

# 5 Monetary Policy in a Speculative Environment

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## 5.1 INTRODUCTION

A successful active monetary policy depends on monetary variables having a powerful and consistent influence on other economic variables. There is however a view that financial markets (as well as goods markets) are subject to unstable shifts in both demand and supply as a result of shifts in expectations. The formation of expectations and acting upon them we call here 'speculation'. Speculation is not limited to wealthy participants in the stock market—it extends to consumption and production decisions, as well as to more general choices between financial assets. It is the purpose of this chapter to outline this alternative view of the speculative environment in which monetary policy operates, in comparison with the more conventional, non-speculative view.

John Maynard Keynes, the father of modern macroeconomics, was not only an academic economist; he also made a fortune by speculating on the London stock market. His theoretical writing, in particular his (1936) *General Theory of Employment, Interest and Money*, seems to have been influenced considerably by his experience as a speculator. However, while economists since Keynes made considerable use of concepts he developed, such as the consumption function, most have played down the role he assigned to speculation. Speculation is given a part to play only as one motive for demanding money. Not only does this suggest that speculation plays no other part in the economy, but even that part has been diminished in importance as alternative reasons were put forward for the demand for money to be a function of the rate of interest.

The neglect of the speculative dimension of economic activity has had a significant impact on policy matters, particularly in the conduct of monetary policy under the Conservative government since 1979.

In this chapter we attempt to show how analysis of the economy is developed once speculation is incorporated as a central feature, with particular reference to monetary policy. It is shown that, rather than advocating control of interest rates or monetary growth at particular target rates, the speculative perspective suggests that monetary policy should be geared to promoting the stability of interest rates, and allowing the money supply to grow in line with demand. The chapter draws on the work of two economists who have *not* neglected Keynes' work on speculation, George Shackle (1974) and Hyman Minsky (1976).

In the next section, a brief outline is given of the conventional theory of monetary policy where speculation plays no significant role. The third section outlines the way in which speculation affects expenditure in general, while the fourth concentrates on speculation in financial markets, and the fifth on speculation and financial institutions. The concluding section includes a policy package, suggested by the theory developed in the previous sections.

## 5.2 MONETARY POLICY IN A NON-SPECULATIVE ENVIRONMENT

Speculation features in the conventional theory of monetary policy, if at all, as one of the motives for holding money, as suggested by Keynes himself. If money is held as an asset, rather than solely to finance specific expenditures, then the future value of *alternative* assets is of considerable importance. If other assets are likely to appreciate in value, then it makes no sense to hold money instead; on the other hand, money is preferable to a depreciating asset. When new assets are issued with lower interest rates than existing assets, the latter become more attractive and their prices rise; the reverse is true if new assets are issued with increased interest rates. So the speculative demand for money is low (and the demand for alternative assets is high) if interest rates are expected to fall and is high if interest rates are likely to rise. On the simplistic assumption that high interest rates are likely to fall and low interest rates are likely to rise, we can say that the speculative demand for money is a negative function of the current rate of interest. This statement encapsulates the *neo-classical synthesis* version of Keynes's theory of speculative demand.

But many economists were uncomfortable with the notion that money was held as an asset, a store of wealth; since money earns no interest, surely other assets would always be preferable. Empirical studies, however, did seem to show that actual money holdings did follow some pattern along with the rate of interest. Rather than

accepting the Keynesian notion of the speculative demand for money, however, the reaction was to find other reasons for the rate of interest to influence the demand for money. One of the two major alternatives was put forward by Baumol (1952), arguing that the interest rate was the opportunity cost of holding money. If the rate of interest rose, then the *transactions* demand for money fell because the opportunity cost of holding money had risen. The other major explanation, put forward by Tobin (1958), attempted to preserve the speculative demand concept by arguing that interest rates acted partly as compensation for the risk of changes in assets' value. People thus spread risk by holding a variety of assets, ranging from money with no interest but no risk to assets with high interest rates but high risk.

The upshot of these developments was that there appeared to be a stable relationship between the rate of interest and the demand for money. Meanwhile, monetarists were developing the argument that there was a stable relationship between the amount of money in the economy and total expenditure, and thus the price level. Keynesians were emphasizing rather the relationship between the rate of interest and investment, which in turn determined total expenditure via the multiplier. Whichever way you looked at it, there seemed to be a stable relationship between both money holdings and the rate of interest, and total expenditure.

Further, the process by which the money supply was generated was also viewed as being stable. Traditionally, the process was described by the money multiplier, which demonstrated how new reserves introduced into the banking system could support a much larger amount of loans and deposits, since banks are only required to hold a proportion of deposits as reserves. But the degree to which banks could increase loans and attract deposits depended on the interest rate, and the multiplier itself was shown to be a function of the interest rate. Further, new reserves entered the banking system primarily in response to demand, which in turn was a function of the rate of interest. As long as the central bank undertakes to meet any demand, through the Lender of Last Resort facility, the supply of money is determined by demand; both can only be controlled by controlling the rate of interest, raising it to choke off demand. This the Bank of England can do by adding to market demand or supply, as appropriate, to influence the market price. The Bank can choose to set a money supply target by manipulating the interest rate or vice versa.

From the mid 1970s, the main aim of macroeconomic policy was the control of inflation, by the control of aggregate expenditure. Monetary policy seemed to be appropriate, since controlling either the rate of interest or the money supply would control total expenditure, according to both Keynesians and monetarists. The main debate

among policy theorists thus centres on whether the Bank of England should concentrate on the rate of interest or on the money supply. Either would do as long as the demand for money was a stable function of the interest rate. A rise in interest rates would reduce the demand for money; alternatively a fall in the supply of money relative to demand would cause interest rates to rise. Keynesians argued for interest rate control, because it had a more direct effect on expenditure by discouraging investment. Monetarists argued for money supply control because it would have the more direct effect on both consumer and investment expenditure (although helped along by higher interest rates). There were further debates about whether it was a practical proposition to control the money supply in the first place. While the government's (1980) Green Paper on Monetary Control advocated a move towards direct control of the money supply by controlling bank reserves (the 'monetary base'), the greater emphasis in practice has remained on interest rates. Policy is expressed now in terms of target ranges for these money supply definitions, but without rigid adherence to the targets; particular attention is paid in addition to the exchange rate as an important influence on inflation. (See Bank of England, 1983a, 1983b.)

Now, while speculation is no longer explicitly mentioned in conventional monetary theory, it is not denied that it occurs. Indeed, if any mention is made at all of decisions made with respect to the future, it is hard to deny that speculation occurs. The important question is whether it is stabilizing or destabilizing. Friedman (1953) has denied that destabilizing speculation can occur (or at least, that it has been observed to occur – see Friedman, 1970). Any speculator who bought assets as their price rose and sold as their price fell (thus adding destabilizing fuel to price movements) would lose money and be driven out of the market. But if speculation can only be stabilizing, it simply helps to make the market process work more smoothly, ironing out fluctuations occurring for other reasons. Speculation simply helps the economy to reach the long-run equilibrium position it was heading for anyway. Speculation in this sense goes under the name of rational expectations.

We now proceed to discuss speculation in the much broader sense intended by Keynes, and re-examine the way in which monetary policy should be designed if it is to contribute to the stabilization of aggregate demand.

### 5.3 SPECULATION AND THE LEVEL OF AGGREGATE DEMAND

Speculative behaviour is central to the very idea of capitalism. But most textbooks underplay this crucial point; they depict demand and cost curves as if they are objective, perfectly known features. In a capitalist economy entrepreneurs make profits by hiring factors and purchasing raw materials in the present, and selling outputs of goods and services derived from them for a higher revenue at a later date. Entrepreneurs may know what their present outlays are – on stocks, fixed capital and wages advanced to workers – but they will usually be rather uncertain as to the total output these outlays will generate. They will be even less sure at what prices they will be able to sell particular volumes of output in the future; their demand curve exists only in their imagination as a set of forecasts based on hunches they have about the market conditions. No amount of information on *past* sales will provide certain knowledge about the future. If their guesses turn out to be wrong they may find themselves bankrupt: making losses, not profits.

The inherently unknowable nature of the future forced Keynes (1936, especially ch. 12) to ask from where entrepreneurs got their confidence to invest. His answer was that much depended on the 'state of the news', on psychologically fluid 'animal spirits', and on observations of how other entrepreneurs were behaving. Entrepreneurial behaviour from this standpoint is seen as based on exceedingly flimsy conjectural foundations and interactions between diverse opinions. It can be prone to sudden changes of direction as the state of the news causes shifts in confidence. Shackle describes investment behaviour as inherently *kaleidoscopic* (referring to the child's toy, the kaleidoscope, where slight movements can produce dramatic changes in multi-coloured patterns observed through a peep-hole). Another analogy, suggested by Coddington (1976) in the light of Shackle and Keynes, is of behaviour during riots – demonstrators taking their cues from each other and from a few opinion leaders.

Entrepreneurs are continually on edge because they are afraid of making losses by sinking money into assets with poor income flows and secondhand values vastly below the price they have paid for them. When they are pessimistic they hold on to their money, foregoing the slim prospects they perceive of profits in order to avoid the possibility of capital loss.

Very much the same predicament is faced by consumers. They are also confronted with an unknowable future and the possibility that they will buy the wrong things and thus make costly mistakes. The

demand curves imagined by entrepreneurs may fit reality very poorly if consumer choice, too, is highly contingent upon flimsy, shifting expectations and crowd behaviour. Expenditure can dry up suddenly or explode into a consumer boom on the basis of mere shifts in consumer confidence and snippets of news.

For example, if rumours are in the air suggesting that I might lose my job, I will be foolish if I commit myself to regular hire purchase payments on a new car, whose capital value falls by hundreds of pounds the moment I drive it out of the showroom. And if I, for reasons of pessimism, cut down my expenditure on items of conspicuous consumption, my neighbours will not need to spend so much either to preserve their positions of relative status. We all simply drive round in rather older cars and attempt to keep more money in our bank and building society accounts, or reduce the extent of our indebtedness. The flow of expenditure dries up, even if nothing has happened to the money supply; the velocity of circulation declines. But because expenditure has fallen, incomes and employment will fall. Redundant car workers do not have money in their bank accounts to spend, because I have immobilized it in my account, or have failed to increase my indebtedness to a financial institution. My fears of redundancy cause redundancy for others, and may indeed turn out to be self-fulfilling.

This kaleidoscopic view of consumer demand is one to which we may adhere not merely on the basis of armchair theorizing but also in the light of empirical work by Katona (1960, 1976) and Smith (1975). Katona's work shows a close relationship between shifts in consumers' confidence in the ability of their governments to manage the economies in which they live (his 1976 study looks at OECD countries) and shifts in the level of consumer investment, that is expenditure on durable goods. Smith's study of the US car market shows that the demand for cars was highly unstable and related more to changes in confidence than the age of cars or availability of hire purchase finance.

As far as matters of monetary policy are concerned, this view of entrepreneurs and consumers suggests it may be foolish to believe, as monetarists do, that there is a direct link running from the volume of money in the economy (on some arbitrary definition) to the volume of aggregate demand. In a world of speculative economic behaviour, any close relationship between the quantity of money and the quantity of nominal expenditure may be explained by a reverse mechanism of causation, a mechanism which happens also to make the velocity of circulation *appear* stable. This reverse mechanism is as follows. A decline in the desire to spend leads to a smaller growth in the money supply than would otherwise have occurred, because the supply of

money responds passively to the demand for it. For example, if I decide not to buy a car, I will not need to increase my overdraft with my bank; the same situation arises with a company which does not borrow to finance an investment scheme because it has decided not to carry it out. The bank, in consequence, will simply be less heavily loaned up than it might have been.

Thus, within a speculative environment, expenditure may not be a stable function either of the money supply or of interest rates. So controlling either will not have a predictable effect on inflation. Even if it has been observed in the past to be related to the money supply or interest rates, it cannot be concluded that a change in either will *cause* a change in expenditure.

#### 5.4 SPECULATION AND INTEREST RATES

In Keynes's analysis of monetary theory, interest rates are depicted as being held where they are at present because holders of monetary assets expect interest rates to be elsewhere in the future.

According to Keynes's speculative motive, individuals who hold wealth in the form of cash do so because they expect the rate of interest to rise and security prices to fall; others who decide instead to hold government stocks do not believe interest rates are going to fall. The balance of opinion determines the rate of interest. But the opinions are contradictory; someone has to be wrong; someone will wish, after the event, that they had taken the other position.

Since interest rates and security prices are held where they are because some people expect that they are going to change, any failure of interest rates to shift in the expected direction will, sooner or later, cause some of the speculators to revise their opinions. If someone is staying out of bonds because they expect interest rates to rise, a tendency for interest rates *not* to rise will suggest that their expectation is incorrect. If they, and others, conclude that interest rates are instead probably going to fall, the natural course of action will be to get out of cash and buy government bonds. The extra demand for bonds will cause their prices to rise and interest rates to fall, confirming the expectations of those who bought the bonds, but falsifying the expectations of other speculators.

Once more, then, we have a vision of speculation and fears of capital losses, set against hopes of capital gains, tending to make markets inherently unstable. Once more, this is in sharp contrast to the prevailing monetarist wisdom. Let us now consider what insights Keynes's view of interest rates gives us in respect of monetary policy.

In Keynes's theory attention is focussed on money which is being

used for speculation. People hoard money, either as cash or in bank deposits, because they are afraid of the risks of committing themselves to physical and financial assets. This causes asset prices to be lower than otherwise might be the case, and makes the issue of new securities and the creation of new physical assets less attractive. It is not that the money does not exist to finance more expenditure; it is simply that a lack of confidence deters people with holdings of wealth from lending it to others who would like to carry out the expenditure. The government, by manipulating the 'state of the news', may be able to bring about a shift of confidence. If so, it will be able to finance increased expenditure by selling new government bonds without bringing about any rise in the rate of interest, despite not also increasing the money supply. A government which increases its borrowing simultaneously with announcing that it will take steps to ensure that interest rates do not rise in consequence (for example, by saying that the Bank of England will stand ready to purchase stocks to stabilize interest rates) will find a ready market for its new issue of bonds.

In monetarist theories of interest rates, the emphasis is on money being held for future transactions purposes or to meet contingent expenditure needs (for example, due to illness or redundancy) – that is, for financing likely expenditure – rather than as a speculative hedge for avoiding losses in the value of wealth. It is as if all money is already tied up in expenditure schemes, as if some kind of full employment prevails in money markets. On this view, a government can only sell stocks to finance increased expenditure by bidding money, *which otherwise would have been spent*, away from other uses, by offering a higher rate of return. This is known as 'crowding out'.

The crowding out idea might seem quite plausible to anyone who thinks of 'people who hold money' as private individuals, who do not normally speculate on money markets because any prospects of higher returns than they can obtain from deposit accounts in banks or building societies would be swamped by brokers' fees. But the vast bulk of financial wealth is owned by institutions – corporations, pension funds, insurance companies – who can, by trading on a large scale, overcome the barriers to financial speculation normally posed by brokers' charges, and who can focus their attention on the detailed events in the City of London in a way which is impossible for the ordinary worker. And, by well-conceived attempts to manipulate the expectations of managers of these institutions, governments may be able to finance reflationary spending schemes without having to increase the money supply and without having to allow a rise in interest rates to draw idle bank deposits into an active financial role.

Once more, our analysis also leads us to see no necessary

relationship between the size of some definition of the money supply and the level of nominal aggregate demand; account must be taken of the level of confidence, how willing 'people' are to exchange money for assets of uncertain resale value.

If the economy is in a highly pessimistic state, attempts by the Bank of England to engineer a monetary expansion, and hence promote higher aggregate demand, may be relatively ineffectual. If the Bank makes it known that it will lend to clearing banks on more favourable terms than hitherto, the latter may be rather unwilling to take advantage of this easing in their ability to create credit. Already they may be less than fully loaned up because they cannot see any more creditworthy potential customers in the group of would-be borrowers. There is little point in lending if you do not expect to get the money back and if attempts to reduce the damage a default would cause, by asking for yet higher interest rates, might merely make the default all the more likely. And, on the customers' side of the loan, there is little point in attempting to borrow if the prospect of disaster looms large: a small reduction in interest rates makes the scale of the disaster smaller to a borrower whose income flow, for whatever reason, dries up, but the disaster of not being able to keep up the payments occurs nonetheless. Hence, in pessimistic times the queue of would-be new borrowers may be reduced to the ranks of the financially foolish. Thus, the money multiplier is unlikely to be a stable function of the rate of interest.

But, just as attempts to stimulate new bank lending may make little impact in a period of pessimistic stagnation, so attempts by the Bank of England to prevent expenditure by a monetary squeeze may be doomed to fail if people are determined to spend. If the Bank tightens the terms on which it makes funds available to clearing banks, the latter may still be perfectly willing to expand their overdraft facilities, despite the greater cost, and find willing takers. Where bank financing forms only a small part of the total financial outlay in respect of a particular scheme, it may still be worth borrowing to finance it, even after a high rise in interest rates, because the opportunity cost is so high. In a situation where activity is declining, the marginal returns to a loan can be very high indeed if the alternative is the break up of a company in bankruptcy.

In the past two years the Monetary Authorities' failure to give any weight to this aspect of monetary economics has led them to drive up interest rates in attempts to reduce the growth of the money supply, only to find that this makes it harder for companies to finance their operations: rising interest charges force them to borrow more, not less, in many cases, and so the money supply expands. The demands of companies for funds for 'distress borrowing' are also enhanced by a

drying up of informally provided 'trade-credit': as companies get worried about their customers' abilities to pay, they reduce the time span over which they are allowed to meet their bills. This forces companies further along the chain to behave similarly – at some point some firm has either to borrow more from a bank, or to contract the scale of its purchasing, passing the buck back along the chain and increasing the financial difficulties of supplying companies.

Thus, although the authorities have chosen to implement monetary control via interest rates, it has not proved to be effective. The demand for money has not proved to be a stable function of the rate of interest. In the last section, the 'speculative' approach was seen to cast doubt on the stability of the money supply–expenditure relationship: here we have extended that doubt to the money demand–interest-rate relationship.

## 5.5 SPECULATION AND COMPETITIVE BANKING

The foregoing difficulties of using interest rates to control the demand for money and thus aggregate spending have, in the past two years, led to suggestions that the money supply be controlled more directly. Among other things, this would require that the 'Lender of Last Resort' role of the Bank should be phased out (see Dow, 1982). Banks should be constrained in their lending by their cash ratios alone. If an individual bank wished to expand its private sector lending, and was already fully loaned up, it would have to bid against other banks for cash reserves, trading in government bonds for cash. This would tend to cause a fall in bond prices and a rise in the rate of interest. If the Bank of England were no longer to step in as a purchaser of bonds to stabilize their prices, interest rates would have to find their own level. The idea is that if there were strict control over the volume of cash in the system, changes in the scale of overdrafts provided by clearing banks to financially hard-pressed customers would take the form of loans made at the expense of other customers, not new loans made possible by accommodating lending by the Bank of England.

Minsky's (1976) development of Keynes's ideas leads us to suspect that such a policy, ruthlessly applied, would comprise a recipe for disaster. Minsky emphasizes that modern financial systems are multi-layered debt structures – a point which should already be apparent following our discussion of trade credit chains – and the ability to borrow of any element in these systems is heavily dependent on the perceived value of its collateral. If a wave of pessimism sweeps over an economy asset prices will tend to fall – the price of shares on the stock market, for example, will fall as expectations of dividends

are revised downwards – and so, too, will expenditure. Since this reduction in expenditure will only have been anticipated imperfectly, some firms will be left with unsold stocks to finance and will need to borrow more to stave off bankruptcy. But the willingness of 'people' to lend will be falling too. Would-be borrowers may, because of the collapse of asset values and expectations of future income flows, be unable to arrange loans and consequently, go bankrupt.

Financial layering means that bankruptcies at one level promote further bankruptcies, and a further scramble for finance to prevent them. Rising interest rates must be the upshot of such a scramble, but they will only exacerbate the problem by reducing asset prices and the value of possible loan collateral still further.

Some indication of Minsky's analysis at work is given by the behaviour of the British property market in 1973–5, and the effects it had on the City of London. In the 1972–3 boom, excessive confidence in the ability of property to provide a hedge against inflation had caused a massive rise in property prices, for the supply of property was relatively fixed. Property firms found the values of their assets rising and used them as collateral against loans to finance further purchases of property. These loans were provided by 'secondary banks', less reliable institutions than clearing banks, which had been able to attract deposits or borrow relatively cheaply on the 'London Interbank Market' as a result of the state of high confidence.

When the property boom came to an end in the pessimism of the Yom Kippur War and with the rise in oil prices at the end of 1973, property prices fell. Since rental earnings could not pay for interest on debts incurred by the property firms, they had to sell off their assets instead. No longer could they use capital gains to meet financing charges in excess of rental yields. Asset sales merely exacerbated the situation. Some property companies failed and this cast doubt on the capital adequacy of the secondary banks (some of whom are 'incestuously' linked with particular property firms), causing a withdrawal of deposits. Secondary banks, too, thus found themselves facing collapse. The plague of failures even threatened to spread itself to the big clearing banks. For a time, the shares of the National Westminster Bank fell below par – something unheard of in such a bank – because of its involvement with the failed London and Counties Securities group. The cumulating collapse was only stopped by the Bank of England stepping in with a financial 'lifeboat' of loans, which aimed to reduce the rate of liquidation of failed firms' assets and thereby to limit the extent of the collapse in asset prices. But the delay in the Bank's Lender of Last Resort action had already enabled a substantial catalogue of failure to accumulate (see further Dow and Earl, 1982, ch. 12).

The Bank of England responded to this experience by extending its supervisory role over a broad range of financial institutions, under the Banking Act of 1979. A series of consultative documents was also issued with proposals for influencing the portfolios of the entire range of deposit-taking institutions, to ensure solvency. (See Dow, 1982.)

The financial chaos of the mid-1970s occurred after the Competition and Credit Control regulations of a few years before had allowed the 'free entry' of precisely those kinds of institutions which failed. It occurred even despite there being no policy decision to prevent the Bank of England from stepping in rapidly with funds to support asset prices. With an effectively passive Central Bank, the free market's unguided search for an equilibrium level of interest rates, in a situation where confidence had completely collapsed, could have dealt a fatal blow to the international credibility of London as a financial centre. A collapse of confidence in the system as a whole, now that foreign exchange controls have been removed, could also lead to a massive outflow of foreign funds and an inflationary collapse of sterling's international value. Free market banking, an absence of foreign exchange controls, and a commitment of the authorities against intervention in a disequilibrium situation would leave the financial sector – perhaps even the economy as a whole – in an extremely vulnerable position.

The 1979 Banking Act represents an attempt to forestall such a situation. But, although monetary base control as such was not in fact implemented, the freer competition it attempted to promote is still cause for concern. Competition is only effective when the threat of bankruptcy is real; and bankruptcy within the financial sector can have very damaging consequences.

In this section, therefore, we have demonstrated the dangers involved in controlling the money supply itself or indeed of any rigid system of control – dangers recognised by the Bank of England (1983a). An *effective* system of control would lead to failures of financial institutions, which could lead to the collapse of the financial system itself.

## 5.6 CONCLUSION

The introduction of a speculative perspective into monetary economics leaves the Keynesian theorist alarmed at the likely outcome of policies developed from the standpoint of a world view that is blind to the destabilizing potential of financial speculation. But the existence of speculators – and we ourselves as consumers, with our discretion in the timing of purchases of durable goods, must count amongst the

ranks of speculators – raises fundamental questions about how the economy should be managed.

The scope for changes in 'the news' to send the economy lurching off discontinuously in different directions means that demand management should be alert to the 'mood' of the economy as much as to measured relationships based on past experience. Second, institutions (particularly in the financial sector) should be designed to limit as far as possible the destabilizing effects of speculative shifts. Third, both monetary and fiscal policy should be implemented in such a way as not to *cause* destabilizing speculative shifts (which would undermine the effectiveness of policy).

In terms of monetary policy, then, the capacity to promote a steady growth of aggregate demand without destabilizing financial developments would be enhanced by the following measures:

- 1 The money supply should be allowed to grow in line with the demand for finance; that is, monetary policy should be passive, but passive in the reverse of the sense entailed in present non-interventionist thinking. The Lender of Last Resort should lend on demand and not attempt to manipulate interest rates.
- 2 No attempt should be made to control expenditure by manipulation of interest rates. Small shifts in interest rates are ineffectual in promoting increases or reductions in the level of expenditure. Large shifts, because of their effects on asset values, are liable to be fiercely powerful (that is, a big increase in interest rates, to reduce the growth of expenditure, will cause a big fall in asset values and a speculative collapse instead of the intended moderate reduction).
- 3 Foreign exchange controls should be reintroduced to prevent divergences between (stable) domestic interest rates and overseas interest rates from causing destabilizing currency flows and exchange rate movements.
- 4 Entry into the business of banking should be carefully controlled, followed up by close supervision.

At present, fiscal policy is subservient to monetary policy, with public sector borrowing limited to allow monetary targets to be met. Having demonstrated the difficulties attached to an 'active' monetary policy, we propose that fiscal policy be the main vehicle for demand management. Fiscal policy within a speculative environment must take account of the role of expectations in influencing private sector expenditure plans. Thus the *awareness* of the existence of the social security system acting as a cushion encourages more stable spending patterns when the employment future is uncertain; this fact itself, by bolstering aggregate demand reduces actual social security expendi-

ture. More generally, the *presentation* of fiscal policy is as important as its content. In wartime as in 'Buy British' campaigns it has been demonstrated that individuals are not selfish economic automatons but are open to persuasion to act in what they are persuaded to perceive as the social interest. This is a fact of political life. It is the task of economists to suggest what policies, given the range of possible social goals, are in fact in the public interest.

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## QUESTIONS FOR DISCUSSION

- 1 'Whilst the weakening of credit is sufficient to bring about a collapse, its strengthening, though a necessary condition of recovery, is not a sufficient condition' (J. M. Keynes (1936), p. 158). Discuss.
- 2 'Demand depends not merely upon a consumer's ability to spend, but also upon her willingness.' Discuss the complications this causes for attempts to manage demand by monetary means.
- 3 Is the level of spending determined by the level of the money supply, or is the level of the money supply determined by the level of spending? In your answer, be careful to explain what you mean by 'the money supply'.
- 4 What is the money multiplier? In what way(s) is it influenced by the rate of interest?
- 5 Why is the speculative demand for money usually expressed as a negative function of the rate of interest? Are there any circumstances where the speculative demand for money might rise even though the rate of interest had not fallen?
- 6 What factors might explain a negative relationship between the demand for money and the rate of interest, other than the speculative demand for money?
- 7 Why do we assume that actual money holdings (the money supply) represents the demand for money?
- 8 'Changes in the quantity of money affect interest rates rather than prices.' Discuss.
- 9 What are the functions of money? How does the government limit the amount of money that banks are able to provide?
- 10 'Monetary policy is preferable to fiscal policy as a means of controlling the economy because it is less discriminatory.' Discuss.
- 11 How are interest rates determined?