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The year monetarism dies?

Debauch the currency, said Lenin, and capitalism will collapse. When the inflation rate in rich capitalist countries was rising towards 14% six years ago, the capitalists heeded his words. They plumped for monetarism, and brought inflation down to 4% in 1985. Ungratefully, the most assertively monetarist governments then turned on the ism that had saved them. America's money supply grew faster than planned. Britain's Treasury dropped its main target for monetary growth. Before the two governments let monetarism vanish from their minds this year, they should remember some of the painful lessons from the 1970s.

What mattered most in monetarist thinking is still true: the idea that, except in the short run, an economy's output is determined by its microeconomic structure, not by aggregate demand. Governments that try to get more output simply by expanding demand will sooner or later get more inflation instead. From this kernel of truth two other things followed. First, activist macro policies will often lead to exaggerated cycles of inflation and depression; stable policy means a more stable economy. Second, if workers and firms know that policy is stable, the economy will reach the path of non-inflationary growth all the sooner, and with less pain while it does so.

These broad principles are no longer distinctively monetarist; many modern Keynesians accept them. But one bit of pure monetarism has gone wrong—the view that the best way to make macro policy both stable and seen-to-be-stable is to set targets for monetary growth. The financial revolution in America and Britain has blurred many of the lines between different types of "money", and introduced new versions as well. Money is now much harder to define and control, and individual measures of monetary growth are a poor guide to short-term movements in demand.

The baby-bathwater danger

Instead of concluding that everything about monetarism is wrong, governments ought to keep its long-term principles and ditch only its short-term targets. They probably won't. The clear danger is that, as Britain and America approach their next elections, sense and nonsense will both go down together.

In Washington, it has become eccentric to say that faster inflation is still a threat. All but the Fed assume that because inflation is unlikely to jump during the next few months, it will not jump during the next few years. Worse, senior American Treasury officials are describing their own approach to economic policy in the crudest Keynesian terms, wet 1960s' vintage. Thus: if real GNP is growing by less than some hypothetical potential (say 4% at an annual rate), monetary policy can safely be eased. This ignores the plainest moral from the inflationary 1970s, that governments should never tie their macro policies to "real" targets like production and employment. Such levers as monetary and fiscal policy shift the nominal economy—ie, the money value of output. They cannot fix the way that total money GNP divides between real output (and jobs) on one side and inflation on the other.

Merely by discussing policy in terms of real growth, the Reagan administration is risking the wrath of the bond market. Money managers have not forgotten that bonds lost two-thirds of their value in the 1970s, when long-term interest rates jumped along with inflation. At current interest rates, investors would quickly stop buying American Treasury paper if inflation revived—and the Treasury has to sell $800m of bonds and bills every working day to finance its budget deficit, let alone what it needs to refinance maturing debt. Now that Wall Street sees the Fed under pressure to loosen up, expectations about economic policy have degenerated into guesses about when Mr Paul Volcker, the Fed's chairman, will find another job.

It should be easier to make coherent policies in Britain, because the power to do so is more concentrated. Partly for this reason, and partly because Britain's inflation is more prone to revive than America's, the anti-inflationary talk of Mr Nigel Lawson is still quite tough. But only by American standards. The City is rightly dismayed that the chancellor's medium-term strategy has collapsed into pre-election ad-hocery: a target dropped here, an asset sale fudged there, robustly worded but entirely non-committal commitments to take the exchange rate into account (hasn't he always?). This is not the stable climate of expectations that the Thatcher government proclaimed in 1980.

Nobody should pretend that running a steady monetary policy is easy. How odd it would be, though, if the difficulties—reminders of the economic impotence of governments—should revive the myth that policy mak-

ers have the knowledge and ability to drive output to whatever potential they judge to exist. Let the lesson be that their macroeconomic powers are even more limited than most cautious people thought five years ago, and the need for a believable commitment to stable and non-inflationary policy all the greater.

The least-bad way to make that commitment is to set, and hit, targets for money GDP or GNP. That does not make monetary policy irrelevant. On the contrary, its long-term significance can be great. Between 1979 and 1985, America's nominal GNP rose by 61%—and its M1 measure of money supply by 58%. Month-by-month, monetarism may have become a fickle guide. For the long haul, its rules still look surprisingly useful.

Bienvenido Iberia

A Europe of 12 is not too big

Ten to twelve is well past the eleventh hour. Yet the common worry about the entry of Spain and Portugal into the EEC on new year's day—that as a 12-member community it may seize up for good—is mistaken. So is the fear many northern Europeans feel that by absorbing Iberia the community will take on an indelibly Latin or Mediterranean hue.

Short-sighted Europeans have always worried that new members could ruin their club. The original six-member community started out as a successful postwar bridge between the largely complementary economies of two former enemies, Germany and France. Unhappily for the EEC, its first big enlargement, which brought in Britain, Denmark and Ireland in 1973, coincided with the first of two deep world recessions. The little-Englandism of the British, the Scandinavian loyalties of the Danes and the tactical pleading of the Irish made worse for the EEC what was bound to have been a difficult decade even without them. When Greece made the nine into ten in 1981, it added a cocky and unco-operative voice of its own.

No need to learn Latin

Yet the community survived. The European Monetary System is working reasonably well, and the British have dropped most of their objections in principle to eventually joining its exchange-rate mechanism. Since France's inflate-alone failure in 1981-82, the European co-ordination of national economic policies has grown appreciably. Instead of putting up trade barriers against each other, the 12 are at least in theory committed to dismantling non-tariff trade obstacles within the common market by the early 1990s. The habit of foreign-policy consultation is growing. A squeeze on the community's outdated and overgrown farm policy has at last started, it is to be hoped, in earnest. Direct elections, a determination to have its voice heard by the council of ministers—and the occasional intriguing scandal (see page 50)—have made the European Parliament a familiar fixture.

All this means that 1986 is a happy year in which the community can take in a grand but long-neglected (because only recently democratic) part of Europe's history and culture. Will the entry of Spain and Portugal create a Latin axis that might split the community a decade from now? Spain and Portugal will share an interest with Greece and Italy (but also with Britain and Ireland) in generous social and regional funds. Agricultural Iberia should also want to help turn a demented Common Agricultural Policy that gives price subsidies to efficient, rich and mainly northern farmers into a slightly saner one that gives direct income-support to poor, mainly southern ones.

But little more than this binds together non-Latin Greece, Atlantic-facing Portugal, and those rival producers of citrus fruits and olive oil, Spain and Italy. Nor is there much in common between the boisterous populism of Greece, the subtle inertia of Italy's government, the nearly two-party division in Spain, and Portugal's kaleido-chaotic politics. Spain's and Portugal's combined population of 48m, and their joint 1984 GDP of around $180 billion is not going to shift the decision-making or decision-blocking power away from West Germany, France and Britain (population: 172m, joint GDP $1,500 billion).

In foreign policy, the EEC is unlikely to look south any more or less than it does today. Spain and Portugal will keep their links with old Latin American and African dependencies—just as Britain has kept its ties with the Commonwealth, France its interest in its former colonies, Italy its Mediterranean connections and West Germany its closeness with Eastern Europe. Such success as Europe has had in creating common foreign policies has depended a lot on not trying to erase or entirely Europeanise these special relationships with countries outside the club.

This toleration of national-mindedness has marked the creation of its supposedly common policies in other fields. Like an old and wily church, the community has from the beginning granted all sorts of exceptions and indulgences in the cause of its own survival. The addition of Spain and Portugal will test the community's skills at this game. But with a bit more majority voting in the council of ministers, it ought not to be impossible for the community to pull off its old trick of giving governments the leeway they want in order to keep the club together. Both Spaniards and Portuguese favour the idea that the EEC should be moving, however slowly and awkwardly, towards a form of political union. By admitting them—for clearer political than economic reasons—the rest of the community has shown that this ideal is not dead.