

MONETARISM IN RETREAT

If monetarism is a religion, then recent weeks have seen a serious outbreak of atheism. Firstly, it seems as if Chancellor Nigel Lawson is close to a dead-end in the implementation of monetarist doctrines. The rate of inflation, the most important symbol of Tory economic 'success', has bottomed out and is on the way back up. There is no possibility of a further drastic deflationary move like the measures of 1980 because the economy is already so depressed. Similarly, Mr Lawson seems to have recognised that no progress towards lower taxation is at present foreseeable; attempts to cut taxes via reductions in public expenditure have proved self-defeating as the tax base itself was weakened.

In both cases there is a clear loss of faith in the underlying dogma of monetarist theory: the assumption, never grounded in convincing evidence, that the market sector of the economy is self-stabilising. If it was, if output and employment in the private sector bounced back to previous levels after a major shock, then it would make some sense to attack inflation with a drastic tightening of credit. As everyone but the most doctrinaire realised that this magic equilibrium was a mirage, reluctance to go on sacrificing real production to monetary targets has grown.

The retreat from monetarist policy recommendations by academics and commentators is a second source of embar-

rassment for the Government, which remains — in principle at least — wedded to its old strategies. (Conservative opponents of the Government, above all Edward Heath, seem to have sensed a growing unease about monetary policy and chosen this moment to become much more explicit in their criticisms.) One of the most influential advocates of monetarist economics in the past, Samuel Brittan of the *Financial Times* is putting an increasing distance between himself and his previous beliefs. He now puts forward only the most diluted version of the doctrine and seems concerned, above all, to devise monetary policies that will not destabilise real output and employment.

Mr Brittan was originally persuaded to monetarist theory by the writings of Milton Friedman, the Chicago professor who is both the originator and the best-known exponent of monetarist economics today. In a third manifestation of rampant disbelief some very damaging criticisms of Friedman have been published by the Bank of



Nigel Lawson: close to a dead-end?

England itself. The document¹ reports on a discussion last October at a meeting of the Bank's Panel of Academic Consultants, a gathering of some twenty senior economists from British universities and the civil service.

The panel met on this occasion to consider a restatement of his position by Friedman and the economic historian Anna Schwartz. About twenty years ago Friedman and Schwartz published a substantial *Monetary History of the US*, very influential in reviving the 'quantity' theory of money which had suffered great damage at the hands of Keynes. The *Monetary History*

sought to revise standard Keynesian interpretations of the Great Depression of the 30s by arguing that faulty monetary policy was the main cause of the collapse.

Friedman and Schwartz have now produced another large study of historical trends in money, output, prices and interest rates which, this time, tries to support Friedman's position by drawing on evidence from both the US and the UK.² It was the book's use of UK data which was examined in two critical papers presented to the Bank of England's panel.

The main claim in the new Friedman and Schwartz study is the existence of a straightforward causal relationship running from the 'quantity of money' to the general level of prices. In this view, price inflation has one simple cause — too much money in circulation — and one, not too painful, cure — restriction of the 'money supply' by the authorities. The first paper presented at the Bank of England, by Professor AJ Brown of Leeds University, makes a detailed scrutiny of the Friedman/Schwartz data, and finds no good basis for their conclusions in the actual pattern of events. The second paper, by Professor D Hendry and Mr N Ericson of Oxford University. Subjects the Friedman-Schwartz results to a battery of sophisticated statistical tests and, again, finds them wanting in nearly every respect. The claims made by Friedman, it is concluded, are 'without empirical support' and 'devoid of credibility.'

Although it has attracted more comment, the Ericson/Hendry paper is weakened by its reliance on hi-tech econometric procedures. Indeed, the tests it puts forward are so stringent that it is hard to think of an economic study that would have survived them. However, the real damage to Friedman and Schwartz comes from what is between the lines of both papers — they are too decorous to say so explicitly but both clearly suggest that Friedman has fudged the evidence: in order to defend his position the data have been subjected to some weird and wonderful manipulations. Friedman, apparently, has not yet exercised his right of reply to the Brown and Ericson/Hendry critiques — which may indicate some embarrassment at his own less than scrupulous handling of the data. The emperor of Chicago is declared to be without clothes.

However, this is not the first time that the assertions of the monetarists have taken such a blow. There have been many previous examples. For example, Ericson and Hendry themselves refer to the similar conclusions reached by Megnad Desai of

the London School of Economics in a book published in 1981³. More interesting is the provenance of the present attacks on monetarism and the publicity they have received.

The Bank of England's Panel of Consultants is fully independent and is certainly not an arm of the Bank itself. Nevertheless, there is clearly considerable opposition to monetarist dogma within the Bank, expressed for example in critical studies in the *Bank's Bulletin*. This is partly because it is the Bank of England which is supposed to operate the various targets for money supply devised, under Friedman's influence, at the Treasury. The experience of running the financial system has taught the Bank that the simple monetarist parables linking the money supply to inflation have nothing to do with the actual working of complex financial markets. A real commitment to monetarist doctrine would deprive the Bank of any discretion in its attempt to control the markets for capital and foreign exchange. In particular, the Bank has in recent weeks firmly repulsed Mr Lawson's rather cranky interest in supplementing monetary policy by new controls on the amount of cash — notes and coin — in the system. Similar strains have appeared in the United States where the monetary authorities have resisted the simple Friedmanite formulas which would take away their freedom of manoeuvre.

In fact, much of the present discussion concerns symbols rather than practice because monetary targets *a la Friedman* have not played much role at the Bank of England for some time. The actual figures for money supply have been running well above target for months, but interest rates and the exchange rate for sterling have once again become the main preoccupations of monetary management.

The new readiness to criticise and challenge the Government's direction of economic policy is clearly of some political significance. But criticism of monetarism as an academic theory is a long way from producing agreement on alternatives to monetarism as a practical strategy. Real monetarist policies never had the 'quantity of money' at the centre; the essence of practical monetarism is the acceptance of unemployment as an instrument of economic control. The academic critiques

¹Monetary trends in the United Kingdom Bank of England Panel of Academic Consultants, panel paper no 22, 1983.

²M Friedman, A Schwartz *Monetary trends in the United States and the United Kingdom*. 1982.

³M Desai *Testing Monetarism* 1981.

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of Friedman are important, but they are only a small part of the vital intellectual battle for effective full employment policies.

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