Comments on the Paper by Alan Budd, Sean Holly, Andrew Longbottom and David Smith

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Of the three sections comprising the paper, the first is of no applied economic value. It is concerned with definitions of who is a monetarist and who is not a monetarist. The discussion strikes me as scholastic and sterile. Every one of the issues on which opinion is said to be divided could be settled by empirical evidence. Why should we rely on models that ‘can show that exchange-rate targets are superior to money-supply targets as a method of controlling inflation’? If there is evidence that manipulation of exchange rates by monetary authorities has been successful in controlling inflation, that is the citation the paper should offer. I do not know why ‘views on the relative sizes of the interest elasticity of demand and the income elasticity of demand for money provide an important distinction between monetarism and non-monetarism’. There should not be ‘views’. There should be evidence.

I accept the first of the propositions the authors state as the meaning of monetarism, namely, that there is a stable demand for money, because I believe there is an impressive body of evidence to support it. I would qualify their statement of the second proposition which they define as ‘changes in the money supply have been an independent source of changes in prices’, by adding to ‘changes in the money supply’ the qualifying phrase ‘relative to changes in output’.

The authors comment that Laidler’s proposition concerning monetarism, namely, fluctuations in the quantity of money are the dominant cause of fluctuations in money income is not necessarily implied by their model, because there have been ‘independent changes in nominal income which have been accommodated by passive changes in the
quantity of money’. I believe there is evidence that that is only a partial account of the direction of influence. A demand-determined change in money supply will still have a dominant effect on subsequent changes in money income. In section II of the paper, the reference to ‘a significant feedback from sterling M₃ to the rest of the economy’ may be consistent with that evidence.

HISTORICAL EVIDENCE

In section II, the authors present historical evidence on the long-run relationship between money and income. As they say, if there is an autonomous change in the money supply and if there is a stable demand for money in terms of income and interest rates, then the restoration of equilibrium will require a change in nominal income and a change in interest rates (however, see the comment below on this point).

The authors state that the existence of a stable demand for money has been explored in two ways, first, by attempts to estimate a demand function directly, second, through the estimation of reduced-form equations relating nominal income to the money supply. They discuss the latter case, saying, ‘it is possible to estimate such reduced-form equations while it is not possible to estimate demand equations by the direct approach’, whether short-term or long-term demand functions. Instead, they rely on graphical evidence to explore the long-term relationship between money and nominal income, based on an array of definitions of money.

Let me therefore digress by reporting on work that Milton Friedman and I have recently completed and included in a book that is now in press.¹ We estimate a stable demand function for the UK M₂ definition of money and a reduced-form equation relating nominal income to the stock of money for the period 1874–1975. Our results are not relevant to short-term policy, since we eliminate short-term cyclical fluctuations by taking the cycle phase (a cyclical expansion or a cyclical contraction) as our basic unit of analysis. All our data has been converted into averages for such phases and into rates of change based on the phase averages.

The variables we include in the demand function for the United Kingdom to represent the demand for money, expressed in real per capita terms, are:

(1) Real per capita income.
(2) The difference between the nominal yield on short-term securities