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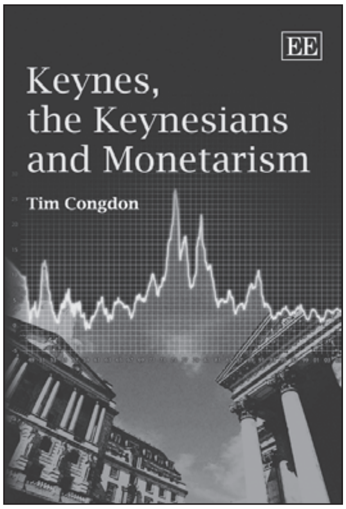

Tim Congdon, **Keynes, Keynesians and Monetarism**, Edward Elgar, 360 pages.

The post-war disputes over economic theory and policy were ferocious, even by the standards of academia. As Tim Congdon was a leading exponent of the monetarist side, his views on the history and resolution of the battles are of great interest and provide a common theme to this collection of clear and persuasive essays. The author divides the post-war era into three periods. The first, which he calls "Stop/Go" lasted from 1945 to the second quarter of 1971; the second ("Boom and Bust") from the third quarter of 1971 to the third quarter of 1992; and the third ("Stability") from the last quarter of 1992 onwards.

In the first period the dominant view among British economists was Keynesian. The objective was to avoid high unemployment, and it was held that this could only be achieved through fiscal policy. The main constraint was the fixed exchange rate. In practice, this meant periodic and politically damaging devaluations, which were only accepted under the stress of apparent necessity. As increases in interest rates allowed such necessities to be postponed, monetary policy came in by the back door, but was otherwise considered to be unimportant. "By the late 1960s hardly any British economist thought that interest rates could or should be varied to influence domestic economic variables," Congdon notes.

Instability

As inflation picked up and the British economy was seen to be poorly managed, dissatisfaction with the Keynesian consensus grew and rival views, despite their heterogeneity, were labelled "monetarist". In June 1972, sterling floated and the management of the domestic economy became unconstrained by the exchange rate and was without any clear guiding policy. In the search for stability several policies were tried, including broad and narrow money targets and joining the exchange rate mechanism. Either because the method was inappropriate, the timing wrong, or the implementation poor, none brought the desired stability. It could be argued, to paraphrase G.K. Chesterton's comment on Christianity, either that each policy was tried and found wanting, or that they were found difficult and not really tried.

For an account of when and an explanation of how the boom and bust period ended, Tim Congdon quotes extensively from Alan Budd's Julian Hodge Institute lecture in April 2002, which considered the key points as (i) policy continuity, (ii) a focus on inflation targets and the de-politicising of decision taking and (iii) transparency. The independence of the Bank of England, which was established in 1997, strengthened rather than changed the system that had prevailed since 1993 whereby the Chancellor of Exchequer was advised by the Treasury's panel of "Wise Men", whose views and advice, which included those of the author, were published.

These institutional arrangements were a necessary rather than a sufficient condition of stability. In addition, there had to be a consensus about the determination of inflation. "It is important to be clear that the policy achievements of the 1990s were not due to the adoption of the most well publicised prescriptions of the most well-known schools of thought," Congdon argues. "In particular, the simpler versions of neither 'Keynesianism' nor 'monetarism' were relevant."

Exchange of views

Several essays concern an incident which illustrates the change that has occurred in the economic consensus. In 1981, 364 economists wrote to *The Times* forecasting, amongst others, that "present policies will deepen the depression…" It is generally perceived today that this forecast was in error. The book contains an exchange between Congdon and Stephen Nickell, a former member of the Bank of England's monetary policy committee, with the latter arguing that this perception is wrong, while Congdon asserts that "the 364 were indeed all wrong". The two economists agree that output rose, but whether it was above or below trend is what is disputed. It is, however, likely that most of the 364 signatories, with the exceptions clearly including Professor Nickell, were quite convinced that the sharp fiscal tightening in the 1981 budget would cause a sharp drop in output, not just a period of below trend growth.

The letter from the 364 economists also contained the claim that "….there is no basis in economic theory or supporting evidence for the government's belief that by deflating demand they will bring inflation permanently under control and thereby induce an automatic recovery in output and employment." Two subsequent developments in economics make it unlikely that such a claim would be made today. It is now agreed that there is no trade-off between unemployment and inflation. If there is a positive output gap, inflation will accelerate. Given the importance of this theory, Tim Congdon reasonably asks whether the pioneers of the output gap framework deserve the Nobel Prize.

The importance of expectations

But the output gap on its own does not explain the phenomenon of stagflation, which was the major concern in the late 1970s and early 1980s. As unemployment and inflation rose together, it did not appear that a negative output gap was sufficient to bring inflation under control. This problem is now seen as one of changing expectations of inflation. If these are rising, the size of the output gap needed to control inflation also rises. It then requires a shock, such as the one provided by Paul Volker's dramatic increase in interest rates in the early 1980s to halt the rise in expectations.

The framework provided by the output gap, amplified by the importance of expectations, largely ignored in these essays, now represents the economic consensus. It was not present in 1981 and could not therefore be the basis for the "policy continuity focused on inflation targets", which has been such a success since 1992.

The final section of the book addresses the transmission mechanism, whereby monetary policy affects the economy. Congdon emphasises the role of asset prices. This convincing argument is already eating away at the economic consensus. If monetary policy first stimulates asset prices, they can readily get out of line with incomes and their return to equilibrium must come either through inflation or by asset deflation. Experience, notably and recently in Japan, suggests that managing an economy under conditions of asset deflation is difficult and the results unhappy. It follows that asset prices should be a concern to central bankers. There is no consensus yet on this, with the Federal Reserve and the Bank of England appearing to take different views. One hopes that Tim Congdon will be expanding on this point in future essays.

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