Dow and Saville's Critique of Monetary Policy - A Review Essay

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DOW AND SAVILLE’S CRITIQUE OF MONETARY POLICY – A REVIEW ESSAY

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INTRODUCTION

In Britain (as elsewhere) academic fashions often come and go with political fads, and the recent demise there of money growth targeting as the centrepiece of monetary policy has created something of an intellectual vacuum in British monetary economics. A Critique of Monetary Policy, written by Christopher Dow, whose distinguished career has included more than a decade in senior advisory positions at the Bank of England, and Iain Saville, also an official of that institution, is an attempt to fill that vacuum. The book is firmly rooted in the tradition of post-war British Keynesian economics, whose most distinguished products were perhaps the Radcliffe Report (Committee on the Working of the Monetary System (1959)) and Dow's own (1964) Management of the British Economy. The hallmarks of that tradition are a careful empiricism which pays attention to the significance of local institutional idiosyncrasies, and a skillful blending of theoretical and historical analysis geared to the generation of policy relevant conclusions. These qualities are very much on display in this book, which is also, and mercifully, free of the shrill polemics which have marred so many recent British contributions to monetary debates.¹

Dow and Saville (hereafter D and S) divide their book into three main parts. After a brief "Introduction", Part I, "The Behaviour of the Financial System" lays out their theoretical framework in six chapters. These discuss, in turn, the place of the banking system in the macroeconomy, the role of interest rates (two chapters) and exchange rates, and the interaction of monetary and fiscal policy. Part II, "Monetary Control and the Course of the Aggregates" deploys this theoretical framework in five chapters dealing with the conduct of, and debates about, British monetary policy since 1971. Part III, "Conclusions" consists of two chapters whose titles are self explanatory: "The Limitations and Role of Monetary Policy", and "Monetary Policy without Targets". The style of their analysis, and its intellectual foundations, will seem rather alien to anyone brought up on any of the competing "mainstreams" (so-called) of North American macroeconomics.² That is all the more reason
for readers of this journal brought up in such traditions to pay attention to D and S. Their book is thoughtful, closely argued, and readable; and it will serve as a useful antidote to the stultifying parochialism of so much American macroeconomics. It directs us to some important unsettled questions, even if it does not always answer them in a way that I find palatable.

In what follows, I shall set out D and S’s arguments first, before offering my own criticisms of them. However, because they sometimes take for granted rather more knowledge of British Keynesian economics than many readers of this journal will possess, I shall pay attention to placing their analysis, particularly their theoretical framework, in the context of this broader intellectual background.

**DOW AND SAVILLE’S THEORETICAL FRAMEWORK AND ITS BRITISH KEYNESIAN CONTEXT**

It is a defining characteristic of post-war British Keynesianism that it treats inflation as mainly a "cost-push" phenomenon having both domestic and foreign sources. Although D and S pay attention to the possibility that demand side influences might also impinge upon the time path of prices, they treat such effects as weak and usually secondary; and, as I shall argue later, a cost push interpretation of inflation is basic to their vision of how the macroeconomy functions. They themselves devote very little space to developing or defending their view of inflation, and the three references to the topic listed in their index all occur in their "Conclusions"; although there are one or two brief mentions of the topic earlier (e.g pp.144–145). However, as we shall see below, what little they have to say on the topic does justify attributing a cost-push view of inflation to them, and such a view gives their theoretical exposition a logical coherence that it otherwise would lack. If the inflation rate is an almost exogenous datum, it makes logical sense to treat nominal aggregate demand as mainly determining real output and associated variables, particularly their short run fluctuations; and
D and S follow British Keynesian practice in doing just that.

They deal with these issues in their third chapter, arguing that demand disturbances usually originate in the private sector of the economy, typically, though not solely, taking the form of essentially autonomous shifts in investment and/or saving. Investment and saving are said to be rather insensitive to interest rates, which are in any event mainly determined by other factors (to be discussed in due course). Thus, it is a central feature of D and S's theoretical framework that ex ante discrepancies between investment and saving are equilibrated mainly by variations in income, and only secondarily by interest rate adjustments, so that the real economy has no strong built in tendency to operate at full employment. In this respect, that framework has, as they themselves note in more than one place, a strong claim to be regarded as reflecting an authentic development of the central ideas of John Maynard Keynes's (1936) *General Theory* . . . (cf. pp. 43–50).

I shall explain later that I do not agree with this Keynesian view of how the macroeconomy functions. Suffice it now to stress that it leads D and S to take a very different position about which monetary variables matter, and what they matter for, than does any version of macroeconomics based upon the Hicks–Hansen IS–LM framework, or indeed any more modern version which starts from the premise that markets are cleared by flexible prices. Most monetary economists, particularly North American monetary economists, would put the explanation of the price level at the top of, or at least high on, the list of problems with which their theory should deal. If inflation is largely a cost-push phenomenon, though, the monetary component of macroeconomic analysis, which deals with the economy's demand side, has rather little to do with explaining it. Only to the extent that aggregate demand might impinge upon a time path of prices mainly determined elsewhere, is there any connection to be made here. In the British Keynesian tradition, then, monetary policy, if it matters at all, matters mainly for real income and employment, not prices.
It has already been noted that D and S's theoretical framework reflects this Keynesian view of where demand fluctuations have their main impact, but it is eclectic enough about the sources of demand side shocks that a role for disturbances originating in the banking system is not ruled out. Such a role is not stressed, though. In this, the framework also reflects the influence of British Keynesianism, which has never given pride of place to monetary factors as influences on aggregate demand. Even less has it treated the activities of the monetary authorities as a source of difficulty. On the contrary, the latter, in conjunction with those in charge of the more important fiscal tools, are thought of as playing a predominantly stabilising role, helping to iron out fluctuations that either stem from changes in the saving and investment decisions of firms and households, or from the activities of the private sector agents, for example commercial banks, in asset markets. Moreover, since savings—investment interaction is crucial, the key monetary variables are those which determine the cost and availability of firms' borrowing: interest rates and credit aggregates, that is to say, rather than the quantity of money per se, however defined.4

For British Keynesians, then, including D and S, monetary theory is not the theory of the price level, nor is it the theory of the causes of fluctuations in real income and employment. It is something less specific, and less grand too: namely, the theory of the financial system and how it interacts with the rest of the economy. There is room for causation to run in both directions here, but the predominant influence runs from the economy at large to the financial sector, rather than vice versa. It follows that the authorities' scope for actively influencing the macroeconomy is limited indeed, and the main role for monetary policy is to affect the nature of the financial system's reaction to real disturbances.5 Most American economists (Moore (1987) is an important counter-example) follow Keynes' (1936) lead in treating, as a first approximation, the quantity of nominal money as an exogenous variable, but D and S follow long-standing British Keynesian practice in rejecting such an approximation. The analysis which they premise on this rejection is both logically coherent
and widely accepted in Britain. Indeed, as I hinted earlier, this way of looking at things is undergoing something of a resurgence there, and one good reason for paying attention to D and S is that they provide the best account of which I am aware of its current state of development.

I have already remarked that D and S take the view that the banking system derives its importance from its lending activities. They portray banks as playing a key role in the co-ordination of saving and investment in the economy as a whole. Though banks often expand and contract credit in response to variations in the demands of their customers, they are far from being agents who merely lend what is asked of them, creating deposit liabilities in the process. On the contrary, D and S attribute to them the market power to administer, within limits, the interest rates at which they lend, and to ration among their customers the amount of credit which they grant. If bank credit tends to expand secularly in response to the growth of nominal income, that is because it is in the self-interest of the banks to permit it to do so, and not because they have no other logically possible choice. Some strands in recent British Keynesian thinking are vulnerable to the charge that, having established the endogeneity of monetary and credit aggregates, they then go on to treat endogeneity as synonymous with passivity. D and S cannot be convicted of this particular reincarnation of the Real-bills Fallacy.6

Credit rationing is an important phenomenon according to D and S. It arises, in their view, because banks are simultaneously risk averse but unable properly to assess the riskiness of individual loans and hence to price them appropriately.7 They stress that, as nominal incomes grow, banks' perceptions of how much it is prudent to lend to individual customers also grow, leading to an expansion of credit and monetary aggregates in response to that of nominal income. However, they also entertain the possibility that banks' perceptions of risk, as well as their willingness to bear it, can themselves change. There is always a significant fringe of unsatisfied would-be borrowers, but the banks have the power to decide where the
line defining that fringe is drawn. If and when that line moves, the banking system becomes a source of disturbance to aggregate demand. Hence, although for D and S observed correlations among the long run time paths of various credit and monetary aggregates and nominal income predominantly reflect causation running from income to the aggregates, there is a secondary channel of causation running in the opposite direction. Their position on this matter is, in effect, directly converse to the monetarist view of Friedman and Anna J. Schwartz (eg. 1982) who explain the same correlations as arising mainly from the influence of money on nominal income, while acknowledging the existence of less important impulses moving in the opposite direction.

D and S note that, if the banking system initiates an increase in its lending to the private sector, the process of credit expansion thus set in motion will simultaneously lead to the creation of bank liabilities. They also argue that, though private sector borrowers may willingly accept the credit they are offered, there is no reason to suppose that they will always simultaneously be willing to hold the counterpart liabilities. Private sector agents do not usually borrow from the banking system simply to increase their holdings of deposits (though D and S tell us that they might sometimes if the latter bear interest at particularly attractive rates). As D and S point out, a similar argument underlies Tobin's well known denial (eg 1963 reprinted 1971) that the banking system possesses a "widow's cruse" for the production of money, because portfolio choices made by the non—bank public constrain the banking system's ability to create deposits. They also note, though, that this argument applies with more force to the ultimate equilibrium of the financial system, after it has fully adjusted to the change in bank lending behaviour, than to the adjustment process itself, during which the public might be willing temporarily to hold deposits in excess of its usual requirements. D & S's recognition of this "buffer stock" effect in the demand for bank deposits represents a new element in British Keynesian thought and creates a bridge which, I hasten to add, they do not venture as far across as I would wish, (cf. pp. 33—34) between their view of the monetary system and that which underlies a good deal of recent monetarist thinking.
Now the banking system can influence the price as well as the availability of credit. In discussing interest rate behaviour, D and S begin with Keynesian orthodoxy, but once more usefully extend it. Keynes (1936), they recall, likened the behaviour of agents in asset markets to that of participants in a newspaper beauty contest, in which the winner must correctly predict the order in which those participants on average place the contestants. As they also recall, this leads to a "bootstrap" theory of the rate of interest, which takes whatever value it does for no better reason than that agents expect it to do so. D and S certainly regard expectations as important determinants of interest rates, but according to them, among the factors affecting those expectations are certain long run fundamentals. They are somewhat vague about what these are, and I shall have more to say about this below. For the moment, though, it will suffice to note that their recognition of the influence of long-run fundamentals transforms the interest rate from a purely to merely a highly psychological phenomenon, and hence renders D and S's analysis defensible against a wide range of simple attacks to which Keynesian interest theory, and the modern efficient markets approach with which it has so much in common, are vulnerable.  

Nevertheless, short run expectational effects are dominant in D and S's view. The fundamentals put bounds on the range within which rates can fluctuate, but these are wide and ill defined, and between them competitive mechanisms leave interest rates essentially indeterminate. From this indeterminacy derive both the banking system's capacity to administer rates, and the monetary authorities' power to influence the levels at which they do so by manipulating the central bank's discount rate. When expectations are diffuse and weakly held, one small market participant (and, D and S argue, that is how the central bank should nowadays be regarded) can exert an influence disproportionate to the scale of its operations, always provided that it has definite views and is prepared to act decisively on them. But interest rates determined in this way cannot automatically equilibrate savings and investment, and so, as I have already noted, that task is mainly left to income fluctuations.
Now D and S's theoretical framework is designed to elucidate the behaviour of the British economy over the last two decades, and to provide a basis for policy recommendations for the future of that economy. The British economy is open, and fiscal policy has traditionally been both important and much debated there. Therefore they address two other matters: namely, the determination of the exchange rate and the interaction of monetary and fiscal policy. Their treatment of the exchange rate closely parallels that of the interest rate. For them the foreign exchange market is an asset market where fundamentals provide only a lightweight anchor for otherwise diffuse and weakly held expectations, which can therefore be influenced by interest rate policy. As we shall see, this analysis is central to the view of the proper conduct of monetary policy which D and S expound towards the end of their book.

The effect of public sector borrowing on the behaviour of monetary and credit aggregates has attracted much attention in Britain in the last fifteen years or so, and, as D and S note, British policy debates generated a set of fallacious beliefs not prevalent elsewhere. In particular, the fact that flow of funds identities give a prominent place to public sector borrowing as a component of money growth led some participants in those debates to postulate a simple cause and effect relationship here, and hence to treat fiscal policy as the principle instrument of monetary control. However desirable public sector spending restraint might have been for other reasons, and however politically useful this fallacy might have been in mobilising popular acceptance of such restraint, it was a fallacy nevertheless. D and S effectively demolish it; and having concluded that "Discussion of the options is obstructed by treating fiscal policy as a matter to be decided merely as a corollary of monetary policy" (p. 114) they quite appropriately consign fiscal policy to the background of their subsequent analysis.
DOW AND SAVILLE'S VIEW OF THE HISTORICAL RECORD AND ITS LESSONS

Part II of D and S's book applies their theoretical framework to analysing British monetary policy since 1971, and Part III sets out the lessons they derive from that analysis. 1971 saw a major reform of the British banking system, known as Competition and Credit Control, whose main intention was, as the name implies, to render the British financial sector competitive, and hence the allocation of credit efficient, by demolishing the many controls which impinged differentially upon various institutions. Cash reserve requirements against the deposit liabilities of the commercial banks, which had been fixed by long-standing convention, though never by law, were done away with, and it became much easier for these institutions to emit interest bearing deposits in competition with near banks. The only important exception to allowing credit markets to work without interference from government concerned the mortgage market, where interest rates were to be prevented from rising unduly, should the (implicitly political) need arise. According to D and S, these reforms led to a shift in the willingness of the banking system to grant loans to the private sector, and they attribute a causative role in the 1972–73 boom, though not a unique one, to the rapid expansion of the monetary and credit aggregates which this brought about. They do not conclude, however, on the basis of this episode, that subsequent attempts to stabilise the economy using target growth rates for these aggregates were well conceived.

On the contrary, and as one would expect from their general theoretical position, D and S argue that such policies, first initiated in 1976 just before the visit of an IMF mission, were largely unworkable, and that, to the limited extent that they were workable, using the mixture of interest rate control and other ad hoc measures which the authorities did in fact deploy, they were ineffective. They also argue that it would have been equally unworkable using the base control methods advocated by the monetarist supporters of growth rate targets. It will be helpful to discuss these two claims separately, because it is quite possible to accept the first of them while disputing the second. It is, however, important to bear in mind that, in setting targets, the British authorities gave pride of place to the control of a very broad aggregate, M3
(or sterling M3), which encompassed essentially all the deposit liabilities, including large wholesale deposits, of the banking system. The liabilities of building societies (the British equivalents of savings and loan associations) do not figure in this aggregate — they are included in what is usually termed "very broad money" — but it nevertheless includes many assets which would much better be termed short-term stores of value than actual (or very close substitutes for) means of exchange. Moreover, and crucially, after *Competition and Credit Control* the interest rates paid on these less liquid components of M3 became more competitive and more flexible.

In D and S's view, the equilibrium volumes of bank credit and of its counterpart liabilities are determined by the demands of the non-bank public. The principal tool of monetary policy is the Bank of England's "Minimum Lending" (ie. discount) rate, at which the Bank has traditionally been willing to make reserves available on demand to the banking system. If the demand for M3 is insensitive to variations in the level of market interest rates, because the marginal return to be had from holding it varies with rates in general, then the authorities cannot affect that demand by influencing interest rates. This argument, which, suitably adapted to a different institutional environment, has also turned up in North American debates, is surely logically correct given its premises. Moreover, there is considerable empirical evidence that the elasticity of the demand for broad money with respect to the level of interest rates has diminished, almost to vanishing point, over the period of D and S's study. Thus, one must agree with them that, as a matter of fact, a target value for broad money cannot, in the British system, be attained by manipulating the interest rate, though a narrow, essentially non-interest bearing, aggregate might be so controlled. The British authorities showed some awareness of this problem, and did not rely on interest rate control alone as a basis for policy. In the 1970s they supplemented it with the so-called "corset", and when this strange garment was removed for the last time in 1980, with control of the public sector borrowing requirement and "overfunding".\(^{12}\)
The "corset" was intended, as its name implies, to squeeze broad money growth within an acceptable range by imposing increasingly onerous marginal reserve requirements against M3 liabilities if they moved out of that range. Its main effect was, D and S convincingly argue, to cause disintermediation, and hence to give monetary policy the appearance of tightness, while making a negligible difference either to the non–bank public's ability to obtain credit, or to the overall liquidity of their portfolios. After its final removal in 1980, attempts to control broad money growth by controlling public sector borrowing were instituted, misguidedly as Dow and Saville once more convincingly argue. (See above p. 10.) These were supplemented by "overfunding" on the part of the Bank of England, which involved the sale of more public debt than was needed to cover current borrowing requirements. This policy eventually led to the Bank holding a "mountain" of commercial bills, whose acquisition had been financed by the sale of treasury bills to the non–bank public; it was, in its effect on the balance sheets of the rest of the banking system, simply another form of largely cosmetic disintermediation, and was abandoned in the mid–1980s when money growth targeting was given up.

The case that D and S make about the ineptitude with which money growth targets were pursued in Britain over the 1976–86 period is hard to argue with. Indeed, their association with the Bank of England lends a special authority to their treatment of these matters. This reviewer is one of those who has long advocated base control as a viable alternative means of implementing such a policy, but D and S regard this alternative too as unworkable, particularly for broad money, thus echoing the position taken by the Bank of England when this issue was seriously debated in the early 1980s.13

D and S's basic objection to base control is that it would force the Bank of England to give up its practice of making reserves available to the banks essentially on demand. Hence the banks would no longer be able to respond freely to their customers' demands for credit. The effects of this in an inflationary environment would be ". . . as if an irresistible force —
continued excess growth of bank lending — met an immovable object — the prescribed path of base money; and something would have to give." The something would be interest rates which ". . . might . . . inevitably be driven to unprecedented levels." (p. 145) Because the levels in question would be unprecedented, Dow and Saville can only surmise what further consequences might follow, but recession and/or disintermediation and confusion in financial markets are among those they speculate about. They make a similar case, albeit less strongly, against the use of base control to regulate the growth of narrow money, specifically M1.14 Here too they envisage the system running into severe difficulties in the face of " . . . a persistent tendency for the narrow money aggregates to grow more rapidly than the authorities wanted" (p.150), a tendency that would be induced by rising money incomes.

D and S's arguments against base control depend, as they themselves point out, upon a judgement that it is more realistic to postulate ". . . that the iterative nature of the wage/price spiral is deeply entrenched, and that inflation is at best only to be slowed gradually . . ." than that " . . . the adoption of base control itself quickly [would moderate] the pace of inflation . . ." (p. 145). This view of inflationary pressures as existing largely independently of the conduct of monetary policy is, as I have noted earlier, quite central to the British Keynesian tradition, and I shall discuss it again later. At this juncture, however, it is worth making the following point. The Thatcher government, elected in 1979, believed that inflation was largely a monetary phenomenon, and wished to control it with growth targets for broad money. The only feasible way of implementing such targets was through base control. This technique was rejected by the Bank of England as unworkable on the basis of what it regarded as good economic arguments, deeply rooted in the abovementioned Keynesian tradition. To anyone believing base control to be feasible, however, it was the Bank's stance on this question, rather than anything inherent in the mechanisms of the British economy that actually made the Government's policy unworkable. Though this disagreement between politicians and the central bank was surely an honest one, it is not surprising that there were complaints at the
time of Thatcher's policies being "sabotaged" by the bureaucracy. It is surprising, however, that the complaints in question often seemed to come from quarters where the idea of defending central bank independence against political pressures is usually a popular one.

D and S's recommendations for the future conduct of policy are set out in the last two chapters of their book, and come as no surprise. Money growth targeting is theoretically unsound and empirically discredited. This should be recognised and interest rates should again become the key policy variables. The limited influence of monetary variables on aggregate demand, however, means that the aims of monetary policy should be modest on the domestic front. The right target for monetary policy is the exchange rate. If expectations about the intentions of the monetary authorities can be influenced and have a significant impact in domestic asset markets they can, indeed will, have a similar effect in the foreign exchange market. According to D and S exchange rate fluctuations have had an important destabilising influence on the British economy, notably but not uniquely, the depreciation of sterling that began in late 1972 and culminated in the crisis of 1976, and its appreciation in 1979–80. Therefore they recommend a monetary policy geared to stabilising the time path (not the level, because of international differences in long run inflation rates) of sterling's exchange rate against some currency basket. Such a policy would, in their view, deal with one potentially important external source of economic instability, while simultaneously being compatible with the pursuit of what they regard as the traditional domestic goals of monetary policy. 15

These domestic goals amount to interfering as little as possible with the conduct of fiscal stabilisation policy, and, within the range of indeterminacy made available by the weak influence of fundamental factors, to keep interest rates as low as possible in order to minimise the burden of servicing the public debt. All this is, as D and S point out, very much in the tradition of the Radcliffe Report; and so is their recipe for dealing with an inflationary emergency. They note that
"... we are unable to propose an adequate answer to the problem of inflation. All the above proposals are fair-weather proposals, on the assumption that inflation is not an overriding problem. But there is always a possibility that it may become one." (p. 247) D and S's response here does not follow the Keynesian orthodoxy of the 1970s. They do not conjure up the possibility of an "effective" programme of wage and price controls to deal with inflation — indeed they express strong skepticism about the existence of such a package. Instead, like the Radcliffe Committee, in an inflationary emergency they would turn to monetary policy, in the form of high interest rates and perhaps direct controls on bank lending too. As the final sentences of this book put it

"The preservation of orderly financial conditions ... may have to be suspended. ... and it would be a deception to believe that there is always an orderly smooth—working solution to hand. If there is not, then disruption of the economy ... may be inevitable, and a price that has to be paid to avoid. ... rapidly acceleration inflation and the disruption that that would entail." (p. 248)

CRITIQUE — THE CAUSES OF INFLATION

As I have hinted on several occasions in the course of describing the contents of this stimulating book, the view of inflation which runs through it is controversial. According to D and S

"... the pace of inflation is determined mainly by factors such as the pressure of demand and independent pressure from wages or import prices ... [A]lthough the growth of the monetary aggregates may, on occasion, be one factor causing over fast expansion of demand, the relationship is not strong or systematic." (p. 240)

If this view of inflation is true, all of their conclusions follow. If it is false, and what may conveniently be termed the "monetarist" view of inflation is true instead, their whole analysis collapses. To see that this is so, accept, for the sake of argument, what I shall refer to
as the "monetarist premise" that the long run time path of prices is fixed by the independently determined rate of growth of nominal money relative to the (also independently determined) growth rate of real income, and that all of the other intrusive factors to which the Keynesian tradition pays attention lead to only short run disturbances around this time path; and then reconsider the arguments of D and S which I have described earlier.

According to their analysis of asset markets, fundamental factors put bounds on fluctuations in interest rates and exchange rates, bounds within which the monetary authorities are able to influence these variables. What, though, if inflation expectations are prominent among the fundamental factors conditioning the behaviour of, as we should now be careful to specify, nominal interest rates, and nominal exchange rates? And what if inflation is largely a monetary phenomenon? Then monetary policy would not be able to manipulate asset prices within exogenously given boundaries. Instead its current conduct would influence the expectations that hold in place the boundaries in question. D and S's theory of asset markets thus becomes incoherent if inflation is not essentially exogenous to monetary policy. Consider also their Tobinesque insistence that it is ultimately the portfolio choices of the non-bank sector which determine the quantity of money, and not those of the banking system. If the monetarist premise about the influence of nominal money on prices is granted, then so are the following propositions: that it is real money whose equilibrium quantity is chosen by the non-bank sector; that the quantity of nominal money is the outcome of the banks' portfolio choices; and that it is the price level which moves to reconcile these two quantities. The banks do have a "widow's cruse" in a monetarist world, it creates nominal, but not real, money, and its misuse causes inflation.

Of course, even given a monetarist view of inflation, credit rationing can still occur and changes in the lending habits of banks, such as D and S discuss, are still possible; and of course such changes could influence demand directly through credit market effects in much the way D and S suggest. However, the deposits created as a by-product of bank lending, and
initially held in temporary "buffer stocks", would exert their own independent influence on demand when non-bank agents eventually tried to get rid of them; and would continue to do so, not until the banks had been forced to adjust the nominal size of their balance sheets, as would have to happen if the price level was given, but until the price level had moved enough to reconcile the non-bank public's portfolio choices with those of the banks. Such effects, which D and S present as factors modifying the transmission mechanism of the effects of bank lending, become, given the monetarist premise, crucial in determining the ultimate behaviour of prices. 16 That same monetarist premise reduces the significance of bank lending to a short-run role in influencing the transmission mechanism linking the quantity of money and the price level.

We may illustrate the practical impact of accepting the monetarist premise by referring to D & S's discussion of Britain's 1971–75 experience. For them the onset of inflation from 1973 onwards was largely caused by exogenous factors, including a depreciating exchange rate, but was aggravated by an expansion of bank lending set in motion by *Competition and Credit Control*. A monetarist would have it that the increase in the quantity of money associated with that expansion was critical, and had, as one of its principal effects, the exchange depreciation that accompanied the onset of inflation. 17 D and S's conclusions about the feasibility of money-growth targeting are also undermined by the monetarist view of inflation. To begin with, that view has it that money is important in its own right as a means of exchange, and not simply as a bookkeeping counterpart of bank credit, so that ideally, a narrower (than M3) aggregate would be the centrepiece of policy, and such an aggregate would be easier to manipulate by interest rate control. Much more important, no matter what aggregate was the object of the authorities' attention, if the quantity of money is indeed the main influence on the rate of inflation, traditional base control methods are in fact quite viable, as D and S themselves explicitly concede. (See above p. 15)
The appeal of D and S's proposals for the future conduct of policy also depends critically on rejecting a monetarist view of inflation, according to which attempts to keep nominal interest rates low are fraught with well known Wicksellian dangers. To keep the interest rate lower than the market would like requires the central bank continuously to provide reserves to the banking system. Such a policy would be inflationary and also self-defeating, with expectational effects driving nominal rates upwards.\textsuperscript{18} The alternative strategy of leaving interest rates to the market, and controlling the monetary base with a view to stabilising prices, however, has implications for policy towards the exchange rate, which would have to be allowed to move to accommodate (among other things) differentials in home and foreign inflation rates. D and S also envisage this possibility, but there is nevertheless a crucial difference if the monetarist premise is true: namely, that inflation differentials would arise from monetary policy choices, rather than from unexplained structural differences among economies' wage-price formation mechanisms to which monetary policy simply adapts itself.

It is tempting at this point for a monetarist reviewer to attempt to persuade readers that D and S are simply wrong about inflation, and that their work may therefore safely be ignored. It is more constructive, however, to set the more modest goal of explaining why it is that reasonable people can disagree about this fundamental issue. D and S's Keynesianism is quite free of the absurd claims made by the Radcliffe Committee that the velocity of circulation is a mere statistic defined by the ratio of two independently determined variables and hence infinitely malleable.\textsuperscript{19} They accept that there exists in British data (as elsewhere) a well determined long run correlation between money income and money growth, and that much secular variation in velocity can be explained by interest rate behaviour (though less so since \textit{Competition and Credit Control}), and that this correlation reflects a structural economic relationship.\textsuperscript{20} The trouble is, though, that the highly time aggregated data in which this relationship is most apparent are essentially useless for dealing with questions of causation. The secular correlation which we all agree exists between money and money income is
consistent with the monetarist premise, but it is equally consistent with D and S's reverse causation postulate.

In order to sustain directly propositions about causation in the long run between money and prices, we need a well articulated and tested story about the mechanisms which link the variables in the much more complicated short run. In that short run it is uncontroversial that a host of non–monetary factors are also capable of influencing the price level, even though a monetarist would qualify this admission with the claim that their effects are transitory. Time aggregated data eliminate their effects, but when they are allowed to intrude, as they must in short–run analysis, they make the task of formulating and testing econometric hypotheses extremely complex. The data on the timing of cyclical turning points in various U. S. time series, which Friedman first drew to our attention in (1958, reprinted 1969), are extremely suggestive, but the simple fact remains that a further thirty years of monetarist analysis has not been able to demonstrate the empirical existence of a structurally stable transmission mechanism between money and inflation to the satisfaction of its own practitioners, let alone its critics. Indeed, the most lasting contribution of the new–classical analysis which grew out of monetarism will almost surely turn out to be the Lucas critique (see Lucas 1976) one of whose implication is that the stability of such a mechanism is unlikely to persist over a wide enough range of experience to enable it to be estimated.

Monetarists in search of support for the case that money is more a causing than a caused variable often turn to the analysis of extreme experiences. They argue, for example, that it is unlikely that recent changes in the behaviour of money and the price level in countries such as Israel or Bolivia arose because of changes in autonomous factors determining the nature of the wage–price spiral; they point to particularly violent episodes such as the onset of the Great Depression in the United States, or the 1982–85 recession in Canada (the worst in OECD) and show that collapses in money growth preceded those of money income; and so on. They then argue that the factors which we can see clearly at work in these extreme
cases are probably present at other times and places too. Such arguments are unlikely to convince those who, like D and S, stress the importance of particular local institutions in conditioning the interaction of money and prices, who are willing to concede an influence to monetary policy if only it is applied hard enough, but who are inclined to deny that smooth continuity to economic relationships upon which the monetarist attempt to generalise from particular extreme cases depends.

A FINAL CAVEAT

In short, it is possible to disagree about the direction of causation between money and money income because the empirical evidence is inconclusive, and that is why we should treat D and S's Critique of Monetary Policy seriously. But we must be careful here. The monetarist case is incomplete, not necessarily wrong; and there are arguments to be made against the Keynesian position too. The validity and relevance of D and S's analysis of monetary policy depends entirely on their view of inflation as mainly a non-monetary phenomenon being correct, but their book defends that view only briefly. It does not tell us which of the many factors that might influence inflation are of particular importance, nor does it say much about the transmission mechanisms through which they work. There may be nothing in the monetarist literature that absolutely requires D and S to set aside their Keynesian views, but it is just as true that they have presented no arguments that require an open minded reader to side with them rather than their opponents.

D and S have shown, however, that conclusions about important policy issues must hinge upon the position one takes about the causes of inflation. These causes have been much debated in the past, but not settled, and have not attracted much attention of late. D and S have also shown, therefore, that there is still a good deal of life in an old debate, and for that alone their book is welcome. Would it be too much to hope, though, that they, or some of the many British Keynesians who share their views, will now do the following: formulate precise
testable hypotheses about the inflationary mechanism; show how they relate to earlier empirical work on these questions such as was, for example, surveyed by Laidler and Michael Parkin (1975); and present at least some preliminary evidence of their empirical superiority to monetarist ideas in the light of data generated in the last fifteen years? If only they would do so, we could get down once again to the serious business of advancing the empirical knowledge upon which further progress in that abovementioned old debate depends.
FOOTNOTES


$55.00. John Pencavel and two anonymous referees provided helpful comments on an earlier draft of this essay, and I have also benefitted considerably from correspondence with Christopher Dow. None of the above, however, should be held responsible for this essay's final contents, which are solely my own responsibility. It was prepared during my tenure during the academic year 1988–89 of a Faculty of Social Science Research Professorship at the University of Western Ontario, and I am grateful to that institution for supporting my work with this appointment.

1 Nicholas Kaldor (1982) and Frank Hahn (1982) are well known examples of what I have in mind here.

2 Here I refer to the "new–classical" approach associated with the work of Robert E. Lucas Jr. (1972) and Thomas J. Sargent and Neil Wallace (1975), and the "new–Keynesianism" of, say John Taylor (1979) or Stanley Fischer (1986). See Jeremy Greenwood (1988) for an insightful commentary on the competition between these two schools of thought, and their respective claims to represent "mainstream" thinking. Note that the so–called "post–Keynesian" element in American macroeconomics does have much in common with British Keynesianism — See for example Basil Moore (1987) or Alfred Eichner (1988) for recent examples of American work in this genre.

3 Among IS – LM based versions of macroeconomics I would include traditional Milton Friedman (eg 1971)—Karl Brunner—Allan Meltzer (eg 1973) monetarism. It is no accident that D and S are quite explicit in rejecting IS–LM analysis (pp. 65–67).

4 The Radcliffe Report (1959) laid great stress on the importance of "liquidity" in influencing economic activity, and a careful reading of that Report supports the view that this rather ill–defined concept is best interpreted as some informal index of the cost and availability of credit. I have discussed this issue in David Laidler (1987).
This is, it should go without saying, a very different view of monetary theory to anything to be found in the writings of Lucas, Friedman, Brunner and Meltzer, or Franco Modigliani (eg. 1977), though it does have something in common with some of James Tobin's contributions, particularly those of the 1960s (eg. 1963 or 1969 both reprinted 1971) Tobin is by far the most frequently cited author in this book.

Kaldor (1982) is one British Keynesian who takes the endogenous money postulate to its passive money extreme. So too, among American exponents of this point of view does Moore (1987). The Real—bills Fallacy to which I refer here was a popular doctrine throughout the 19th century, though its origins are earlier. Its exponents held that, provided the banking system confined its activities to discounting good quality short term commercial paper backed by goods in process (real—bills), the quantity of money would be passively self—regulating and incapable of affecting the price level. Lloyd Mints (1945) gives what is still the classic account of the history of this doctrine.

D and S’s argument here is close to, though different in detail from, that of Joseph Stiglitz and Andrew Weiss (1981), as they themselves note. (cf. pp. 18—19).

See David Cobham (1986) for a perceptive account of the potential of the buffer—stock money notion to forge links between hitherto incompatible Keynesian and monetarist traditions in British monetary economics. At the level of the individual experiment, this notion simply reaffirms the idea that the demand for money is a precautionary demand for a temporary abode of purchasing power. However at the level of the market experiment, and in conditions of less than perfect price flexibility, it leads to the following predictions: that departures in observed money holdings from the amount determined by the long run demand for money function reflect not only random fluctuations in the demand for money, but also the influence of changes in its supply; and that the lagged adjustment of actual to desired money holding which underlies the relationship which we usually call the short—run demand for money function is a consequence, not of the costly adjustment of money holdings to changes...
in factors affecting their target value, but of the costly adjustment of factors affecting the
demand for money to the abovementioned changes in its supply. On all this see Laidler (1984)
and Cobham (1986).

9. The similarity between traditional Keynesian analysis and that stemming from the
new—classical tradition on this particular issue is striking, but as Peter Howitt (1987) has
convincingly shown, this is by no means the only place in which what began as an explicitly
anti—Keynesian approach to macroeconomics has begun to yield some very Keynesian looking
insights.

10. Perhaps the most forceful criticism of the British practice of treating fiscal policy as
a tool of monetary policy was offered by Milton Friedman in his (1980) evidence to a British
Parliamentary Committee, evidence which D and S quote at considerable length (pp.142—143),
albeit not in this context but in the course of their discussion of the feasibility of using base
control to influence the behaviour of the quantity of money. As is often the case, there was a
good historical reason why this particular confusion arose in British policy thinking. The
inflation of 1974—75 came at a time when British public expenditure was, in essence, indexed,
and the authorities lost control of their borrowing during that episode. When any government
loses control of its nominal borrowing requirement, there arises a danger that debt will be
monetised, faute de mieux, and that a classic hyper—inflationary spiral will be set in motion.
These fears did surface in Britain in the mid 1970s, and underlay subsequent overemphasis on
the links between fiscal deficits and money creation.

11. It should be noted that it is only since 1981 that the British mortgage market has
become as competitive as the rest of the financial system with the return of Commercial Banks
to mortgage lending. D and S discuss the consequences of this change for the behaviour of
credit markets in general (pp. 193—195).
12. The official name for the "corset" was *Supplementary Special Deposits*. Though this scheme was not continuously in force from 1976 until 1980, there always existed the well understood possibility that it would be put back in place should money growth become unacceptably high. Hence D and S are surely correct in arguing that it was continuously influencing banks' behaviour during this period.

13. This debate is touched on by D and S (pp. 142 et seq.) where the interested reader will find references to key contributions to it. D and S argue, surely correctly, that the existence or not of a required reserve ratio on the banks makes no essential difference to the operations of base control, and in the main present their case on the no—required—reserve assumption that best fits British institutional arrangements.

14. Here they argue, surely erroneously, that a required reserve ratio would be needed.

15. At this point D and S's argument is similar indeed to that often propounded by British advocates of joining the European Monetary System, so it should be pointed out that they explicitly reject this option. The European basket is too narrow in their view. It should also be noted that their defence of an, albeit heavily managed, floating exchange rate sets D and S's recommendations apart from those of the *Radcliffe Report* which recommended the maintenance of a fixed sterling exchange rate. Finally, as John Pencavel has pointed out to me, D and S's proposal to use monetary policy for exchange rate stabilisation bears a strong resemblance to the "global monetarist" ideas usually associated with Ronald McKinnon (e.g. 1979). McKinnon, however, wants monetary policies to be geared not just to stabilising exchange rates between countries, but also to be so conducted as to generate price stability in the world economy. D and S do not take this second step.

16. I have discussed the relationship between the "buffer stock" notion and cash balance mechanics such as are referred to here in more detail in Laidler (1984).

17. In addition to *Competition and Credit Control*, a monetarist would also draw attention to the expansionary fiscal policy embodied in the 1972 budget under the slogan "Go
for Growth", and the manner in which that budget was accommodated by a monetary policy conducted, one suspects, with half an eye on keeping down politically sensitive mortgage interest rates.

18 Though the monetarist premise leads to the view that interest rate determination is better left to the market, it does not make nonsense of D and S's Keynesian doubts about the capacity of interest rate variations quickly and smoothly to co-ordinate choices about the inter-temporal allocation of resources if and when saving and investment functions shift. Their advocacy of the use of fiscal policy to iron out any problems that might arise from this source is thus not undermined by accepting the view that variations in the quantity of money are the major determinant of inflation.

19 See Radcliffe Report para. 391 p.133.

20 This basic conclusion of Friedman and Schwartz (1982) has been strongly confirmed by the more recent and much more sophisticated econometric work of David Hendry and Neil Ericsson (1983). Hendry and Ericsson present their results as refuting Friedman and Schwartz, and D and S accept this interpretation (cf. p.208). However, their preferred error correction equation has a steady state in which velocity is determined by the interest rate, along with three dummy variables for different time periods. (See Hendry and Ericsson pp. 73–75 and particularly eqs. 27 and 28.) This is exactly the result that Friedman and Schwartz obtain using more traditional National Bureau methods. The difference of opinion between these two pairs of authors lies in their assessment of the significance of rather low, and hard to explain value of velocity in the the interwar period, for one's overall judgement about the robustness of the velocity function, and not in any disagreement about what the data show.
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