MONEY AND INFLATION

A. A. Walters

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The views expressed in this study are the author's and do not necessarily represent those of Aims of Industry

MONEY AND INFLATION

I

It is a simple but well-attested principle of economics that the more plentiful a commodity the lower will be its price. Summer strawberries are much cheaper than winter ones. So men have long reasoned that the same sort of rules must also apply to money. An increase in the supply of money will cause the "price" of money to fall. In this context the "price of money" means that one must give up a smaller quantity of goods or labour in order to acquire a pound sterling. This implies that the prices of all other goods and labour services rise: hence the simple rule that more money means higher prices. The general principle is that high prices are *caused* by too much money.

This most famous law of economics—the "quantity theory of money"—might be thought to be almost self evident. But, alas, the evidence of recent years shows that distinguished statesmen have ignored or positively rejected this principle. There are two ostensible reasons for rejecting the quantity theory. First, it is argued that an increase in the quantity of money will give rise to a larger demand and a larger flow of goods and greater volume of employment. (The reader may recall the boom-and-bust speeches of Messrs Barber and Heath.) A large monetary demand will be manifest in a higher rate of growth and, it is alleged, this will offset the pressure to raise prices; miracle growth, vanishing unemployment and constant prices will be the result of expanding rapidly the money supply.

Secondly, it is argued that an increase in the money stock is not the real cause of inflation of the price level. Prices are determined by costs of production and these, in turn, are generated by the thrust of trade union power and by the prices of our imports from abroad. We may blame inflation on the motley crowd of Joe Gormley, Jack Jones, Sheikh Yamani, and Harry Hyams. Trade unionists, foreigners, and property speculators are the causes of our cost-push inflation. It would be rough but sufficient justice to paraphrase the official view that "more money causes growth, not inflation; trade unionists, foreigners, speculators and other monopolists cause inflation; the Government is innocent."

I shall argue that there is some truth in the proposition that more money will generate growth, but the important point is that such an increase in the flow of goods *will be only transitory and will quickly disappear.* Indeed, the economy will thereafter fall into a decline *below* its normal rate of growth, and unemployment will again grow to "unacceptable" levels. Furthermore the economy will not merely end up with no increase in the rate of growth, but there will also be a *permanent* increase in the rate of inflation. The belief that either trade unionists or foreigners cause inflation is merely a fallacy, indeed, an understandable fallacy of composition. I shall argue that it is better to have open rather than suppressed inflation. Finally, I shall review some of the political consequences of this monetary process and the hopes for years to come.

II

Let us suppose that the Government, which had been increasing the money supply at three per cent per annum, raises this rate of increase to 23 per cent per annum. Now it is unlikely that there would be any inflation in the first instance since the trend rate of growth of real output in the British economy is of the order of three per cent. Consequently, the three per cent expansion in money stock just matches the increase in the supply of goods. With a rate of growth of the money supply of 23 per cent, however, this is no longer the case. People will find that they have "too much" money relative to the quantity of other goods, and will be attempting to "get out of money and into goods"; thus the demand for goods is increased.

The reaction of a businessman to an increase in the demand for his product is well known. He will not immediately increase the price. First he will wish to make sure that the increase in demand is permanent and not a flash in the pan. Thus the first reaction is to produce more from existing resources. Any slack is taken up, stocks are run down, short-time working is eliminated, and the quantity of output of the firm is increased and sold readily at the existing prices. Thus it seems that there is an increase in the rate of growth without any increase in the price level. It seems, therefore, that one can have unusually high growth without inflation. And it is tempting to end the story at this point; but we must face the consequences and go on.

The businessmen who have run down their stocks and eliminated part-time working will be induced to attempt to hire more labour and to buy more stocks of raw materials to keep the higher rate of production going. But, of course, *all* businessmen will be there trying to buy labour and commodities. The price of such raw materials would be increased, and one would find that the wage rates of labour, particularly those of skilled workers in short supply, would rise quickly. The businessman will then say that "costs have risen", and so he must put up his prices; he will agree that it was not the rise in demand that gave rise to his need to increase prices; on the contrary the higher demand kept down costs because of the greater throughput. It was the cost-push that caused it all. The corollary is that if we could only keep down the prices of raw materials and commodities and the wages of labour, then we would beat inflation.

This is the most important and fatally-wrong diagnosis. In economics it is very common to mistake appearances for reality, to attribute blame to the proximate "causes", or, to put it in the vernacular, not to look farther than one's nose. But there is a very good reason for governments and their advisers stopping at their noses. The real cause of the inflation is the accelerating money supply, and that is under the control of the government. The politicians are the guilty men. It is, therefore, tempting for politicians and their bureaucrats to shift the blame to trade unions, foreigners, property speculators, etc.

GROWTH-INFLATION-DECLINE PROCESS

Before we discuss the case put against trade unions and foreigners, however, let us review the pattern of this growth-inflation-decline process. There are four stages:

Stage 1 The rate of growth of the money supply increases and begins to affect demand.

Stage 2 Approximately nine months after Stage 1 there is an increase in the rate of growth of real output as businessmen employ more effectively the resources they have at their command.

Stage 3 About 18 to 24 months after Stage 1 the combined effects of businessmen trying to hire labour and buy raw materials will cause the prices to increase—thus the inflation gets under way. At about this time also the rate of growth begins to decline as businessmen bump up against the various restrictions on the expansion of output. "Shortages" appear and growth becomes stultified.

Stage 4 Approximately four years after the increase in the money supply in Stage 1 the economy settles back roughly at its old rate of growth, but with a higher rate of inflation . . . and that higher rate of inflation is permanent, not transitory.

Of course, it takes a very long time for the increase in the rate of growth of the money supply to work its way through the system—I believe that it is about four years before 90 per cent of the effects have occurred. But it is important to see that the initial effects are euphoric—growth increases and the rate of inflation is not affected. Only later—between two years and four years later—we find that the rate of growth falls below the trend rate and the inflation manifests itself. In the long run we get no growth from monetary expansion—only the pain of adjusting to a new and higher rate of inflation.

III

Now let us consider the scapegoats—the trade unions and the foreigners. It is true that trade unions have some monopoly power, and they will be induced to exert this power to acquire a higher wage rate for their members. One notes, however, that this is a once-and-for-all effect; after the monopoly power has been exploited there is no reason to expect such power to affect the wage rate again. The monopoly power of trade unions cannot be the driving force of a *continuous* inflation. The normal reaction to this contention is to allege that the monopoly power of unions has been increasing over time. The short answer is that it is not true. The growth of international trade, reductions in transport costs and alternative sources of supply have considerably eroded the monopoly power of the unions, in spite of various attempts through nationalization to eliminate domestic competition.

LABOUR MONOPOLY—THE CULPRIT

To establish the proposition that labour monopoly is the main culprit of inflation one must explain *first* why it has only just appeared after decades when the unions seem to have been more powerful than they are now—for example, in the miners' strike in 1926 there was no effective substitute for coal. *Secondly,* it is even more difficult to explain why this monopoly power was delayed apparently in *all* such democratic countries until the last years of the 1960s and early 1970s. Such coincidences strain my credulity too far. If there is some reason why the labour monopolists *all* held their hand for more or less the same two decades, then I have yet to hear that convincing rationalisation for such a remarkable degree of albeit implicit international co-operation.[1] *Thirdly,* one must establish that in conditions of extensive unemployment (as in 1970-71) the unions have apparently greater monopoly power than they had under conditions of full employment in the 1950s and 1960s. If it could be shown that as unemployment grows so does monopoly power of the unions, then one would willingly admit that there is a serious case to answer—but so far as I am aware, no one has faced this implication of the cost-push argument. And so one could go on . . .

But let us leave aside such carping and pursue the *reasoning* of the union-pressure case. The rise in the wages of the unionised industries will result in a rise of the relative prices of those

1 Professor E. H. Phelps-Brown suggests that the touchstone was the 1968 Paris riots. How or why is not easy to elucidate.

industries only if the firms are monopolies and exert substantial market power. Suppose that this is the case. Then people will generally have to spend more money to acquire these products, and so would have less to spend on other things. Thus the prices of goods in the competitive non-unionised sector would fall relative to the monopoly's prices (under inflationary conditions this means that the monopoly sector's wages and prices increase more rapidly than those in the competitive sector). But this is merely robbing Peter to pay Paul. There is no reason why the *general* or *overall* level of prices should rise more rapidly, provided that the total demand is not increased. And there is clearly no reason to suppose that demand will be increased simply because one section of industry is a monopoly.

Another possible outcome is that the increase in the price of the monopolised good causes a decline in the quantity sold, and so may give rise to unemployment in the unionised-monopoly sector. If this labour could not easily be absorbed by the competitive non-unionised sector, there will be an increase in the unemployed.

WHO CAUSES INFLATION?

It is possible that a Government committed to a policy of full employment—and I leave aside the definition of this much-abused aim—would then be induced to expand the money supply to increase aggregate demand in order to make it profitable for the competitive sector to hire these "unsuitable" workers. But, of course, increasing the money supply also increases the demand for the products of the monopolised unionised sector—so the demands of the union increase once more, and unemployment is again created. Then with a full employment policy the Government increases the money supply to attempt to mop up unemployment . . . and so it goes on. The authorities really do "hold a tiger by the tail". But it would be a gross fallacy to adduce from this that the trade unions *cause* inflation. Clearly they do not. It is the authorities in their pursuit of full employment policies that are the guilty party.

The bogey of high unemployment is still presented in even the most informed and influential discussions as the true underlying rationalisation for accelerating the rate of growth of the money supply *and* for the various attempts through incomes and price controls to "protect" special groups whose votes are sought by the politicians. In other words it is widely believed that it is better to have suppressed inflation rather than have open inflation—and the suppression takes the form of a regulated economy. I shall argue later that it is much better to have an open inflation; but first we still have another scapegoat, the foreigners, to deal with.

IV

Politicians and most economists have been loud in proclaiming that the increase in the price of imports is the cause of inflation. Superficially the argument seems sound; if more money has to be paid for imported goods then this suggests that it will contribute to domestic inflation. But the argument is wrong.[2] There is no reason why increased import prices should cause inflation provided that the authorities do not expand demand by creating money to support the increase in prices. Of course, the prices of imports will rise *relative* to the prices of domestic goods; this is merely a matter of "relativities" (to adopt the current jargon of the bureaucrats). But the *general* level of prices, or the *general* level of inflation, will be determined by aggregate demand, which in turn is largely set by the rate of growth of the money supply. In principle it is possible to have a stable general price level by counterbalancing the increase in the price of imports with reductions in domestic prices (in practice such a balance was achieved for Malaysia in the 1960s; but it would be silly to attempt to introduce such a drastic policy in the inflation-ridden 1970s).

If Britain had been on a gold standard system—or if the rate of exchange of sterling were absolutely and irrevocably fixed in terms of all other currencies—then it is true that the price level in

2 For a more complete exposition of the argument, see my "Importing and Exporting Inflation" in the *International Currency Review*, December, 1973.

Britain cannot for long deviate from that of the rest of the world. A ton of steel must be priced roughly the same, converting at the fixed rates of exchange, in all countries; if that were not the case there would be massive imbalances of trade that would have to be financed by gold (and foreign exchange) flows which must soon come to an end. This gold flow will cease when the prices are again roughly equal. But, of course, Britain is not on a gold standard or a fixed exchange rate; the pound has been floating since 1972.

IN CONTROL OF GOVERNMENT

Consequently there is no reason why Britain should ensure that her price inflation follows the rest of the world. The exchange rate will be adjusted to make the price of a ton of steel in sterling roughly equal to the price in US dollars. Thus we can choose to expand the money supply and to inflate at any chosen rate without any pressing discipline from the deterioration in the balance of payments through loss of gold and foreign exchange reserves. The rate of expansion of the money supply and so the rate of inflation is a matter entirely in the control of the Government of the United Kingdom; the free floating rate of exchange will ensure that there is no substantial and sustained differences in prices between traded goods between Britain and her trading partners.

One may also trace the effects of monetary expansion on the balance of payments deficit and the exchange rate. The increase in demand will be first reflected and taken up by the slack in the domestic economy; but the burgeoning demand will soon spill over into imports, and goods intended for the export market will find softer sells on the home market. Thus the balance of payments deficit will increase, and if nothing is done by way of extensive foreign borrowing by the authorities and others, there will be pressure to reduce the exchange rate. Such a devaluation will raise the sterling price of imports again, relative to domestic prices; again, however, there is no reason why this will raise the rate of inflation; that rate will be determined by the expansion of the money supply. But there is another serious consequence of

the devaluation; initially the effect will be to make the balance of payments worse. It takes time for exports to expand – probably at least two years or more – and for imports to contract. And when this does happen it means fewer goods on the domestic market, which with a *given* money demand will give rise to another upward twist to prices. Again, however, the authorities can offset this effect by a suitably contained expansion of the money stock.

The sustained confusion that has been generated by the belief that inflation and deflation are imported has been amply demonstrated in recent months. The price of oil has increased dramatically, and the import prices of many raw materials have also risen substantially. It has been widely reported by the most reputable economists and by Mr Barber that the increase in the price of oil is *de*flationary whereas the rise in imported commodity prices is *in*flationary. The casual theorising that gave rise to this paradox runs as follows: the increase in the price of oil is like an indirect tax, and since people will pay more for oil they will have less to spend on other goods, hence there will be a reduction in demand and so deflation. On the other hand, higher prices of commodities will cause retailers to charge more in the shops, so there will be additional inflation, not deflation.

EXPORTING OR INFLATION

I hope that by now the reader can see the basic fallacy behind this paradox. Whether it is oil or commodity prices we are concerned with, the answer is exactly the same. Whether such increases in prices are associated with inflation or deflation depends entirely on (a) what happens to monetary demand (via the increase in the money supply) and (b) whether there is a matching increase in the balance of payments deficit. Suppose that the money demand is not increased as the import prices increase, then the answer turns on whether Britain achieves an increase in exports to pay for the increased bill for imports. Over the past two years Britain has *in fact* not increased her exports sufficiently and has increased the deficit more than sufficient to pay for the increased price of imports.

Thus we see that there would be an unaffected money demand meeting rather more goods, both domestic and imports, on the

home market; why, therefore, should there be an additional inflationary pressure on the general price level? Of course, the domestic content of the price level will rise less rapidly than that of imported goods. But we must see this in the perspective of an accelerating inflation. Roughly speaking, we are saying that domestic components were inflating at an eight per cent rate during 1973, whereas imported components will increase by some 20 per cent to give an overall rate of inflation of a little over 10 per cent.[3] During the 12 months from January, 1974, one may expect that domestic components of prices would rise to 10 per cent per annum, whereas the rate of inflation of imported commodities and oil would be about 40 per cent, thus giving an overall inflation rate of 16 per cent per annum. Such rates may be modified or exacerbated by an increase or decrease in the balance of payments deficit: or, to put it a another way, we can export more or less of our inflation to foreigners.

The general lesson we learn is that we cannot blame foreigners for our own inflation, and that there is no easy way out through devaluation of sterling or floating the exchange rate. Floating eases some of the problems of adjustment, but is no substitute for a proper monetary policy.

V

Fears of the alleged consequences on the unemployment rate of a proper monetary policy have led governments to pursue direct prices and incomes controls in an attempt to contain the inflation. It is hoped first that such controls will somehow "modify wage demands" if prices are controlled and, secondly, that unemployment will be prevented from rising. Such measures of control over prices and incomes are often discussed by the dirigiste politician and civil servant as though they were comprehensive and all embracing. But they are not.

In the most viciously regulated economies, and even more in the democratic regimes of the West, there are substantial sectors

3 This is obtained by weighting the import component by 1/5th and the domestic component by 4/5ths.

which cannot be brought within the ambit of control. In the prices-incomes machinery of the United Kingdom over the years 1972-74 we have seen many areas where, for example, control of wages has simply not been effective—such as the wages of secretaries employed by the private sector and many building workers. Their wages have increased very rapidly. And the avoidance of the regulations is even more important in the control of prices. Thus a prices-incomes policy is rather like trying to reduce the temperature of an overheated house merely by turning off the radiators in two rooms; since the furnace is not turned down the other rooms merely become so much hotter and uncomfortable.

DISTORTING ALLOCATION OF RESOURCES

A second feature of prices and incomes policy is that, if persistently and effectively pursued for any length of time, there will be a need for rationing or some other non-price system of allocation. The regulation of prices below those which would obtain on a free market will have the effect of drying up the supplies and so exacerbating the shortages. (A dramatic example of this is the fast-disappearing housing-for-rent market in the United Kingdom.) But supplies, such as they are, must be allocated either by a formal system of rationing or by political favour, or perhaps by some shady grey markets.

A third feature of these policies is that the allocation of resources becomes distorted. It becomes unprofitable to produce the goods which have too low a regulated price—and such goods are usually "essentials" such as food, fuel, steel, etc. Consequently, there is an incentive to switch resources to more profitable pursuits where control does not run—such as the service industries of the private sector.

All these arguments suggest that the attempt to suppress inflation will lead to a fall in output—and that fall will, in fact, *intensify* not moderate the inflationary pressure. This theoretical conjecture is amply confirmed by the history of many countries that have practised so-called effective control. I believe the most interesting recent example is Allende's Chile. There, industry

seemed to be grinding to a halt under the imposition of price controls and rationing systems; only the black market kept things moving. After the *coup,* although there has been a massive inflation as the suppressed money expansion was unleashed, the elimination of rationing and controls has produced a massive boom in output. One may trace a similar history of Germany in 1945-48 before the "free economy" brought the German miracle we have all observed in the 1950s and 1960s. As for the history of Britain in recent months, I will leave that for the reader to plot and brood upon.

Not for the first time in economic policy is it necessary to conclude that it is always better to face the reality of inflation rather than pretend that it can be contained, regulated and controlled. Not for the first time in economics, as in medicine before 1850 or so, the "cure" is much worse than the disease.

VI

So far in this essay I have been concerned with the *economic* problems of money and of inflation—understandably, because I am a professional economist. The economic lesson is clear: there is ample evidence to confirm the proposition that a reduction in the rate of inflation can be achieved only be reducing the rate of growth of the money supply. Indeed many economists who hitherto vigorously rejected this proposition are now embracing such monetarists' views. But it has been argued that such a policy, although in principle desirable, is politically impossible. In fact many proposals made in the past (such as floating the exchange rate and reducing War Loan below 40) have been condemned as politically impossible. But look now: impossibilities have become conventional wisdom. The political case against monetary discipline, however, is thought to hinge mainly on the long lags before beneficial effects appear.

The evidence shows that if the Government reduced the rate of growth of the money supply there would be a reduction in the rate of growth of real output for a period of approximately nine to

20 months later. This would be associated with some increase —and perhaps a substantial increase—in the level of unemployment. However, the rate of inflation would begin to go down only after a period of two years, and the substantial effects would be realised only after about four years. It is true that one can reduce the dampening initial effects on employment and output by ensuring that the reduction in the rate of growth of the money supply is gradual and not sudden. But then that makes the adjustment to a lower rate of inflation so much more delayed. A gradual treatment gives only a slow cure.

Any politician who wishes to put before the electorate a policy of monetary restraint can only offer a very hard time for two years; after those years have passed, the economy will begin to grow again, and the rate of inflation will substantially fall. A party that has just secured the reins of power will find it difficult to implement such a policy for at least one year and very probably two. Clearly this is electoral suicide. The electorate have been schooled to expect results "at a stroke". A patient submission to the long-term forces of economic reality is too much to expect.

Yet, is it? One must review the alternatives. As I have argued, they involve substantial reductions in real output, much dislocation, and savage inequity. The public are being led meekly to these hardships because they still hope for the long-promised miracle cure. But the only cure is the long and albeit temporarily painful one. The public will—indeed, perhaps have—become disillusioned. And disillusionment is the most fertile of grounds for the breeding of violent reaction. No one can pretend to forecast the outcome of these momentous events. British democracy and freedom have never been in greater peril.

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