

TYÖVÄEN TALOUDELLINEN TUTKIMUSLAITOS
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THE RISE AND DECLINE OF MONETARISM

The great revival of "monetarism" in the 1970's, culminating in the adoption of the strict prescriptions of the monetarist creed by a number of Western governments at the turn of the decade - particularly by President Reagan's administration in the U.S. and Mrs. Thatcher's in Great Britain - will, I am sure, go down in history as one of the most curious episodes, comparable only to the periodic outbreaks of mass hysteria (such as the witch hunts) of the Middle Ages. Indeed I know of no other instance in economics where an utterly false doctrine concerning the causation of economic events had such a sweeping success in a matter of a few years.

The peculiarity of that revival was that it did not arise as a consequence of developments in the field of economic theory - it was a political reaction to the Keynesian era, not an intellectual reaction. The Keynesian revolution in economics meant a dethronement of monetary factors from the dominant position which they traditionally occupied as the causes of inflationary and deflationary tendencies. The core of economic stabilisation of policy in post-Keynesian economics was sought in the regulation of the pressure of demand so as to secure full utilisation of capacity, whilst avoiding demand being excessive. On past experience investment expenditure debited to capital account has been unstable for a number of reasons - on account of changes in long-term expectations concerning economic prospects, or on account of changes caused by the varying instance of technological progress- in the flow of new inventions, or a new method of production - or, in considering a single country on account of changes of export demand originating in changes in the level of effective demand in other countries; finally, but possibly to only a minor degree, on account of changes in the propensity to save of income recipients at any given level of output and employment.

All such changes in the private sector of market economies would cause inflationary or deflationary tendencies: that is to say, they would set up forces either to contract or expand economic activity. Assuming that such tendencies emanating in the private sector are intended to be offset by countervailing measures in the public sector implies what normally is called "full employment budgeting" - which means that the taxation imposed by the Central Government ostensibly serving the traditional purpose of financing government strategy expenditure, has in fact been framed or adjusted so as to generate a level of effective demand in the economy that is regarded by the government of the day as neither excessive nor inadequate for securing full employment.

For the purpose of economic stabilisation in this sense, fiscal and budgetary policies have been regarded as the primary instrument of regulation and not policies concerning the money supply. On this view, the stability of the value of money, that is to say of the price level, has been seen, in an industrial economy, far more a matter of the stability of money costs of production - which primarily depend on the rate of increase in money wages relative to the increase in productivity - than a policy seeking to regulate, or at least to influence, the money supply through central bank policies operating mainly through the instrument of interest rates.

The monetarist creed by contrast asserted that the main, if not the sole cause of inflation, is an excessive increase in the money supply: with the implication if the growth of money supply is kept within the limits set by the growth of productive capacity, the economy will develop in a stable manner. This monetarist view implied, inter alia, that changes in the money supply are determined by the policy of the note-issuing authority, the Central Bank, who has a decisive power in these matters irrespective of the state of the economy and the rate of increase of money costs and prices. The cyclical fluctuations of the economy on this view reflect the irregularities and aberrations with which the money supply is increased by the monetary authorities who are regarded as responsible also for the

distortions in the structure of production caused by imperfect anticipation of the delayed effects of increases in the money supply on prices.

Though normally the increase in the supply of money in circulation was a response to increased demand and not an autonomous event, occasionally the supply of the money commodity ran ahead of the increase in the supply of other commodities - as with the gold discovered in the new Spanish colonies of the 16th century - when money could be said to have exerted an autonomous stimulating influence on the demand for goods and services. It did so because those who first came into the possession of the new gold were thereby personally enriched, and thus became the source of additional demand for goods and services; and I think it is fairly generally agreed by economic historians that the effect of Spanish gold in the 16th and 17th centuries had a beneficial effect on the level and rate of growth of European production which was far more important than its price raising effect. But the converse of this proposition has been equally true: where the increase in the supply of the money commodity lagged behind the potentialities for economic growth, this placed obstacles on economic expansion which historically were gradually overcome with the successive introduction of money substitutes.

This latter development was closely associated with the development of banking. Originally goldsmiths (who possessed strongrooms for the safe-keeping of gold and other valuables) developed the facility of accepting gold for safe keeping, and issued deposit certificates to the owners, and the latter found it convenient to make payments by means of these certificates. The next step in the evolution towards a credit money system was when the goldsmiths found it convenient to lend money, as well as to accept money on deposit for safe keeping.

For the purpose of lending they had to issue their own promissory notes to pay cash to the bearer (as distinct from a named depositor) on demand; with this latter development the goldsmiths became bankers i.e. financial intermediaries between lenders and

borrowers. Since real money (gold) was only required on specific occasions (i.e. for making payments abroad or when the nature of the contract specifically provided for payment in cash) the banks found that the amount of such notes issued to borrowers came to exceed many times the amount of gold deposited in their lenders - though the total amount they owed to the lenders was always larger than the total amount lent to the borrowers.

Since the notes issued by some banks were found more acceptable than those of others, giving rise to periodic payments crises and uncertainty, it was sooner or later everywhere found necessary to concentrate the right of issuing bank notes in the hands of a single institution,¹ such rights being circumscribed by legal reserve requirements. These banknotes, in the course of the present century, became the ultimate form of money since gold convertibility was abandoned in most countries either as a result of the First World War or of the economic crisis after 1929. However, just as gold coins gave way to current accounts with the clearing banks, which proved a safer and more convenient way of holding money than cash in the form of bank notes, and to transfer money between persons through the agency of cheques. And for much the same reason which led to the creation of money through credits granted by the banks in the form of the banks' promissory notes, the granting of bank credit led to the creation of money in the form of chequeing deposits which came to exceed manifold the amount of banknotes in the vaults of the banks (or, what comes to the same, of credits with the central bank) in existence. This "credit money" in the form of either non-interest bearing chequeing accounts or of interestbearing deposits which though not directly used as medium of payment could hardly be left out of account (if only because the two kinds of deposits are so easily interchangeable). Moreover, deposits of the clearing banks have close substitutes in other, easily transferable and capital-certain forms of holding wealth, such as deposits with building societies, Treasury Bills or short-term bonds (bonds with near-dates of maturity), travellers cheques, and, most of all, deposits in the Eurocurrency markets (the total value of which latter has been estimated to have risen from 39 billion U.S. dollars to 1.35

trillion dollars, or by 3,353 per cent between 1965 and November 1981).² The latest "money substitutes" consist of credit cards which came into use after World War II, and which are now estimated to account for much the greater part of payments in the more expensive hotels and restaurants.

The main contention - and indeed, the sine-qua-non - of monetarism is that the money supply of each "economy" is exogenously determined by the monetary authority of the "economy" concerned.³ Monetarists, following Milton Friedman, assume that the monetary authority determines the so-called "monetary base" (or "high-powered money" to use Friedman's expression) which is nothing else but the amount of banknotes issued which at any one time are partly in the hands of the public and partly in the hands of the banks, whether in the form of vault-cash or of deposits with the central bank. It is further assumed that there is an established ratio determined by legally enforceable rules or conventions between this "base money" and of all other forms of money. Hence the "monetary authority" ultimately determines the supply of money in all forms. It does so partly by active measures such as "open market operations" by which the central bank buys or sells government securities in exchange for its own notes, and partly by passive measures, the re-discounting of short term paper consisting of public or private debt, where it seeks to achieve its objective as regards the money supply by varying its own rate of re-discount. The further assumption that the (inverted) pyramid of bank-money bears a stable relationship to the monetary base is supposed to be ensured by the banks' rationing credit so as to prevent their liabilities from becoming larger (or rising faster) than the legal or prudential reserve ratio permit. It is admitted however that each "economy" characterised by the possession of a separate currency must be wholly autonomous, which implies that the central bank is not under any obligation to maintain its exchange rate, at a pre-determined relationship with other exchange rates (as was the case under the pre-1914 gold standard or the Bretton Woods system), but that it allows its exchange rate to fluctuate freely so as to achieve a balance in the foreign exchange market without central bank intervention.

While the first and most important credo of monetarism is that the supply of money is always exogenous⁴ the second and almost equally important credo is that the public's demand for money, as a proportion of income is a stable one, not much influenced by changes of interest rates and other factors.⁵

Given the fact that the demand for money represents a stable function of incomes (or expenditures) Friedman and his associates conclude that any increase in the supply of money, however brought about (including, i.e. that caused by open market operations which lead to the substitution of cash for short-term Government debt in the hands of discount houses or other financial institutions) will imply that the supply of money will exceed the demand at the prevailing level of incomes (people will "find themselves" with more money than they wish to hold) and this defect can only be remedied by an increase in expenditures which will raise incomes sufficiently to eliminate the excess of supply over the demand for money. As a description of what happens in a modern economy, and as a piece of reasoning applied to situations where money consists of "credit-money" brought about by the creation of public or private debt, this is a fallacious piece of reasoning - an illegitimate application of the original propositions of the quantity theory of money which (by its originators at any rate) were applied to situations in which money consisted of commodities, such as gold or silver, where the total quantity in existence could be regarded as exogenously given at any one time as a heritage of the past. If in such circumstances sudden and unexpected increases in supply occurred (such as those following the Spanish conquest of the Inca empire), their absorption necessitated a fall in the value of money-commodity relatively to other commodities. Until that happened, someone was always holding more gold than he desired. The only way supply could be brought into conformity, and kept in conformity, with demand was through changes in the value of the commodity used as money.

However, the same reasoning cannot be applied to cases where money was not a commodity like gold or oxen, but a piece of paper (bank notes) or simply a book-keeping entry in the accounts of banks.

The rules relevant to the creation of "credit-money" are not of the same kind as those relevant to the production of gold or similar commodities. Credit money comes into existence as a result of the extension of credit to borrowers. As the money is spent on wages, the purchase of materials, etc., the same addition will appear in the balances of the recipients, except insofar as there are leakages into imports or taxation.

Could we then suppose that the additional credit of £100 brings about an "excess supply" of money in an analogous manner to that created by the discovery of new gold? If the original borrower did not need £100 he would have borrowed less - say, £80 - and left the remainder as an unutilized borrowing facility. If the subsequent recipients find that they have more money in hand than they need, it is they who will repay some of their bank loans. Again, the "excess money" is extinguished through loan repayment. If the second recipient is a net creditor to the bank, his bank balance will be enlarged; and if he finds that it is now too large he will transfer some of it to interest-bearing savings deposits or apply it to the purchase of financial assets of some other kind. This means that in the sense required by monetarist theory an excess in the supply of money cannot come into existence; and if it did, it would be automatically extinguished through the repayment of bank indebtedness either by the original borrower or by others.

The vital difference in the modus operandi of the two kinds of money, commodity money and credit money, was not perceived (as far as I know) by any of the 'schools' of economic theory. The original inventors of the quantity theory of money in the 18th Century, such as David Hume, were naturally thinking of the supply of gold as determining the amount of money in circulation, and the same remained true of writers in the 19th Century, such as Walras and Marshall, who wrote at a time when paper money was a far more important element in monetary circulation. None of them questioned the assumption that the quantity of money, however defined, is an exogenous variable or that the variations in the quantity of money were the main cause of fluctuations in prices. This was true of Keynes, who advocated a "managed currency" in 1923⁶ in

preference to a return to the gold standard, mainly in order to secure a more stable money supply and thus avoid the effects of the vagaries of gold on the price level. The causal chain running from money to prices was never questioned; and the exogenous character of the money supply was something Keynes continued to believe in even when his new theory of effective demand gave a wholly new explanation of how the demand for goods and services is determined. Side by side with the multiplier equation ($Y = \frac{1}{1-k}I$), which gives the core of the new theory, he retained traces of his old beliefs in the liquidity preference equation, $M = L(Y,r)$, where the demand for money is assumed to vary with the rate of interest as well as the level of money incomes, thus allowing incomes and prices to vary even though the supply of money was treated as an exogenous constant. This formulation puts the whole burden of adjustment following upon changes in profit expectations, investment, etc. on the velocity of circulation, which was assumed (tacitly rather than explicitly) to vary to whatever extent was necessary to reconcile the change in demand brought about by Keynesian factors with the change in the level of expenditure defined according to Fisher.

Milton Friedman first thought of testing the Keynesian hypothesis by comparing the movements in total money income (or expenditure) with the corresponding movements of the quantity of money. He took the absence of any correlation between M and Y as an empirical test of the Keynesian theory - which is only another way of saying that changes in V (the velocity of circulation) induced by changes in the rate of interest, proved sufficient to validate changes in demand originating in changes in investment or in the propensity to consume.⁷

Much to his (initial) surprise he found that historically the correlation was not between Y (or the GDP) and V , but between Y and M ; changes in money income were strongly correlated with changes in the quantity of money in circulation, normally with a (highly variable) time lag.⁸ And this brought him to the rather sweeping conclusion of rejecting Keynes and opting for Irving

Fisher and neo-classicism on empirical grounds. The economy, in this view, taken by itself is fully self-adjusting, and will follow the optimal path so long as the money supply, which is fully under the control of the Central Bank, increases at the optimal rate.

Improbable as it may sound, this extraordinary proposition was firmly believed in at the turn of the last decade in a number of important countries simultaneously - by Mr. Volcker, the Chairman of the Federal Reserve, by Mrs. Thatcher and her close personal advisers in England, and by leading figures in a number of other countries. Its outward expression was the setting of "targets" for the increase in money supply in a large number of countries and, at least for a time, to regard the realisation of these targets as the first priority of policy. By these measures "monetarist" governments and central bankers managed to reduce the effective demand for goods and services below their potential considerably, which in turn may have caused a slow-down in the increase of the amount of money people wished to hold.

However, experience has soon demonstrated that the central bank has no direct control over the amount of its bank notes in circulation. The reason for this is that Bank cannot refuse payments to its own creditors by refusing to honour cheques drawn on itself by the account holders, and if it wishes to avoid major crises in the banking and financial system it cannot close the "discount window", i.e., it cannot refuse to re-discount eligible bills on the ground that it is only willing to issue new money up to certain daily maximum. Central banks are extremely sensitive to the danger of bank failures which can easily escalate. To an extent which is rarely admitted in public, central banks regards the maintenance of the credit pyramid - the solvency of the banking system - as their most important function, which takes precedence over economic objectives if their appear to be in conflict.

Traditionally, the core of central banking policy consisted of protecting the reserves (in gold or reserve currencies) through

the instrument of changes in the Bank Rate. Ostensibly, such changes served the purpose of keeping the balance of payments with foreign countries on an even keel - a loss of reserves was taken as evidence of an unfavourable balance, and vice versa. The policy worked in the sense that even moderate changes in short-term interest rates (relatively to other financial centres) sufficed to reserve the trend in the movement in reserves. But until the new monetarism came into fashion stabilizing the the quantity of money in circulation, as distinct from stabilizing the volume of international reserves, was not regarded as a primary objective.

In the last five years or so all this has changed. A number of countries adopted monetarist policies with the objective of stabilizing the economy (and, in the view of some, of increasing its operational efficiency) by regulating the amount of money in circulation. There is no time here to give even an outline of a comprehensive survey. Two examples must suffice.

The first relates to Britain where monetarism was first adopted by Denis Healey, under a Labour Government, sometime in 1977. However, since its methods and objectives have never been made explicit, it is best to begin with the monetarist policies of the present Government, which came into office in May 1980. The first year of the policy was a disastrous failure. The chosen monetary target, "sterling M3",⁹ was planned to rise by 7-11 per cent, but had actually risen by 22 per cent; both the money supply and the price level rose twice as fast under the new monetarist regime than they did under five years of the previous Labour Government.¹⁰ This was attributed, with extreme naivete, to the lack of confidence of the public in the Government's "earnestness" in carrying out its policies. Hence in the second year the Government adopted a "medium term strategy" which provided that the annual change of the money stock, the public sector borrowing requirement and the rate of increase in the price level, were to be gradually and steadily reduced over a four-year period. It was never explained why public belief in the seriousness of the Government's intentions should operate as a stabilizing instrument, and why a four-year plan should be taken so seriously.

Anyhow, the performance in the second and third years was not much better than that of the first year - the money supply targets were never met and had to be repeatedly "re-based" to start from a higher level. In the meantime the "supporting policies" of tax increases and expenditure cuts, and allowing the £ to become extremely over-valued, meant that unemployment kept on growing, and industrial production shrinking, rapidly. Over the period as a whole total real consumption increased by 5 per cent. But there was 9,5 per cent fall in the total number of employees in employment and a 13 per cent fall in the output of manufacturing industries. Gross investment in the manufacturing industries fell by 42 per cent, that in plant and machinery alone by 33 per cent.¹¹ This is a far worse record than that of the Great Depression of 1929-32. Though there has been some recovery since 1981, the level of manufacturing production in 1985 was still 5,5 per cent below 1979, while investment in manufacturing industries was 18 per cent lower.

The other example I wish to mention is that of the United States of America. Here the Federal Reserve traditionally followed much the same kind of policies as European central banks, operating mainly through short-term interest rates and engaging in open market operations so as to ensure that actual rates conformed to the desired rates. In addition, the Federal Reserve maintained tighter controls on its member banks through the institution of variable minimum reserve requirements. But there was no attempt to regulate the quantity of money other than through the instrument of interest rates and changes in minimum reserve requirements.

However, in the monetarists' view all this was the wrong policy for securing stability of prices. To stabilise the economy and to avoid inflation what is needed first of all is to secure a steady growth in the money supply, not a steady rate of interest. Hence the "new" policy of the Federal Reserve, formally announced by Mr. Volcker, the Chairman of the Federal Reserve Board, on October 6, 1979, was to secure a slow and steady growth of the monetary aggregates M1 and M2 by varying the reserves available to the banking system through open market operations, irrespective of the

accompanying movements in the rates of interest. From that day on dramatic changes started to happen which were quite different from those expected. The money supply failed to grow at a smooth and steady rate; its behaviour exhibited a series of wriggles. The rate of interest and the rate of inflation, though both were very high at the start, soared to unprecedented heights in a very short time. By March 1980 the rate of interest rose to 18,6 per cent and the rate of inflation to 15,2 per cent (in annual terms), and a little later both were over 20 per cent - which had never occurred before in the United States since the Civil War, whether in peacetime or in war-time. And there was a mushroom-like growth in new forms of making payments and new instruments for circumventing the Fed's policy - through the invention of money substitutes of all kinds, like "now" accounts and money market funds, the transfer of business to non-member banks or to branches of foreign banks, and so on. The Fed's reply to all this was that the failures in its declared policies were all due to 'loopholes' in the existing system which must be closed. Congress obliged their friends in the Fed. very quickly, passing the Monetary Control Act of 1980, supplemented by invoking the International Banking Act and the Credit Control Act. These extended minimum reserve requirements to all deposit-taking institutions, whether or not they were member banks of the Fed., as well as to branches of foreign banks in the U.S. But none of this helped, as the British Radcliffe Committee foretold would happen twenty-two years earlier, when it said that the extension and multiplication of controls through a wider spread of regulated institutions would only mean that new forms of financial intermediaries and of transactions will appear which will cause the situation continually "to slip from under the grip" of the authorities.

The American monetarist experiment was a terrible failure, as was publicly admitted by Friedman and Meltzer in 1982, though they insisted that it was the fault of the authorities in not being able to run a monetarist policy properly. Short of the old Chicago plan for 100 per cent reserves there was certainly no way in which the authorities could have stopped the banks inducing the public to exchange more of their currency notes for deposits and thereby

enlarge the lending power of the banks. After a year and a half of continued failures and a chaotic volatility of everything - interest rates, exchange rates, inflation rates - the experiment was abandoned and the system returned, in effect, to the traditional policy of regulating interest rates but with a more deflationary stance; partly, I presume, to offset the inflationary force of excessive federal deficits - and thereby cause the rest of the world to suffer (or benefit, as the case may be) from the consequences of an overvalued dollar - more recently of an undervalued dollar though no one can explain why these switches occurred.

In retrospect none of this would have happened if the Fed. had studied and understood the analysis and prescription of the British Radcliffe Committee in 1958, according to which central banks should not really be concerned with the money supply as such - it is the regulation of interest rates, and not of the quantity of money, which in the words of that Report "is the centre-piece of monetary action".

In Britain "monetarism" has not been formally renounced but it is vieux jeu. Nobody watches the money supply figures any longer, and Ministers, though professing complete consistency in their policies, are increasingly forgetful about money, and increasingly emphatic about the need to moderate the excessive rise in wages - something which is quite contrary to monetarist philosophy. The economy has been slowly recovering since the middle of 1982, though the foreign trade position in manufactures continued to deteriorate. Britain, for the first time for centuries, became a net importer of manufactured goods. Her share in world exports in manufactures, which was on a slowly rising trend up to 1979, declined by nearly one fifth in 1980-84. Unemployment, at 13,5 per cent of the labour force, is far higher than that of any major developed industrial country. There is nothing to set against these losses in terms of greater mobility between industries, or in the field of quality and product innovation which would enable one to say that the monetarist experiment brought some

improvements as well as imposing large losses of output relative to Britain's enlarged potential.

In the United States, on the other hand, the continuation of a strict monetary policy conducted through a policy of very high interest rates, was far more than offset by the expansionary effects of the very large deficit in the Federal Budget, so that real GNP rose by nearly 10 per cent between the first quarter of 1983 and the first half of 1984, and unemployment fell from 10,2 per cent to 7,6 per cent.

The U.S. and U.K. experiments in monetarism have thus left Friedman and the monetarists in an intellectually highly embarrassing position. Friedman has admitted that as far as the United Kingdom is concerned, the money supply is not exogenously determined by the monetary authorities but he attributed this to the "gross incompetence" of the Bank of England. Later he implied the same about his own country. However, this puts an entirely new complexion on monetarism. It was nowhere stated in the writings of Friedman or any of his followers that the quantity theory of money only holds in countries where the monetary authorities are sufficiently "competent" to regulate the money supply. If the Bank of England is so incompetent that it cannot do so, how can we be sure that the Bank of Chile or of Argentina or Mexico - to take only the highly inflationary countries - are so competent, or rather so competently incompetent, as to make it possible to assert that the inflation of these countries was the consequence of the deliberate action of their central banks in flooding these countries with money? How indeed can we be sure that any Central Bank - not excluding even the German Bundesbank or the Swiss Bank - are sufficiently competent to be able to treat their money supplies as exogenously determined? And what happens if they are not? Surely we need a general theory of money and prices which is capable of embracing the cases of countries with "incompetent" central banks, such as Britain and the United States.

NOTES

- 1 The Bank of England was granted the monopoly of the right of issuing notes by a joint stock company in England in 1709, and most European countries granted such a monopoly of the right to issue notes to a bank which became the "central bank" - i.e. the bank which kept the reserves of all other banks. In the U.S. the Federal Reserve Banks were given the monopoly to issue bank notes in the present century.
- 2 Estimates given in the New York Herald Tribune's Special Supplement on Euromarkets, November, 1981.
- 3 The monetary authority is the note issuing central bank, which may or may not be acting with the consent or under the advice of the Government of the country concerned.
- 4 Friedman at one stage considered that this need not necessarily be the case, but that it has mostly been the case in the past, as a matter of fact (The Optimum Quantity of Money and Other Essays, Chicago, 1969, pp. 266-84), though in his latest book (Friedman and Schwartz, Monetary Trends in the United States and the United Kingdom, their Relation to Income, Prices and Interest Rates, 1867-1975, 1982) the exogeneity of the money supply is taken for granted without any discussion or argument.
- 5 For a critical appraisal of the latter assertions see Hendry and Ericsson "Assertion Without Empirical Basis: an Econometric Appraisal of Friedman and Schwartz", Bank of England Panel of Academic Consultants, Panel Paper No. 22, Bank of England, October 1983.
- 6 In the "Tract on Monetary Reform", London, 1923.
- 7 At one stage economists of both the Keynesian and anti-Keynesian persuasion appeared to be in agreement that the validity of the Keynesian theory hangs on an empirical issue - the interest sensitivity of the velocity of circulation. This entirely depended on the assumption that M is an exogenous constant. If, as is argued in this paper, M is endogenous and varies with the individual's demand for cash, the Keynesian theory would be refuted (not confirmed) by the absence of correlation between M and Y .
- 8 If our main proposition is correct, and the changes in the money supply arise in consequence of changes in the demand for goods and services, we would expect, in the course of the investment cycle, increases in the amount of money in circulation to precede increases in investment: the finance for a particular investment project has to be assembled first, before the actual expenditure is incurred.
- 9 This is the broader definition of money comprising both demand deposits and time deposits of the clearing bank.

10 The cause of this was their failure to recognise (in true monetarist fashion) that prices can rise on account of a rise in costs and not only the pressure of demand. Their first budget was deflationary in terms of the pressure of demand but strongly inflationary in its effects on prices on account of the switch from direct to indirect taxation, the rise in mortgage rates, charges for school meals, etc.

11 In all this it was the coincidence of the sudden large turn-around in the balance of payments due to oil with the deflationary policies of the Government which had the most unfortunate consequences. In order to take full advantage of oil as an additional source of income (amounting to 6-7 % of the GDP and 20 % of imports) internal demand needed to be expanded sufficiently to allow the foreign importers of oil (mainly the countries of the EEC) to pay for oil by exports (mainly of manufactures) without such exports followed were the very opposite, so that the benefit of oil, in terms of the GDP, was offset by the induced additional shrinkage of manufacturing output and employment.