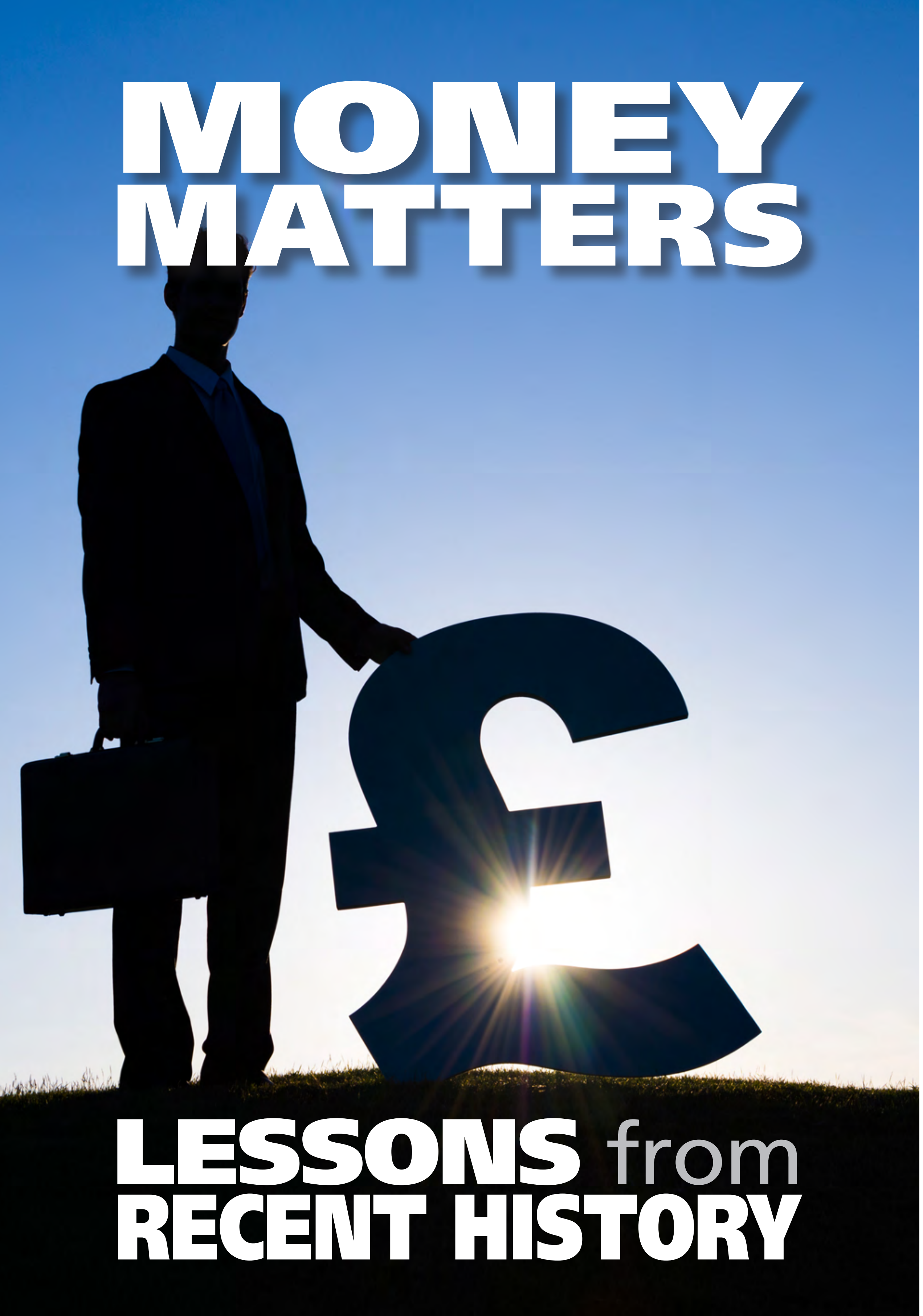

MONEY MATTERS

LESSONS from RECENT HISTORY

What is the purpose of the National Institute of Economic and Social Research?

According to the home page of its website, it has provided "independent and influential economic research since 1938". That apparently remains its mission, with the website having five tabs, on "Financing Britain", "Macroeconomics", "Productivity performance", "Social mobility" and "UK, Europe and devolution".

On the face of it, the National Institute's interests today are eclectic and wide-ranging, and it has no particular ideological axe to grind. But that has not always been so.

Its heyday was in the 25 or so years from 1953 when, at the initiative of Christopher Dow and Bryan Hopkin, it established a macroeconomic forecasting group.

From the outset the National Institute's forecasting work had strong support from the Treasury. At first this support was mostly intellectual, but for many years from 1961 it took the form of financial grants, so that the National Institute was really part of the public sector.

The National Institute had a definite world-view. It was the champion of a Keynesian approach to macroeconomic policy, where "Keynesianism" meant the centrality of fiscal policy in so-called "demand management".

Dow pioneered the application of the Keynesian income-expenditure model to real-world macro-forecasting and policy decisions.

According to the model, which is a standard part of A-level and much undergraduate instruction in economics, output depends on expenditure which depends on income, with the incomes received as a result of the production of output.

The payments in an economy are then conceived as being a so-called "circular flow", which goes on forever unless it is hit by an outside shock of some sort.

An important characteristic of this model is that there is no role for the banking system or the quantity of money in determining macroeconomic outcomes. (Whether the National Institute's interpretation of Keynesianism had much contact with Keynes' own work is a moot question.

Dow was particularly dismissive of money, claiming that the quantity of money reflected expenditure and incomes, rather than the other way round.

The Keynesians' tendency to pooh-pooh money and monetary policy was associated with an entirely non-monetary theory of inflation.

Price increases were said to stem from cost pressures which were attributed to trades unions' wage demands. The unions had therefore to be restrained by direct government control of wages and prices.

National Institute thinking endorsed "the dash for growth" under Ted Heath's Conservative government from 1970 to 1974.

Highly expansionary policies began in late 1971 and early 1972, with big increases in public expenditure and explosively rapid increases in the quantity of money.

THE KEYNESIANS' TENDENCY TO POOH-POOH MONEY AND MONETARY POLICY WAS ASSOCIATED WITH AN ENTIRELY NON-MONETARY THEORY OF INFLATION

By early 1973 inflation was starting to become a concern, causing the government to impose limits on future price and wage increases, so that the annual rate of inflation was to stay in single digits. At the same time the quantity of broad money was growing at about 25 per cent a year.

Would money growth or the incomes policy determine inflation? Would the boom in demand stimulate sufficient extra supply? Would the dash for growth succeed?

The National Institute's February 1973 Review gave its blessing to official policy. Its author saw Heath's policies as Britain's exercise in expansionary Keynesianism, following the model of the USA in the Kennedy years when fiscal reflation had (allegedly) been the spur to several years of above-trend output growth.

The key features of the National Institute's February 1973 forecast are given in table 1. The forecast for output was annual out to 1976, but quarterly for the next 18 months, that is, to the second quarter of 1974.

The table compares the National Institute's view of output growth up to 1976 with the outturn.

The table shows that the National Institute was fantasising over the possibility that the Keynesian dash for growth in

Table1: The National Institute's forecast of UK output growth in early 1973, compared with the outturn

Year	Forecast in February 1973 *Review*	Outturn, according to latest data in 2015
1972	2.25	3.9
1973	6.25	8.0
1974	5.25	-0.9
1975	5.00	-0.2
1976	3.25	2.1

Source: National Institute *Review* for February 1973 and Office for National Statistics for outturn. (Mnemonic CDID in September 2015 database. Note that the outturn is on 2010 price basis, whereas the 1973 forecast was on a 1963 price basis, and this may affect the comparison).

the UK would succeed.

Instead of several years of smooth above-trend growth, the UK had one year of crazy boom (1973) and then two years of falling output. (To give some perspective on how dreadful the boom-bust experience was, the UK did not suffer a single year with an outright output decline in the 25 years from 1948 to 1973.)

It is also clear that the National Institute was hopeless at predicting inflation. Whereas in February 1973 it had expected consumer prices to rise by 6 per cent in the next six quarters, in practice they went up by over 16 per cent. The peak increase in the retail price index came a bit later, in August 1975, at 26.9 per cent, a figure which was uncannily close to the highest rates of money growth seen in 1973.

The similarity of the peak rates of increase in both the price level and the quantity of money was compelling evidence that money did matter, regardless of the views of Christopher Dow and the Treasury mandarins.

The next period of extremely fast money growth began in late 1985, as the Thatcher government ditched the monetary control that had been basic to its original agenda.

By early 1987 the stock market and house prices were advancing quickly, and once more a boom was under way.

But the National Institute denied that anything of the sort was happening. It failed completely to anticipate the 5.0 per cent and 5.5 per cent growth rates of national output recorded in 1987 and 1988.

After gleefully reporting that the Thatcher government's monetarist framework had been "almost entirely abandoned", the February 1987 issue of the National Institute Review forecast output growth of 1.5 per cent in the last three quarters of 1987 and 2.5 per cent (i.e., at an annualised 1.4 per cent) in the seven quarters to end-1988. The outturns were three times higher to end-1987 and four times higher to end-1988.

Because banking and money are not integrated in National Institute forecasting, its model breaks down – hopelessly – in periods of financial upheaval and monetary instability.

Needless to say, the forecast in its July 2008 Review gave no warning about the Great Recession.

It gave an 18-page analysis of "Prospects for the UK economy", with quarterly changes in output projected to the end of 2010. Not one quarter of falling output was foreseen.

Again, the National Institute's forecasting team had been unable to spot the early signs of a damaging boom-bust episode.

The National Institute has failed to forecast these episodes correctly because of the failures of the Keynesian income-expenditure model and the associated apparatus of macro-forecasting.

These failures have been both intellectual and practical, and at root go back to the ludicrous notion that the quantity of money is irrelevant to the economy's behaviour.

That notion was put about by Dow and many others in the 1940s and 1950s, in a mendacious misrepresentation of Keynes' own beliefs•

Tim Congdon
Institute for International Monetary Research
University of Buckingham
timcongdon@btinternet.com