Mr. Fforde O/R

CONFIDENTIAL 10.4.81

JSFF
Thank you. Fascinating. But how do you propose to control inflation without very hairy shirts. By an incomes policy? Can that trick be worked? If not, then what, other than our hair shirts?
LAEL

Mr George
Mr Goodhart } personally.

FSN

THE GOVERNOR

Copies to The Deputy Governor
Mr Dow

I dare to suggest you might read this. The argument, if there be one, goes unclearly in parts; but the conclusion is not too bad. It is a fragment, out of which quite a lot could be assembled if one had the time.

THE DILEMMA OF THE LIBERAL CENTRAL BANKER IN XXTH CENTURY BRITAIN*

(A Fragment for Easter)

1 In the autumn of 1976 the British Government adopted a published monetary target. It had for some time been urged by the Bank to do this. Failure to do so in the preceding July was judged to have contributed to the ensuing deepening of the exchange crisis of that year. The move brought us broadly into line with practice in North America and West Germany, and was widely regarded in the financial community as putting into use an effective and overriding brake on British inflation.

2 This adoption of a published target was a response to the manifest defeat of "orthodox" post-war economic management, marked by the fall of the Heath government in March 1974 and the acceleration of inflation in 1974-75. The new Callaghan government, despite its close links with the Trades Unions, then found that it could not in practice rely upon a combination of cautious demand management and voluntary incomes policies to re-establish the necessary degree of external confidence in its ability to prevent run-away inflation. So it had to adopt monetary targets, and it had (in its terms) to manage demand downwards in an attempt to hit the targets.

3 This was not in practice a move direct to "monetarism" though the result was sometimes described as "practical monetarism" in an endeavour to give it the counter-inflationary kudos without the supposed doctrinal stigma. It would be more correct to say that the move was an exercise in "practical corporatism" in that it gave or purported to give the Treasury an additional persuasive card in its endless game of pressure against sectional interests. In so far as use of the card required justification in terms of intellectual economics, the result can only be described in retrospect as patently ambiguous.

*This title is, with adaptation, stolen from Isaiah Berlin, with humble acknowledgments.

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4 Attention to the money supply was partly justified on arguments that it was the best available indicator of "thrust", in the context of a continuing if more cautious strategy of demand management and incomes policy, and partly on arguments that a monetary target provided an overriding framework of financial stability within which demand management could subordinately be pursued. As the Mais Lecture saw it: "Monetary policy is often classed as an instrument of demand management: in practice, until we have made more progress with inflation, its services are likely to be pre-empted by the need to use it as an instrument against inflation" (my italics). This was a case of keeping a foot firmly in both camps; as was also strongly suggested by the continued concentration on broad money and its direct links with government finance, bank lending and so forth rather than on the "black box" characteristics of narrow money.

5 In the end, this experiment in "practical monetarism" as an adjunct to "practical corporatism" came to grief in the Winter of Discontent and the fall of the Callaghan government. There followed the election of the Thatcher administration whose Treasury Ministers, and their private economic advisers, were determined to abandon "corporatism" and "practical monetarism" in favour of straight gradualist monetarism, Chicago style. But they were not at first taken altogether seriously. The Budget of July 1979, and retention of a £M3 target, was regarded more as managing demand downwards, in orthodox disinflationary fashion, than as a preliminary exercise in managing the fiscal/monetary balance within an overriding framework of money-supply control; while Mr Lawson's argument that the increase in VAT would not put up prices overall was treated as a jeu d'esprit rather than a serious opinion. More importantly, "rational expectations" failed to respond to the change of political direction and an ominously excessive pay round got under way. As for the Bank, we remained "practical monetarists", with feet in both camps, though the monetarist foot was for a time somewhat more in evidence than the demand management foot.

6 It was this reluctance to follow all the way the strategic change in governmental approach to macroeconomic policy that first tended to make communication difficult between the Bank and the government, and to set us at odds with it at times of stress. For example, in the discussions on monetary base control that took place in the winter of

1979/80, we were baffled by an appearance of Ministerial indifference to the overriding question of abandoning discretionary control of short-term interest rates and by Ministerial refusal even to consider the domestic monetary implications of full entry into the EMS. For their part, Ministers could not understand why a Bank that seemed to share their monetary objectives did not at the same time show enthusiasm for avant garde methods of monetary control when existing methods did not seem to be effective in controlling £M3.

7 By the spring of 1980, the differences of approach were becoming more apparent. The Bank, as a practical monetarist, objected instinctively to the publication of the medium term financial strategy without perhaps fully appreciating why Treasury Ministers could not possibly do without it. Likewise we were at a loss to understand how the government could insist on a published strategy which in our terms seemed to offer no prospect of sufficient success and every prospect of a dangerous decline in public support. But for Treasury Ministers the MTFS was the Ark of a new Covenant, differentiating their whole approach from that of every other government since the last war; and the gloomy forecasts of Keynesian models were regarded as merely the reflection of the wrongheaded political economy of those who fed them their assumptions. But it was these Ministers, in the conditions of 1980/81, who were about to be forced by the severity of the recession and of the pressures on the corporate sector to behave slightly and very reluctantly in the manner of the "practical monetarist".

8 In the spring of 1980 upward pressures on short-term rates were resisted. In July MLR was reduced when the monetary position did not justify it. In November, despite highly excessive growth in £M3, MLR was reduced again - partly in anticipation of lower monetary growth in the future. For Treasury Ministers all this was somehow accommodated within the philosophy of the MTFS; and an easing of monetary policy was indeed latterly accompanied by a tightening of fiscal policy. At the same time pressure on the Bank to alter the system of monetary control in favour of diminishing discretionary influence on money rates was intensified, with some success.

9 If the stresses of 1980/81 obliged Ministers to temper a little the practical rigour of their strategy, they obliged the Bank to begin re-thinking the ambiguities of its practical monetarism and to

contemplate re-establishing its macroeconomic attitudes on firmer ground nearer to the "Keynesian" camp. Examining and assessing the growth of £M3 in terms of sectoral imbalances, judging the pressures on the corporate sector in terms of external competitiveness (including the exchange rate), looking at the PSBR in terms of contracyclical demand management, and judging the Budget's effect on aggregate demand, all came naturally and positively to the Bank. But for the government most of these seem to have been no more than a check-list of convenient excuses, to be forgotten as soon as possible after use, forgotten notably in the Budget of 1981/82 and its reaffirmation of the MTFS.

10 The basic ambiguity of our "practical monetarism" was in part the reflection of a compromise within the Bank. On one side were those who felt that reintroduction of a declaratory restraint on money, somewhat analogous to the provisions of the 1844 Bank Charter Act, would have a valuable and lasting effect on inflationary behaviour at an acceptable real cost in lost output and jobs. On the other side were those who felt that steering by monetary aggregates would prove a very hit and miss method of temporarily reducing inflation at very heavy cost indeed. Behind these differences of view about solutions lay differences in view about the ultimate causes of inflation, and their strength; but in the dark days of 1976 it was possible to sink these differences in face of the intractable external crisis and its domestic inflationary implications.

11 These underlying differences of view illustrate the Dilemma of the liberal Central Banker in Twentieth Century Britain. Discerning them has been complicated by the prevailing dominance of econometric models, with their "forecasts", "scenarios", "simulations", "robust (or unrobust) relationships" and the like. These constructions encourage people to think that "the economy" is a stable and largely determinist system that will reliably respond in predictable ways to external "stimuli". This kind of economy is supposedly rather like a human body that is vulnerable to smallpox but responds predictably to vaccination, and is supposedly quite unlike the body that is vulnerable to the common cold, whose virus mutates so frequently that no vaccination is reliably effective for long. In this way, econometricism encourages lay people to believe that scientific discovery in economics, by white-collar people working with statistics, equations, and computers, can in practice provide <u>the</u> solution, or

solutions, to obstinate economic problems. It is only when one observes the often remarkable correlation between the output of models and the political attitude of their operators that one begins to see through the mists of algebra the familiar landscape of economists disagreeing with one another and of laymen using abstract economics to support their own prejudices.

12 This ill-tempered digression about models helps to uncover and illuminate the underlying difference of approach between "monetarism" on the one hand and (for want of a better word) "pragmatism" on the other. Monetarists, like marxists and others, are "system people". They are possessed of a systemic theory, or Revelation, which provides them with a single normative and overriding solution to economic problems and enables them to regard those who disagree as enemies, to be fought and if possible eliminated. Allegedly determinist theory, on one view logically devoid of ethical content, gets converted into the normative support of a Calvinist crusade. Of course, some degree of expedient softening is allowable: but as Sir Geoffrey Howe aptly remarked at a recent meeting, to the distaste of central bankers present, it is allowable "only so long as the Ten Commandments remain hanging on the wall".

13 The dilemma of the liberal central banker, to get back to the point, is that of the pragmatist par excellence who approves of the general direction in which the Crusader wants to go but finds himself dragged along too far and then regarded by the Crusader as at best a reluctant fellow-traveller and at worst an enemy within the gates. Central banks in the twentieth century became discretionary managers of money because Calvinist methods, with their Iron Laws, were broken in the West by force of circumstance. Central bankers then became accustomed to saying that theirs was "an art, not a science". "Mechanistic" became one of their terms of abuse. Yet their pragmatism was habitually conservative, and in practice reminiscent of the Calvinism they replaced. Devaluation, inflation, government deficits, industrial democracy, "living beyond one's means" and the like, were all definitely bad even in quite small doses. Hair shirts were always a good thing. Discretion, in the safe hands of the central bank, was allowed. But in the wrong hands it became "laxity" and "permissiveness". The Bank of England was no exception in these respects; though the eventual agony of its dilemma has been made worse by its lack of independence. Fellow-travelling is bad enough. Being a Crusader's Creature is almost unbearable.

14 The novelist Turgenev, when his like dilemma became unbearable, had a nervous breakdown and fled to Paris from St Petersburg. That course is not open to us. All we can do is either to stop grumbling and fellow-travel without further complaint, or else to make quite clear the gulf between us and the system-men. But choosing the latter implies a willingness to swallow our pride and admit that hair shirts can sometimes be vicious. Perhaps that is the task of a second Mais Lecture.

10 April 1981