# Inflation
## and the
# Function of Monetary Policy in Britain

by Edward Holloway

with a foreword by Sir David Barran

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EDWARD HOLLOWAY is a founder member and Honorary Secretary of the Economic Research Council. Director of the Commonwealth Industries Association, he also edits "Britain and Overseas", and is Associate Editor of "Far East Trade". He was co-founder of the Economic Reform Club and Institute, 1936. He initiated the campaign which led to the appointment by H.M. Government in 1959 of the Radcliffe Committee on credit and currency.

In 1967 he sponsored the Programme for National Recovery, supported by nineteen industrialists, economists and writers. Five research reports have been published, dealing with inflation, the balance of payments, taxation, and the use of resources.

Well-known as a lecturer on economic affairs and contributor to a number of journals.

# FOREWORD

This is a statement about inflation. Those who were once heard to say "A little inflation does no harm" are now mostly silenced. Today, almost everyone is "against inflation", as the Preacher was "against sin". But the difference is that while the Preacher and his congregation knew what sin was, very few people understand what inflation is.

You can hear complaints all the time about how prices and costs have risen—you never hear boasts about how wages have risen; though Chancellors have been known to boast about how much they have taken out of the economy in increased taxes, apparently unaware that taxation is in its nature inflationary.

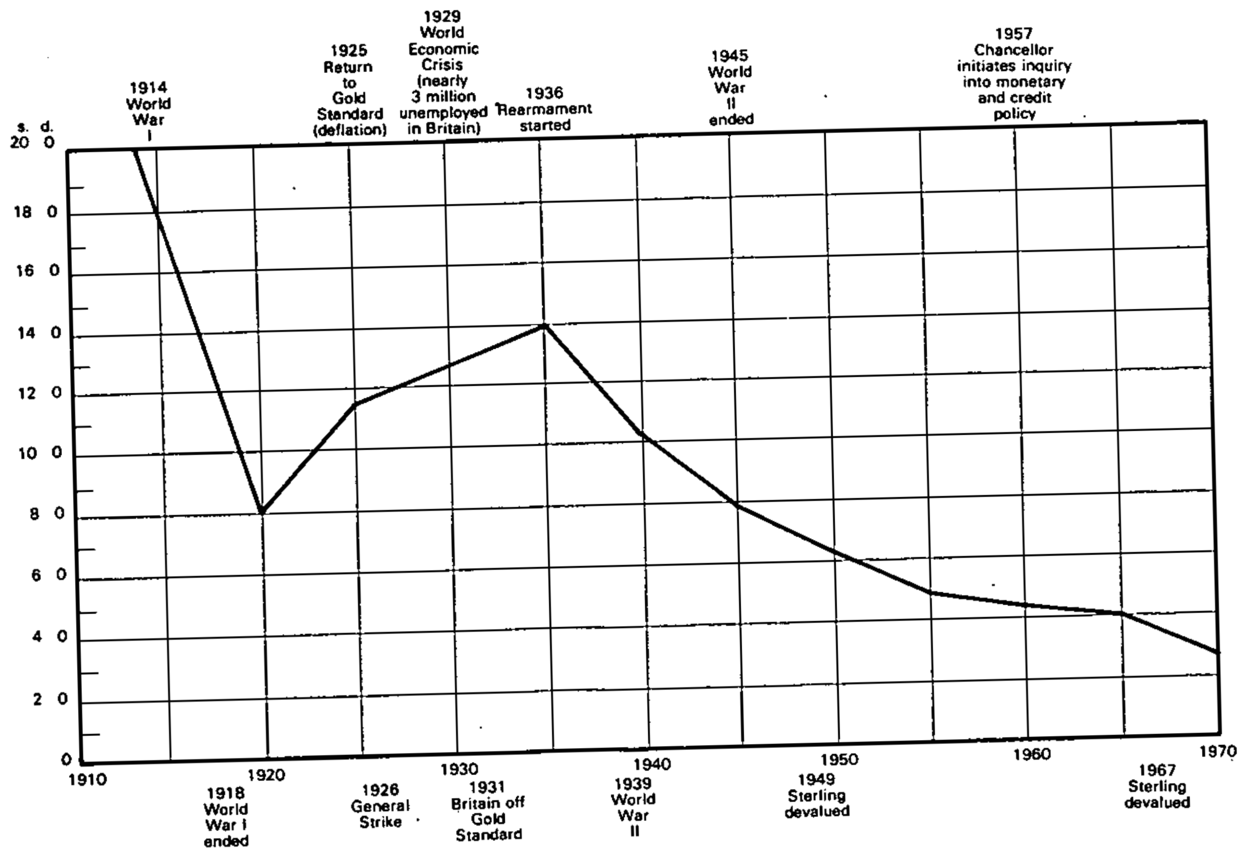
In this booklet, Mr. Edward Holloway explains in language that all can understand what inflation is, why it is evil, and why it must be stopped. He proposes a method for achieving this. I believe no-one can read this booklet without feeling that it is a most valuable statement on this vital subject, whether or not he accepts Mr. Holloway's proposed cure.

In particular, the author points out the reason why inflation is particularly evil; it hits hardest at the undefended—the old and the poorest. The working population can and does defend itself by demanding more wages—and so feeds the inflation further. The poorest must wait for Government bounty (which of course will be extracted by higher taxation and so in turn will feed inflation) but which is always late and meagre.

The key to the matter which Mr. Holloway so clearly points out is that goods and services are the only true backing to the value of currency. If all those who work for wages would realise that they are working not to provide profits for the owners (which are in a way incidental though vital too) but to safeguard and even enhance the value of their own wages, then inflation would be in a fair way to being halted.

DAVID BARRAN

*March 1971*




**Estimated changes in the purchasing power of the £ sterling for the years since 1914, taking the index as £1 in 1914.**

# Introduction

The following letter was published in The Times Business News on September 14, 1970.

### THE FUNCTION OF MONETARY POLICY IN BRITAIN

Sir,—'There is no subtler means of overturning the existing basis of society than to debauch the currency." So wrote John Maynard Keynes in *The Economic Consequences of the Peace*, 1919. The truth of these words are now becoming increasingly apparent. Taking the 1914 level of the pound at 20s., it is now worth 2s. 11d. Since 1946 the deterioration in the value of the pound has been continuous.

A different situation obtained in the inter-war years; from 1922 to 1935 there was a steady appreciation in the purchasing power of our money. Under the rules of the modified form of gold standards introduced in 1925, the amount of money in circulation was related to the amount of gold in the vaults of the Central Bank. The outcome was deflation—by 1930 there were nearly 3m. unemployed, there was appalling poverty, misery, growing dole queues, and human degradation. We live today with the results in terms of irrational behaviour of large numbers of the working population.

As it became clear that the rigid discipline of the gold standard no longer applies in the world of advanced scientific knowledge and vast actual and potential resources, we were forced off gold in 1931. It should have been clear that some alternative discipline was needed to replace gold as a regulator of the flow of new money into the economy.

Instead, we settled for the superstructure of the gold standard with its controlling base removed. As, in these circumstances, the only things that gave money value were the goods and services it would buy, we should have moved from a gold standard to a commodity standard.

This would have meant that money would have been given consistent value by being geared to and sustained by the production of goods and services. Instead, our entire money supply has been created haphazardly, with no governing principle of control or regulation.

Since 1946 a constantly increasing flow of new money has come into circulation in no way related to the growth of production. In the three years from September, 1964 to September, 1967, there was an increase of liquid purchasing power in the hands of the consumer by an amount of the order of £2,500m.

Having allowed this growing volume of pent-up purchasing power to intensify the pressure of demand on the currently available supply of goods

and services, it is not surprising that prices rose and there was a marked erosion in the purchasing power of money incomes.

Having failed to keep inflation in check by means of monetary policy, successive Chancellors have tried to regulate consumption by fiscal policies. This has meant vast increases in taxation which did not necessarily reduce total demand, but meant a switch of liquidity from the private sector to the public sector.

Total taxation, national and local, took 11½ per cent of the national income in 1913-14; by 1924-25 this had increased to about 25 per cent. Today, the proportion is around 50 per cent. This means that the private sector, which creates the nation's wealth, is starved of liquidity, resulting in stagnant production.

The remedy would seem to be to take immediate steps to reduce taxation, particularly where this would have an immediate effect on costs and prices, and on investment. The aim should be to take not more than 35 per cent of the national income in taxation, both national and local. This could be done if we restored the pre-war provision that capital requirements of the public sector came from authorized borrowing from the non-bank private sector, instead of from current taxation. It would be vitally necessary to explain to people that their savings provided an essential element in this.

Secondly, we must in future recognise that prevention of inflation is a function of monetary policy and not fiscal policy. The aim of monetary policy should be to maintain liquidity of the monetary system at such a volume that the general price level is held reasonably constant.

Yours faithfully,

EDWARD HOLLOWAY,
Honorary Secretary.

Economic Research Council,
10 Upper Berkeley Street, London, W.1.
September,8.

The publication of this letter resulted in a lively correspondence in which considerable agreement was shown for the views expressed. This paper is an attempt to amplify the case made in the letter and is intended mainly for the layman.

## Inflation

The erosion in the purchasing power of money which has continued, virtually without check, since the 1940's has had the effect of damaging confidence in money both internally and overseas; it has falsified economic relations between all engaged in business and professional life; made us less competitive in overseas markets and created a sense of injustice and frustration among people. Inflation, therefore, is one of the major evils calling for attention.

*It is a salutary thought that only those over thirty years* of age have lived in an economic climate in which inflation has not existed. Only those who are now over fifty have actually lived and worked in conditions where deflation was experienced. The degree of understanding on this vital problem is deplorably limited and many myths prevail. In his memoirs of the last war Sir Winston Churchill wrote: "The multitudes remained plunged in ignorance of the simplest economic facts, and their leaders seeking their votes did not dare undeceive them". Sir Winston was referring to wartime finance; the same can certainly be said of peace-time inflation.

This has led to a situation where there are many who now accept that the evils of inflation are inevitable. The claim is made that the only alternative to inflation is deflation with attendant recession, unemployment and suffering such as Britain and many other nations experienced in the inter-war years. **There is no law of nature which says that there are only two alternative policies—inflation or deflation—excess demand or deficient demand. It would be just as sensible to say that to cure obesity there is only one alternative remedy—starvation.** History shows that there have been periods of inflation and of deflation. During both there have been major disruptions in the economic life of the nation. Equally, there have been periods of growth and expansion when great advances have been made in the national well-being.

## The Elizabethan Age

One such period in British history is now referred to as "The Elizabethan Age". This was the period in the sixteenth century when the Elizabethan recoinage succeeded the debasement of the currency by Henry VIII. We were then on a silver standard; trade was carried on by means of silver coins. In 1545 Henry started to debase the coinage by issuing coins which were only one-third silver to two-thirds base metal. The effect of this was to undermine confidence in the currency. Prices rose alarmingly and the breakdown in exchange which this debasing of the currency brought about had its customary effect on production. Conditions deteriorated, starvation appeared, and people became desperate—"robbing, killing and hunting without any fear", as a contemporary account puts it.

This unhappy situation continued for thirteen years until in the second year of her reign Elizabeth I carried out her great recoinage. The records show that at this time the total weight of money handed in was 631,950 lbs., while the silver content was only 244,416 lbs. This meant that there were more than 2½ lbs. of base metal to every one of silver. Yet with the recoinage the whole scene changed with startling rapidity. Ample evidence of the transformation which took place exists even today in the innumerable small manor houses, farms and cottages, as well as many of the stately homes which owe their origins to the new confidence which the circulation of "honest money" re-established. Between 1545 and 1560, when dishonest money was the rule, industry declined and practically no new building was carried out—always a sign of a stagnating economy. The "Elizabethan Age" provided a startling contrast.

## Island Experiments

There are many other illustrations from history which could be quoted and from which the same conclusion can be drawn. One small-scale experiment began in the island of Guernsey in 1815, during the Napoleonic wars. The

disruption which had taken place in the economic life of the island is shown by a brief extract from a document presented by the States (the island Parliament) to the Privy Council. It described a situation where "not a vehicle, hardly a horse kept for hire; no four-wheeled carriage existed of *any kind, and the traveller landed in a town of lofty houses,* confined and miserably-paved streets from which he could only penetrate into the country by worse roads, and left the island in haste under the most unfavourable impression. . . . Thus, at the Peace (1815), this island found itself with little or no trade, little or no disposable revenue, no inducement for the affluent to continue their abode and no prospect of employment for the poor".

By 1827 a transformation had taken place and the Bailiff was able to speak of "the improvements which are the admiration of visitors and which contribute so much to the joy, the health and well-being of the inhabitants". The change had been effected by the States availing themselves of their ancient prerogative of issuing their own money to pay for the rebuilding of the market place, the construction of schools and other buildings, new roads, sewers and other essential services. But the issue of this new money was strictly controlled: in the words of the Bailiff, "we must realise the necessity of limiting the issue of paper money to the need and customs, and the benefit of the community in general. Permission cannot be granted to certain individuals to play with the wealth and prosperity of society".

Another island experiment which is worth mentioning took place in 1903. Sir Daniel Hamilton, a businessman from Calcutta, took the lease of Gosaba, an island in the Indian Ocean off the coast of Bengal, from the Indian Government. The island was uninhabited; it was usually submerged at high tide. Sir Daniel brought labour from the mainland, built dykes to keep out the sea, a plant to distil seawater and other similar works. To finance this activity he issued his own notes based on the sum of eleven hundred rupees held in the Estate Office. It is interesting to note the words which appeared on his own note issue. On one side it stated:

*"Sir Daniel Mackinnon Hamilton promises to pay the Bearer, on demand, at the Co-operative Bhundar, in exchange for*

*value received, one rupee's worth of rice, cloth, oil or other goods.*

*(Signed) D. M. Hamilton."*

On the back of the note was written:

*"The value received in exchange for this Note may be given in the form of bunds constructed, or tanks excavated, or land reclaimed, or buildings erected; or in medical or educational service. The Note may be exchanged for coin, if necessary, at the Estate Office. The Note is made good, not by the coin, which makes nothing, but by the assets created and the services rendered. The Note is based on the living man, not on the dead coin. It costs practically nothing, and yields a dividend of One Hundred percent in land reclaimed, tanks excavated, houses built, etc. and in a more healthy and abundant LIFE."*

These notes were willingly accepted by the workers on the island, villages were built—each with its school—and eventually what was formerly an uninhabited area achieved a population of twelve thousand.

Similar experiments took place in Bavaria and Austria following the 1914-18 war. They shared the same basic factor that the money issued was related to the flow of goods and services. They showed that expansion can be achieved without inflation; evidence that is worth more than many volumes of theory.

The situation has of course, changed materially in the 20th century. To a very large extent coins and notes have been replaced by credit money which is now by far the largest element in the stock of money. The same fundamental truth applies, however. If confidence in money in all its forms is to be maintained, then the purchasing power of money must be kept *reasonably stable.* If confidence is undermined either by inflation (relative increase in money) or deflation (relative decrease in money) then production, trade and exchange and the whole economy suffer.

## German Experiences

An example of inflation which, in more recent times, got completely out of hand is the German experience following the 1914-18 war. To meet increasing government expenditure which could not be met by taxation or savings in the impoverished state of the country, the Reichsbank printed notes to provide the government with the funds it needed. They went on doing it to such an extent that confidence in money was completely destroyed. After a time "the Reichsbank could no longer keep up with the sheer physical task of printing sufficient currency. One hundred and thirty-three additional printing firms using 1,783 machines were needed to meet the demand, while more than thirty paper manufacturers worked around the clock to provide the paper for the bank notes".[1]

*Thus, money in Germany ceased to fulfil its main* function as a means of exchange and a store and measure of value. It was Schacht who made it possible for the German economy to recover. He introduced the *Rentenmark,* a bank note equivalent to 1,000,000,000 debased Reichsmarks. This new note, based on German landed property, restored confidence as people recognised that it was backed by something of real value. The frustrated energies of the German people were thus released and recovery assured.

There is also a very useful lesson to be learned from the post-war experience in Western Germany after 1945. Following the devastation caused by defeat, the production of wealth in Germany had been brought to a virtual stand-still. No railways were running, electricity, gas and water *supplies were non-existent, mails and telephones were not* working, and there were hordes of homeless people close to starvation who were desperately striving to barter their few remaining possessions for food.

Nazi war finance had allowed inflation to reach such a scale that money no longer operated as a means of exchange, and had to be replaced by direct controls. Rationing and price controls were imposed and exchange of goods and services was kept going largely on the black market.

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[1] The Politics of Money by Brian Johnson. John Murray Oct. 1970.

In June, 1948, the authorities somewhat reluctantly agreed to a major currency reform. It was inevitable that this was on a ruthless scale in the chaotic conditions then prevailing. The value of the wartime Mark was cut by 93.5 percent; on presentation of 100 Marks in cash or on savings deposits, holders were allotted only 6.5 Marks. Ludwig Erhard the German Chancellor, also decreed the ending of rationing and price control over manufactured consumer goods.

This courageous action brought immediate results. Almost overnight the black market disappeared, the currency reform made it possible for the Bundesbank to regain control of the financial mechanism and to regulate the flow of new money and credit strictly to the needs of the economy, and the "German Miracle" was thus made possible. What was supremely important was that the purchasing power of the Mark was kept stable over a long period of time, thus proving that this is an objective capable of realisation, providing the authorities adopt the right policies.

## Deflation and Inflation in Britain

The effects of deflation and inflation in Britain are clearly shown by reference to the following table covering the years 1914 to 1969:[1]

| | s. | d. | | s. | d. | | s. | d. |
|---|---|---|---|---|---|---|---|---|
| 1914 | 20 | 0 | 1932 | 13 | 11 | 1950 | 6 | 3 |
| 1915 | 16 | 4 | 1933 | 14 | 4 | 1951 | 5 | 9 |
| 1916 | 13 | 8 | 1934 | 14 | 2 | 1952 | 5 | 5 |
| 1917 | 11 | 5 | 1935 | 14 | 0 | 1953 | 5 | 4 |
| 1918 | 9 | 11 | 1936 | 13 | 7 | 1954 | 5 | 3 |
| 1919 | 9 | 4 | 1937 | 13 | 0 | 1955 | 5 | 0 |
| 1920 | 8 | 0 | 1938 | 12 | 10 | 1956 | 4 | 10 |
| 1921 | 8 | 10 | 1939 | 12 | .5 | 1957 | 4 | 8 |
| 1922 | 10 | 11 | 1940 | 10 | 3 | 1958 | 4 | 7 |
| 1923 | 11 | 6 | 1941 | 9 | 3 | 1959 | 4 | 6 |
| 1924 | 11 | 5 | 1942 | 8 | 6 | 1960 | 4 | 6 |
| 1925 | 11 | 5 | 1943 | 8 | 2 | 1961 | 4 | 5 |
| 1926 | 11 | 7 | 1944 | 8 | 0 | 1962 | 4 | 3 |
| 1927 | 11 | 11 | 1945 | 7 | 10 | 1964 | 4 | 0 |
| 1928 | 12 | 0 | 1946 | 7 | 7 | 1965 | 3 | 11 |
| 1929 | 12 | 2 | 1947 | 7 | 1 | 1966 | 3 | 1 |
| 1930 | 12 | 8 | 1948 | 6 | 7 | 1967 | 3 | 1 |
| 1931 | 13 | 7 | 1949 | 6 | 5 | 1968 | 2 | 11 |
| | | | | | | 1969 | 2 | 9 |

[1] Hansard 22.1.65 and 5.7.66 and The British Economy in figures 1970 Lloyds Bank.

It will be seen that the effect of the period of deflation imposed on the country by the ill-fated return to the gold standard in 1925, which meant that the amount of money in circulation was related to the amount of gold in the vaults of the Central Bank, was to bring about a steady *appreciation* in the purchasing power of money. Prices fell, sometimes to a level below the costs of production, bringing bankruptcy and ruin to many producers. Retrenchment was the order of the day. "Tighten your belts", said the authorities, while at the same time the country was full of unsaleable goods and foodstuffs rotted. By 1930 there were nearly three million unemployed, and the injury done to them and to their dependants can only be fully appreciated by those who lived through that period.

So deeply has the misery and frustration of these deflationary years sunk into the minds of the British people that fears of a return to this appalling situation dominate the actions of both employers and workers alike. Restrictive practices, go-slows, work-to-rule and other illogical weapons hold back production and the full use of our resources. It is interesting to note that while the British worker fears redundancy and unemployment as a result of past mistakes, the German worker fears inflation as a result of his own experience.

Unfortunately, these deep-rooted fears in the minds of the British working population have been encouraged by the policies followed since 1945. It will be seen from the table above that this has been a period of continuing inflation; contrary to the deflationary period of 1922-1935 when money *appreciated* in value, since 1939 money has steadily *depreciated* in value. Attempts to remedy this by successive governments have led to what became known as "stop-go". As inflation threatens to get out of hand the brakes have been applied, this has caused a slow-down with the threat of recession and unemployment, which in turn have resulted in the removal of restraints and the threats of inflation has again held sway. This alternate stop and go has fed the fears of the working population who are always on the lookout for a return to the twenties and thirties. As a result they take steps to safeguard their position and this takes the form of restricting output through restrictive practices, which

hold back the full utilisation of our resources. Consequently, our rate of growth has fallen behind all the other nations of the O.E.C.D.

In the Budget debate on 10th April, 1970, Mr. Antony Barber said "In the final analysis, the raising of real living standards of the nation can be achieved in only one way, and that is from faster growth in the national output". Research Report No. 5 published by the National Recovery Programme[1] showed that Britain could achieve a rate of growth of 6½ per cent per annum, if we made full use of our available resources. An essential pre-requisite is that our money supply should be effectively regulated so as to avoid both inflation and deflation.

## Money—A Claim to Real Wealth

**Perhaps the main lesson we need to learn is that money is not itself wealth, but only a claim to wealth (i.e. goods and services of all kinds).** In a less sophisticated era it could be claimed that money itself was wealth, that is, something of intrinsic value. Gold and silver coins of an agreed weight and fineness were something tangible, but this does not apply to modern forms of money, which are mainly in the form of bank-notes or credit. The only value in the pieces of paper[2] and the figures in books which comprise our money today is that they can be used to buy goods and services of all kinds, just as Sir Daniel Hamilton's notes were based on wealth created. One has only to pose the question: what would be the value of a £ note in three months' time if everyone stopped producing goods or providing services? The answer is, of course, nothing. The object of monetary policy should be to keep the aggregate volume of spending adjusted to current economic conditions, thus avoiding inflation or deflation. On this basis, the

[1] "The Use of Resources in Britain"—National Recovery Programme.

[2] See the meaningless wording on a £ note—"I promise to pay the bearer on demand the sum of one pound".

purchasing power of the currency is held stable and the economy could be allowed to expand without the risk of inflation.

**This is the central theme which needs to be recognised at all levels, by government and people alike. Until this is realised and acted upon we are not likely to find the solution to the problems of inflation or deflation.**

## Money and Goods

Once this relationship between money and the goods and services it buys can be established, then a more realistic approach to incomes can be possible. When inflation is continuing it is quite possible for employers to give wage rises, because these can be passed on in increased prices while still maintaining ever-rising (paper) profits. More well-organised and powerful elements in industry make claims not only to cover inflation, which has already reduced the purchasing power of their pay packets, but also future inflation which will erode it still further. In Germany in 1923 wages had to be paid out daily and even two or three times a day to allow workers to hand the million, billion and even trillions of paper marks to their wives waiting at the factory gates, who then rushed to buy anything wanted or unwanted before the paper wages became worth even less. Once it is clearly understood that increases of incomes unmatched by an increased volume of goods and services, merely add to the existing inflation, then a more sane approach will become possible. Given stability in the purchasing power of the unit of currency, then the pressure for unrealistic wage increases would decline.

## Goods and Gold

To understand the present position in Britain, we must look at the situation as it has evolved over the last fifty years. In 1925 we had the return to a gold standard. This imposed a rigid control over the creation of new money and was the main cause of the unemployment of the inter-war

years. The gold standard meant that we controlled the money supply by relating the amount of money in circulation to the amount of gold in the vaults of the Central Bank. By 1931, with nearly three million unemployed and the economy virtually becoming bankrupt, we were forced off the gold standard and thus the control of money supply was removed. Unfortunately, however, no alternative system of regulation of the flow of new money into the economy was adopted. The superstructure of the gold standard remained in being with its regulating base removed.[1] It should have been realised that modern money being composed of pieces of paper and credit in the form of book entries only had value because it could be used to buy goods and services.

The post-war attitude towards monetary policy was well illustrated by the statement contained in the Radcliffe Report on Credit and Currency, published in 1959[2]. It stated, "Spending is not limited by the amount of money in existence, but it is related to the amount of money people think that they can get hold of . . ." In other words, people having been brought up to believe that the pound had a "Value" concluded that the more pounds they had, the better off they would be. Governments thought that the way to keep people happy (and so get themselves re-elected) was to provide unlimited pounds for them. Therefore, they pumped more and more money into circulation, regardless of the growth of production of real wealth, and so encouraged people to believe that their spending could continue to rise without let or hindrance. **This comes up against the awkward fact that more money does not necessarily increase the quantity of goods and services available to be consumed. The only result of more money coming into circulation without an equivalent increase in production is to erode the value of the monetary unit.** To give a man £100 when there is only £50 worth of goods to buy with it merely reduces the purchasing power of the £100 to £50. This is inflation.

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[1] It is clear that the 8 per cent cash ratio is no longer effective and the liquidity ratio is also unsatisfactory as a regulator of money supply.

[2] Cmnd. 827.

If we examine post-war monetary policy, it will be seen that successive governments have actually pursued a policy of inflation. In the same way as the Sovereigns of old debased the currency by introducing base metal into the silver coins, the policy of inflation has resulted in taxing *the weaker and poorer section of the community without* their consent. It is nothing more or less than a confidence trick which has been perpetrated on that section of the community least able to safeguard itself from the effects of *the constant decline in the purchasing power of money*. Not only does the Government benefit from this form of hidden taxation; as incomes rise to keep pace with the increased cost of living, they run into progressively stiffer rates of taxation, and the amount collected by the government increases. So governments reap a double benefit by continued inflation. Although lip-service is given to the need for "honest" money, governments have continued to encourage inflation, placing the blame almost everywhere but on their own dishonest policies.

The way in which new money has come into circulation was very well expressed by Lord Cromer when he spoke at the first annual dinner of the Confederation of British Industry in May, 1966. He said:

**"Practically every country has had the intractable problem of inflation to deal with—very often encouraged, certainly made easier, by allowing the money supply to increase faster than production, to the accompaniment of excessive wage increases and excessive increase in imports. This surely is one of our basic problems—for last year our money supply increased by some 7½ percent against an increase in the real output of about 2 percent. We, unfortunately, have a system under which Exchequer financing can and does lead to the creation of money *quasi-automatically* to the extent that the *requirements* of the Exchequer are not met by genuine savings or taxation . . . As newly created money finds its way into the economy as a whole, it makes it easier for potential *demands to find expression and, indeed, it probably swells* demand so that means have to be devised to mop it up in the form of the credit squeeze."**

This flow of new money into the economy has continued since Lord Cromer spoke. As was shown in Research Paper No. 2, published by the National Recovery Programme,[1] between 1964 and 1967 the mass of liquid purchasing power available to the people of Britain increased by an amount of the order of £2,500 million, equivalent to about £50 of spending money in hand for every man, woman and child in the entire population of the country. This during a period when growth in production was negligible.

This flow of new money has persisted into 1971. The money supply rose at a rate of about 16 percent in the second quarter of the financial year 1970/71. Again this occurred with an abysmally low rate of growth in the production of real wealth. "Britain's stock of money expanded at an annual rate of nearly 12 per cent in the first nine months of the financial year and the rate of growth was sharper still in the last three months. The money supply, seasonally adjusted and measured in the broadest of the three available ways, rose by £1,414 million to £17,541 million in the nine months according to the Bank of England's latest *Quarterly Bulletin*.[2]"

The Radcliffe Committee Report on Credit and Currency[3] stated that the Committee could "find no automatic rule for restricting a government that is determined to spend". Although ten years have elapsed and a lot of study has been given to the problem of government borrowing and spending, there is still no automatic rule applied in this vastly important aspect of monetary policy. Nevertheless, there has been a striking reversal of policy since 1967-68. The central Government has moved from a deficit of £1,335 million in that year to a surplus of £273 million in 1968-69.

It was the National Recovery Programme Report No. 2 that first indentified the Government's "borrowing requirement" as the main source of the inflationary growth in money supply between 1964-68, and it is encouraging to find that this particular lesson has been learned. Since then other sources of increase in money supply arising from the activities of the Government broker, and from overseas

[1] Expansion without Inflation. Research Report No. 2 National Recovery Programme.
[2] From "The Times" 11/3/71.
[3] Cmnd. 827.

borrowing have been identified. But although an attempt has been made to close these loopholes, there has, as yet, been no discernible effect on the volume of credit. It is, however, a welcome sign that the authorities are at least aware of the need to regulate money supply to the needs of the community.

The growing volume of pent-up purchasing power made possible under previous policies has intensified the pressure of demand on the currently available supply of goods and services. It is scarcely surprising, therefore, that prices are constantly rising and there has been a continued erosion in the purchasing power of profits, wages, salaries and pensions. For people to maintain their living standards in a situation where the price level is constantly rising, it is essential for them to be able to *increase* their money incomes. It is this very natural desire to prevent a deterioration in their standard of living which lies behind the current spate of wage demands. Continued inflation has encouraged trades unions to safeguard their members not only by discounting the effect of current inflation, but also to take into account future inflation. Such wage increases, when granted, add to industrial costs and the inflationary spiral, unless they are compensated for by a genuine increase in production.

## Siphoning Off Excess Demand

The situation has been worsened by the attempts made by successive Chancellors to regulate consumption by increasing taxation. It has been made clear that swingeing increases in taxes have been imposed, not only to meet government expenditure, but also to "siphon-off' excess demand. For example, in his Budget Statement in 1965, Mr. Callaghan said: "I have concluded that we must act so as to reduce home demand . . . by £250 million at an annual rate".

This attempt to siphon-off purchasing power by increased taxation has resulted in a position where over 50 percent of the national income is taken by the public sector

as against 40 percent. in 1966. The private sector, which is principally responsible for producing the real wealth of the nation, is thereby left with a decreasing proportion of the national income, hence in spite of inflation, there is a crisis of liquidity in the private sector made worse by a sustained credit squeeze.

Indirect taxation levied against goods and services, purchase tax, taxes on petrol, tobacco, wines and spirits, and tariff duties on imports, have the immediate effect of increasing prices, so the overall effect of increased taxation is to give a sharp upward push to the price level and so to further inflation.

Total taxation has been progressively increased over the years. In 1913-14 national and local taxation took only 11½ of the national income. This increased to about 25½ by 1924-25, to 40 percent by 1966, and to over 50 percent today. In its recent White Paper[1], the Conservative government has accepted the need "to reduce substantially previous plans for public spending and to permit taxation, including personal taxation, to be reduced".

The quickest and most effective means available to the government to reduce taxation would be to restore the pre-1956 position when the capital requirements of the public sector came from authorised borrowing from the non-bank private sector instead of from current taxation[2]. There are vast liquid assets in the personal sector which could be tapped provided the terms could be made sufficiently attractive.

## Excessive Wage Demands

As a result of these mistaken monetary and fiscal policies two-thirds has been knocked off the purchasing power of the £ since 1945. So a man earning £10 per week in 1945 now requires £30 per week to maintain the same *standard* of living. Those belonging to trade unions have

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[1] *Cmnd.* 4578, "Public Expenditure 1969-70 to 1974-75", H.M.S.O.

[2] The case for this is cogently argued in "Taxation: The Financing of Public Expenditure". No. 4 in the series published by the National Recovery Programme.

been able (more or less) to safeguard their position. The weaker have gone to the wall. It would be wrong to saddle blame for excessive wage demands on those who make them, for in an inflationary situation they must increase their money incomes to stay where they are.[1] **The blame for this increasingly serious situation lies with the monetary authorities who have by their failure to regulate the supply of new money in circulation created conditions in which money has ceased to do its job properly.**

This failure was unfortunately reinforced by the Radcliffe Report. Mr. W. T. Newlyn, of the Department of Economics at Leeds University recently wrote:

**"The Radcliffe Committee did not merely reject the quantity theory of money: it rejected money itself in a significant sense. The really distinctive feature of the Radcliffe Report is not that it emphasised that exclusive concentration on the quantity of money was wrong, but that in doing so it denied that money had any special significance at all. '. . . we view it as only part of the wider structure of liquidity. (pare. 389)' It is this view, reflected right throughout the Report, that justifies the complaint that Radcliffe threw out the baby with the bath-water, or, to adapt the metaphor, drowned the baby with an excess of liquidity".[2]**

Thus, it is just not good enough in those circumstances for Government spokesmen to blame the wage and salary earner for inflation: Government action in allowing an unrealistic flow of new money into the economy has been responsible for creating the inflationary climate which at present prevails. Tacit recognition of this is now being shown by Mr. Barber, Chancellor of the Exchequer, who promised in a speech at Birmingham on 12th January, 1971, "We shall continue to maintain a background of responsible fiscal policies and suitably firm monetary policies".

Unfortunately, however, Government spokesmen have failed to make sufficiently clear to the electorate the real

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[1] The close relationships between incomes, prices and stock of money is shown on charts 1 and 2 (see pages 22-23).

[2] Money in Britain 1959-69, edited by R. Croome and Harry G. Johnson. (Oxford University Press 1970).

reason for inflation and continue to allege that somehow the wage and salary earner are mainly responsible.

As a result, there are many who advocate the regulation of wages and prices, but this would be to sit on a powder-keg so long as the cause of inflation remains. The remedy is to accept the rise in costs and prices which inflation has already created, but to ensure that in the future the flow of new money into the economy only increases at a rate commensurate with the growth of production. This view was well expressed in the Economic Report of the President of the United States of America, submitted to Congress on January 28th, 1954:

**"Also required is a supply of money in keeping with the increases in the physical volume of production and trade. Such a growing money supply is necessary to prevent the development of deflationary pressure, to maintain equity values and to keep the purchasing power of the dollar reasonably stable."**

## Commodity Standard— The Long-term Aim

Reality and stability demand that money and goods should be linked together; and the obvious way to do this is to base money on goods and services, just as we formerly based it on one commodity, gold. Instead of a gold standard we should have a goods or, as it is more often called, a Commodity Standard. The arguments for a Commodity Standard were first put forward in the 1920's by a great American economist, Irving Fisher, of Yale University, when he proposed that the United States should adopt a "commodity dollar". This was not to be tied to a specific commodity like silver or gold, but one that measured the composite of domestic commodity price movements, and of business activity and of liquidity requirements. In his book, "Politics of Money",[1] Brian Johnson comments: "Such a

[1] The Politics of Money, by Brian Johnson. John Murray Oct. 1970.

standard was (and is) the ultimate logical one for money's value. In implies, of course, monetary management as a tool for controlling the domestic economy as a whole; a practice that, with the failure of the gold standard, was just beginning to gain acceptance with government". Now, nearly fifty years later, we still need to adopt this sensible idea.

In his book on "Money",[1] Sir Roy Harrod comments: "One could carry that idea a great deal further by making the currency unit convertible into certain quantities, not merely of two commodities, but also of quite a wide range of commodities. Thus, one gets to the idea of having what is sometimes known as a 'commodity standard'."

"One might argue that the idea of such a 'commodity standard' never came within our horizon of what was practical, but remained rather a remote idea. Nonetheless, one could urge that it was the idea towards which monetary reformers should be continually striving."

Commodity money would appear to represent a logical step in the evolution of money over the ages. By adopting it we would be returning to the original principle on which money had evolved. The essence of this principle was that as far as possible money should keep its identity with the goods for which it was to be exchanged. Corn and cattle, gold and silver, were all goods.

If a commodity standard for our currency were introduced it would be necessary to base this, not on a few selected commodities, but on as wide a range of goods and services as possible. Professor Meade, in his valuable scheme for stabilising the price level, suggests that "the best price index to choose for our purpose would thus appear to be one which was specially constructed to cover the selling prices of all domestically produced goods and services, except those subject to price control, excluding from such prices the import content of home production and indirect taxes. But if some such index is chosen, there are powerful arguments in favour of taking the plunge and guaranteeing that it will not be allowed to rise above a given ceiling".[2]

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[1] Money by Sir Roy Harrod. Macmillan.

[2] The Control of Inflation: Prof. J. E. Meade.

Once the supply of goods and services, and the supply of money moved together, either up or down, the relationship between them would be maintained and the price level would be kept steady. Moreover, the velocity of circulation which at present tends to react to inflation and deflation by worsening the current trend would tend to settle down to an established pattern. It is when deflation threatens and prices begin to drop that people hold off buying, thus adding to the deflationary trend. When inflation threatens and prices are constantly rising, people tend to buy, thus adding to the inflationary trend. Given stability in the purchasing power of the pound, neither of these factors would be present.

This does not mean stabilising the rate of growth of money supply to some fixed annual rate. As Professor Paul Samuelson put it in a recent article in the "Sunday Telegraph":[1] "Optimal policy does not call for a frozen rate of money growth. Instead, depending upon other policy measures being pursued and upon the best judgments about the outlook for eighteen months ahead, money and credit should be shaped in an anti-cyclical way, being slowed in years like 1969, when chronic inflation is threatening, and being speeded up in years like 1970-71, when stubborn unemployment is the greatest concern".

The Government already has powers under the Bank of England Act, 1946, to control the volume of money in circulation. Those powers should be used to ensure that the right quantity of money and credit is in circulation to maintain the stability of the general price level.

The Government should make it clear that in future the quantity of new money issued by the banking system on behalf of the nation will be scientifically regulated by impartial and disinterested statisticians to correspond always with the productive activities of the nation and the volume of real wealth flowing through the markets, with the intention and effect of maintaining the average price-level constant.

This policy will only work if it is understood by the people of the country. The present Government are trying by their policies of reduction in government spending and

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[1] Sunday Telegraph 24.1.71.

taxation to remedy the inflationary trends. Their failure lies in lack of communication on this vitally important topic. It is essential to the success of their policies to explain simply and clearly the "economic facts of life" to the people. **Inflation is a disease: it creates a condition of mind which causes otherwise rational people to behave irrationally. They will continue to do so until the facts about inflation are made clear and the myth destroyed that money is itself wealth.**

Chart 1
Incomes, Prices and Stock of Money in U.K. 1876-1965

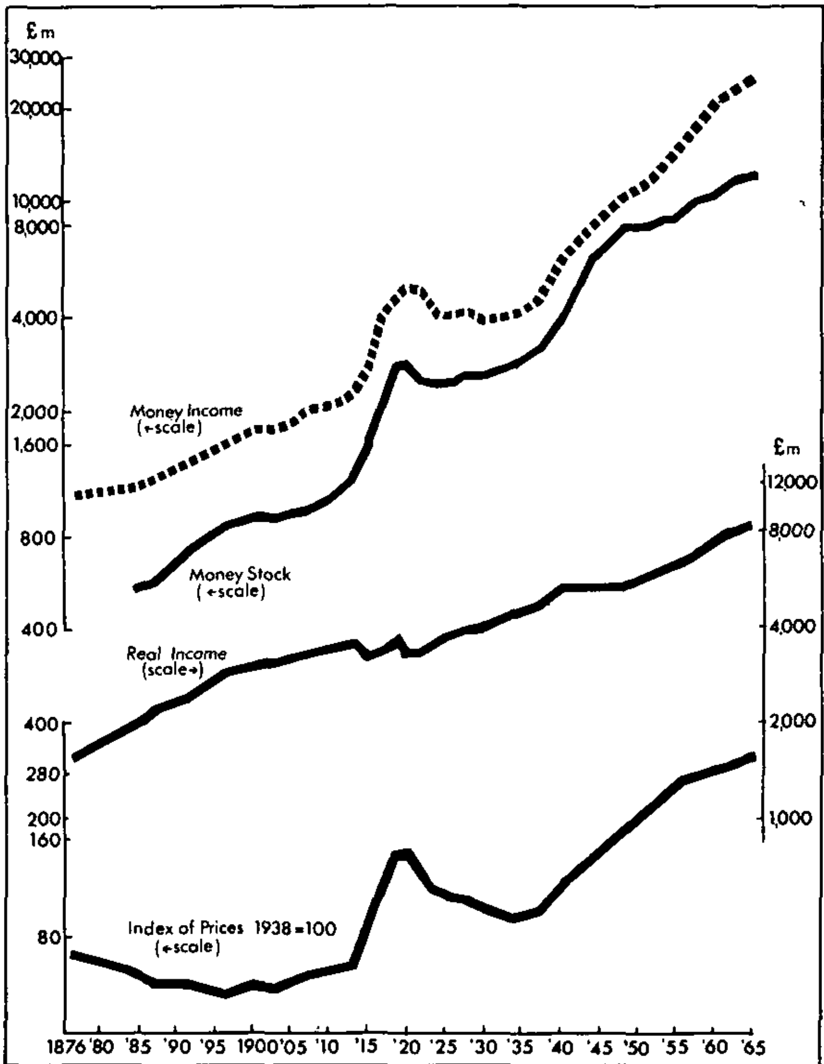


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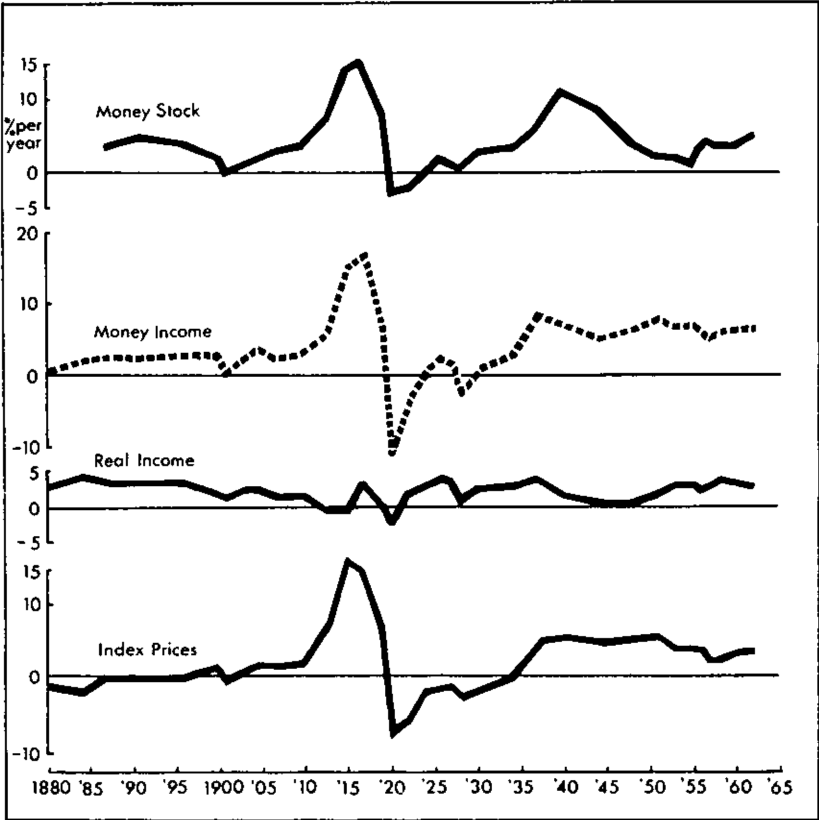
Chart 2
Rates of Change in Incomes, Prices and Stock of Money in U.K. 1880-1962

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## GROWTH OF MONEY SUPPLY 1963-1969

*£ million*

| | *1963* | *1964* | *1965* | *1966* | *1967* | *1968* | *1969* |
|---|---|---|---|---|---|---|---|
| Money Supply (M3) at end of the year: | | | | | | | |
| —Currency in circulation with the public | 2,251 | 2,452 | 2,636 | 2,695 | 2,815 | 2,859 | 3,006 |
| —Sterling deposits with banking sector by U.K. residents ...... | 9,053 | 9,436 | 10,156 | 10,626 | 11,918 | 12,941 | 13,249 |
| **Total Money Supply** .. | 11,304 | 11,887 | 12,792 | 13,321 | 14,733 | 15,800 | 16,255 |
| Increase of Money Supply in Year: | | | | | | | |
| —Increase in public holding of currency | | 200 | 185 | 59 | 120 | 44 | 147 |
| —Increase in bank deposits by U.K. residents........... | | 383 | 720 | 470 | 1,292 | 1,023 | 308 |
| **Total Increase of Money Supply** ..... | | 583 | 905 | 529 | 1,412 | 1,067 | 455 |
| **Percentage Increase in Money Supply on Previous Year-End** | | 5.2 | 7.6 | 4.1 | 10.6 | 7.2 | 2.9 |
| Gross domestic product at current market prices .......... | 30,245 | 32,873 | 35,323 | 37,667 | 39,658 | 42,556 | 45,174 |
| Gross domestic product at constant (1963) market prices | 30,245 | 31,932 | 32,687 | 33,383 | 34,083 | 35,214 | 35,578 |
| Percentage Increase in GDP on previous year: | | | | | | | |
| —at current prices .... | | 8.6 | 7.4 | 6.7 | 5.3 | 7.3 | 7.1 |
| —at constant prices... | | 5.5 | 2.3 | 2.1 | 2.1 | 3.3 | 1.0 |
| Implied percentages inflation in the year ("deflator")......... | | 2.9 | 5.0 | 4.5 | 3.1 | 3.9 | 5.1 |

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