge Economic Handbooks, which he edited until 1936.

4 M. Friedman *The Optimum Quantity of Money* Macmillan: London p. 84.

5 F. Hayek *Law, Legislation and Liberty* vol. 1 Routledge & Kegan Paul: London 1973 p. 14.

6 Professor Maurice Dobb has made the distinction between the two types of theory particularly well in a number of books – notably in *Political Economy and Capitalism* Routledge and Kegan Paul: London 1970.

7 R. Oakeshott *Rationalism in Politics* Methuen: London 1962 p. 45. The remark appears in a review of Henry Simons' *Economic Policy for a Free Society.*

8 M. Friedman "The fragility of freedom" *Encounter* November 1976 pp. 8-14.

9 It should be noted that the ideas put forward by Friedman in this article owe much to work on the theory of public choice done at the University of Western Virginia. They have been adopted by the Chicago school.

10 The point may seem remote from the realities of Britain in 1977 when inflation is running at "only" 10 per cent a year. However, even this rate of price increases means that the value of money over a five or ten year time-span is highly uncertain and prohibitive

of long-term contracts. The issue of debentures and loan stocks on London financial markets has practically ceased, except when an early redemption date is envisaged. The result is that companies have instead to seek long-term finance from state agencies on favourable terms.

As inflation accelerates, the time-horizon of the typical economic transector shortens until finally it is no more than a few hours or minutes. See an amusing footnote on p. 41 of J. M. Keynes *A Tract on Monetary Reform* in vol. 4 of D. E. Moggridge and E. Johnson (eds.) *The Collected Economic Writings of John Maynard Keynes* Macmillan: London 1971.

MONETARISM: An Essay in Definition

The term "monetarism" has entered the vocabulary of public debate – sometimes as a clarion call for action to improve economic policy, often as an epithet of abuse. A set of beliefs about the way an economy functions and about the best economic policies for a country to follow, monetarism may provisionally be described as resting on two essential ideas: that "money matters", and that the government should control money supply growth to keep it in line with productive capacity.

In this valuable contribution to a controversy that has lasted some three hundred years, the author sets out to define the meaning of monetarism and provides a clear and informative account of the present state of development of monetary theory in Britain. He provides powerful support for the view that it is the issue of money which determines the level of prices, and that trade has to come to terms with a constant rate of issue of money rather than the other way round.

Tim Congdon was educated at St John's College and Nuffield College, Oxford, and graduated with a First in Modern History and Economics. Former economics correspondent on *The Times*, he is now economic advisor to stockbrokers L. Messel and Company. He has written widely in journals and newspapers and has published *Basic Economics: A Dictionary of Terms, Concepts and Ideas.*

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