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Money out of control

By Richard Henderson

It has been a worrying time for all those who accept the general proposition that money matters – and, as a recent conference of the Royal Economic Society made plain, that includes far more than "monetarists". A number of important issues in monetary economics seem to have moved out of the field of immediate discussion, and the academic debate seems to be moving on towards a number of secondary, and often empirical, propositions. There is room for debate between the neo-Austrians, neo-Keynesians, and all the other "neos" on whether the money stock (or changes in the money stock, or unanticipated changes) affect mainly prices or the level of economic activity, in given circumstances, or over a given timescale. There is certainly room for further theoretical development of *Rational Expectations* theory, and of questions of how money is to be recognised and measured. The most important point is that the general proposition has been accepted, and the days when major changes in monetary policy could go totally unremarked or unnoticed, even by the financial press, are over, for the moment at least.

Strangely, this fact has not appeared to contribute to the solution of monetary problems in the U.K. After a period of (externally imposed) respectability after 1976, monetary growth accelerated in 1978 and through 1979, and has continued at a high level in 1980. A change of government to one for whom monetary control was a major policy plank has helped not at all. We now have the authority of the Chancellor of the Exchequer for the fact that the discovery (which was in itself a discovery only to those previously determined not to see) that money was growing up to 10% faster than the officially sanctioned rate will not be allowed to influence policy. This raises several practical and constitutional problems and questions.

Learning

First, why did a government, whose commitment to monetary discipline seemed to be of considerable importance in prestige terms alone, allow such a state of affairs to come about? The answer I believe to be that however fast government has learned since the bad old days of Heath and Barber, the process has gone further and faster elsewhere. Individuals and corporations who were appalled in the mid-70s by a Minimum Lending Rate of 13% and then 15% have now come to terms with the facts. With inflation in the high teens or the twenties, and interest rates of the same order, borrowing often still makes sense. Indeed to any corporation paying tax (and therefore getting relief on interest) and to owner-occupiers it can be a positive bargain. The higher the inflation and interest rates, the better the bargain, and the higher the subsidy paid by lenders via the tax system. Borrowers get tax relief, and lenders are taxed on what is called interest, but in economic terms is really repayment of capital. The result of this growing realisation, born of experience, is that the level of interest rates needed to choke off monetary growth in given circumstances has grown and is probably still growing. Alas, a government which was prepared to put up with a Minimum Lending Rate of 14%, or at a push 17%, refused to accept that even 17% might not be enough, or at least refused to accept the consequences, especially for heavily subsidised owner-occupiers.

Second, why did such a fundamental U-turn as the decision early in 1980 to go to any lengths to keep interest rates down (notably by injecting huge amounts of liquidity into the banking system) go unpunished by the financial markets? One of the most important benefits which many of us had expected to see from the growing acceptance of the central role of money was that any deviation from the straight and true path on the part of the authorities would have such an immediate and severe effect on the pound, and government securities, that the prestige of government, and the cost of its borrowing, would move so much as to make deviation unattractive. Financial markets have it in their power to make irresponsibility unprofitable, but that power has not been used this time. Sterling stands at the level of 5 years ago, despite all our intervening inflation, and that which is still to come, and both government securities and industrial share markets have registered remarkable optimism.

Corset

Here a large part of the answer lies in deliberate deceit. A device known to its friends (of which it has none) as the *Corset*, or more formally as the Supplementary Special Deposits Scheme, was invented under Barber in 1973, and has been used off and on ever since, to hide a large part of the monetary growth which was going on. The details are complex and unsavoury, but the essence of it was to compel the banks, on pain of losing a large part of their deposits, to move a large part of their business out of those areas formally classified as money into other channels. The fact that the details are complex is important, for although most of us whose job is to follow monetary developments knew well enough what was happening, a government which preached monetary control was able to produce statistics which backed up its claims.

There can be no denying the importance of the almost desperate wish of many in the City, and indeed abroad, to believe in the Conservative Party. Those who backed the Heath government to the end, whatever they may say about it now, are as determined to back his successor until her failure is proven, or beyond.

Also, importantly, there are the two barely more objective factors of oil and relative international interest rates. Anything related to them has attracted the mindless attention of fashion, and sterling has not escaped. No matter that the pound is not in any sense oil-backed as it was once gold-backed. Indeed successive Chancellors have shown that the discovery of oil under the North Sea has merely allowed the U.K. a greater degree of financial improvidence than would otherwise have been permitted. Further, the fact of U.K. interest rates, "high" by world standards, have made the pound attractive to foreigners, provided only that the currency remains stable on the international exchanges. Of course, as long as that attraction persists it may in itself generate a temporary stability rather like pyramid selling.

The answers to these questions suggest two very important general propositions. At least in this country, we cannot rely on politicians or central bankers to maintain the integrity of the currency. Nor can we expect the financial markets automatically to impose that discipline from outside. What then can be done?

The most common idea is the imposition of a "monetary rule". The suggestion, familiar from much work emerging from Chicago and its intellectual environs, is that the monetary authorities should not be allowed any discretion in the setting or meeting of monetary targets. There should be, enshrined in statute, or indeed in the constitution, a rule which the central bank would merely have to obey.

Objections

There are two fundamental objections of very different kinds to this plan. The first, of course, is the difficulty of persuading the executive to part with a prerogative which experience has shown to be very important to it. Even if this problem could be overcome, presumably in some time of national emergency or in the early days of a particularly optimistic administration, there remains a greater. How could the inviolable monetary target be made to react to changing circumstances? The question of what is and what is not money is essentially empirical, and varies both in time and from country to country as banking and other practices vary. Money is money only because it behaves like money. Leaving aside the natural evolution of the financial system, would the central bank not be both tempted and able to change banking rules to distort the figures, just as it did almost seven years ago with the *Corset*?

For these main reasons, I am persuaded that a monetary rule would be unreliable, and therefore worse than useless. At least in its absence, the failure of government may be quantifiable, in "excess" money, but when the statistics are distorted information is lost. How then can we escape the apparently perfect trap of untrustworthy monetary authorities on whom reliability is unenforceable? To an extent, the end of exchange controls last year provides an answer, for we U.K. residents can now hold our assets in virtually any currency or commodity of our choice. Yet, as long as the tax system, for example, is sterling-based, it is not possible to escape the influence of this ever-shifting bench-mark, the pound sterling, Hayekian competing currencies provide only a partial answer in a country in which taxes are raised.

Shock

I must confess to a deep-seated pessimism in the matter. Virtually every sovereign nation has discovered the value of a currency of its own. The longer-established have centuries of experience of the profitability of the systematic debasement of that currency, and all have access to any number of theoretical and historical accounts of how to achieve that debasement. I am drawn, with the greatest reluctance, to the conclusion that inflation is a more or less inevitable product of government expenditure, and that only the slow learning process of both governments themselves and financial markets, and hence the passage of time, provide real hope. The hopes of only a few months ago have been disproved most cruelly. So long as the sentiments expressed are of the right kind ("no U-turns", "sticking to guidelines", "money supply is probably under control"), and provided that they are expressed by the right people, so long will the facts, apparently, be strictly secondary. The shock, when it comes, will be all the greater, and the lesson, one may therefore hope, the longer-lasting. The important thing is now to devote all possible energy to explaining as loudly and often as possible what is going on, and why.

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