The HARD FACTS about HARD MONEY

In the first of a regular series, TIM CONGDON stresses the importance of the invisible...

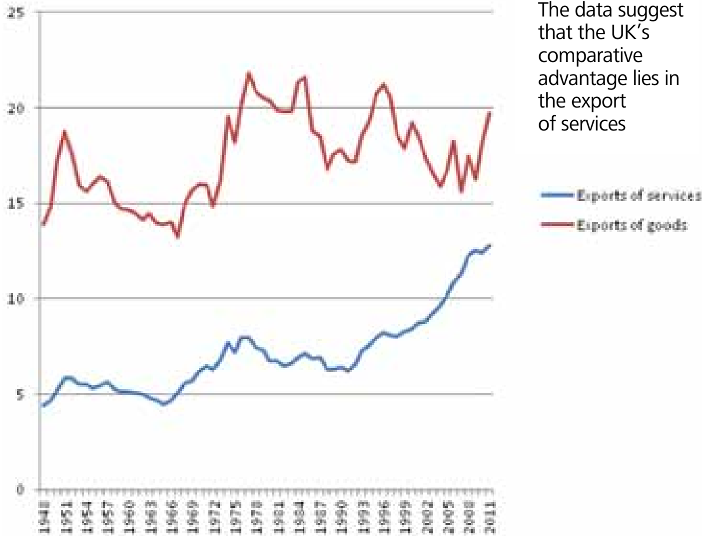
Economists sometimes claim that their subject is scientific. Thus, the London School of Economics describes itself as "unique in its concentration on teaching and research across the full range of the social, political and economic sciences". The scientific status is intended to put economics on a pedestal. Its principles are meant to be established objectively on empirical foundations, and to be free from the biases and preconceptions that clutter so much public policy discussion. Meanwhile its vocabulary purports to be rigorous and definite, and so to avoid the ambiguities that mar debates in the humanities.

The truth is different. Economists have prejudices, often rather silly prejudices, and they use words carelessly in order to maximise rhetorical effect. One particular habit seems to be deeply ingrained, to approve of "things", in the broadest sense, that can be seen and touched. Such things are tangible and "hard". This habit comes through in two ways that matter to public debate, the veneration of money that can be felt and weighed (i.e., of money that is "hard") and the endorsement of activities that produce goods rather than services (i.e., products that come from "hard industry").

The hard-money school has been vocal in the monetary policy debate of the last few years. In order to offset the contraction in money balances due to official attempts to make banks hold less risky assets, central banks around the world have created money by so-called "quantitative easing" (QE). The mechanism involved has been artificial, even tacky, with large sums added to banks' cash reserves and the resulting balances spent on purchases of assets from the private sector. Of course, the cash reserves can be exchanged for notes that come from the printing presses. QE has therefore been widely characterised as "money printing".

INFLATION IS CAUSED BY EXCESSIVE GROWTH OF THE QUANTITY OF MONEY – BROADLY DEFINED – RELATIVE TO THE QUANTITY OF GOODS AND SERVICES

In the kindergartens of economics one lesson is that too much printing of money causes inflation. The hard-money school (represented, for example, by Liam Halligan in his Sunday Telegraph column) has claimed that QE is inherently inflationary and hence a sign of modern civilisation's financial debauchery. In a recent speech Lord Turner, chairman of the Financial Services Authority, argued that QE – to be understood as the monetisation of budget deficits – should become a permanent feature of monetary policy. His proposal was thought to be shocking, in that it appeared to



The data suggest that the UK's comparative advantage lies in the export of services

support a policy that would deliberately stoke inflation.

However, both Halligan and Turner are shadow-boxing. Inflation is caused by excessive growth of the quantity of money relative to the quantity of goods and services, and large bodies of evidence demonstrate that the relevant quantity of money is one that is broadly defined to include all bank deposits. Inside a broad money aggregate the printed note issue is nowadays very small compared with bank deposits, and is of little importance in business and financial transactions.

Halligan and Turner are shadow-boxing because they have been unable to rid themselves of the hard money fallacy, the fallacy that money is better the closer it is to a physical commodity. Halligan makes absurd conjectures about hyperinflation because he is worried about the excessive printing of money, when in fact growth rates of the quantity of money are low or moderate across the industrial world. Turner feels that he has to soften up his audience to the alarming idea of permanent debt monetisation, when in fact the critical influence on inflation is not the degree to which a deficit is monetised, but the rate of growth of the quantity of money.

The hard-industry school has started to articulate a case for currency devaluation. The idea here (expressed, for example, by Martin Wolf in his column for the Financial Times on 22nd February) is that devaluation

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would increase the profitability of manufacturing compared with services, and hence promote the expansion of the export-oriented manufacturing sector relative to the assumedly less-export-oriented services sector. By this means the hard-industry argument links up with the topical enthusiasm, in some quarters, for "rebalancing" the economy. Central to this enthusiasm is an implicit belief that manufacturing industry and the regions are good and deserving causes, whereas finance and the City of London are bad and undeserving.

But it is not an economist's job to applaud or condemn particular branches of the economy. With apologies to Gertrude Stein, a pound sterling of marketed output is a pound sterling of marketed output is a pound sterling of marketed output. Over the last 50 years the UK's exports of business services have been far more buoyant than its exports of manufactured goods, which suggests that our country's comparative advantage lies in the services sector. Indeed, exports of services have also been far less cyclical than those of goods, and have even been robust in the wake of the crash (see chart). Pace Wolf, Adam Smith and David Ricardo showed more than 200 years ago that nations should specialise according to comparative advantage, not according to the prejudices of the commentariat.

The doctrines of both the hard-money and the hard-industry schools are misconceived. They arise from a naïve view of the world in which something that can be seen and felt is better than something (a sum in a bank account which is merely a symbol for a quantity of notes, or a service activity such as a dramatic performance which – unless recorded – disappears when completed) that cannot be seen and felt. Ironically, as economies progress, the importance of things that cannot be seen or felt rises relative to tangible "hard" production, and the financial system increasingly dispenses with hard money and relies more on symbolic money•

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