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# the politics of monetarism

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chapter
1 introduction 1
2 the Labour Government 4
3 what is monetarism ? 6
4 monetarism and growth 10
5 international monetarism 13
6 the international monetary fund and Labour's policy 16
7 an old song 18

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# 1. introduction

The most significant development in economic policy over the last two or three years has been the conversion of almost everyone concerned with the management of the British economy to the doctrines of monetarism. This development has had the full support of the financial establishment and of the Conservative Party, as well as that of most of the leading figures in the last Labour Government. The result of the General Election is therefore unlikely to make any major difference to this vital aspect of the way our affairs are run. The monetarist consensus, underpinned by the Governor of the Bank of England and by the financial institutions, seems likely to continue to prevail.

## a superficial and erroneous theory

This is an exceedingly unfortunate turn of events. Monetarism, far from providing a solution to any of our perennial problems, is only compounding them. It is based on a superficial and erroneous view of the way in which the economy works. Its policy implications, especially in terms of growth and unemployment, run clean contrary to everything the Labour Party stands for. The efficacy of monetary policies in dealing with inflation has been grossly exaggerated, but the deflationary consequences of a tight monetary policy are inflicting real and lasting damage to our already weak and uncompetitive economy. The prospects for prosperity and full employment in Britain, based as they must be on an expanding and secure manufacturing base, are desperately gloomy unless there is a fundamental change of course.

The fatal flaw in monetarism is that it sees everything in terms of the money economy to the total exclusion of the real economy. Our current economic position illustrates this well. The last Labour Government, over the past two years, did much that the monetarists would ask of it. It prevented the money supply from expanding to the level required to maintain output and employment. It pushed up interest rates to astronomic levels to enable the public sector borrowing requirement to be financed by the sale of long terms debt on terms dictated by the banks, finance houses and other bodies known as the City " institutions ". It deliberately priced British goods out of home and overseas markets by raising the exchange rate, despite our relatively high rate of inflation. This display of monetarist virtue has earned the Chancellor plaudits in the City and financial press, but has had a predictably disastrous effect on the real economy. Manufacturing output in the fourth quarter of 1978 was nearly 2 per cent less than during the three day week of 1974 and shows no sign of climbing even slowly above its present dismal level. If monetarism fails the practical test by a very wide margin its theoretical basis is no more convincing. Monetarist theory postulates a consistent and predetermined causal relationship between the growth in the money supply and the rate of inflation. This relationship has never been shown to exist. The causal mechanism has never been established. The measurements of money supply used are both arbitrary and misleading, and real factors in the economy, such as commodity prices and wage levels, are totally ignored. Despite the pretensions of its theoreticians the truth about monetarism is that it is simply old fashioned deflation dressed up in newly fashionable jargon.

## the attractions of monetarism

Adherence to deflationary policies as the way to solve the chronic problems of the British economy is, unfortunately, nothing new. The City, the financial press and the moneyed establishment in this country have always advocated the bankers' policies of retrenchment and restraint as the way to improve our poor economic performance. The reason why those in financially powerful positions should so consistently favour remedies which manifestly do not work is not difficult to explain. It is the political attractiveness of these policies which explains why they are held in such esteem.

First, monetarism is ideologically very congenial to those whose philosophy and interests are completely at odds with those in the Labour Party, because it reduces the ability of any Government to intervene decisively in the management of the economy. The role of a Government pursuing monetarist policies is limited to the management of the money supply; beyond that the achievement of economic targets must be left to others. If monetarism is in principle profoundly anti-interventionist and anti-socialist, its main practical manifestation is in tying public expenditure into an ever tightening strait-jacket. In both practice and theory, therefore, it is not surprising that monetarism accords well with the political prejudices of those who are opposed to Labour's aspirations.

Second, monetarism places the City and the money markets in an extremely powerful position. If the Government's sole functions is to manage the money supply, which in turn determines the level of the exchange rate, then it follows that the money markets and the exchange rate markets have a weapon of great power. It is they who are in effect daily passing judgment on the Govemnment's economic policies. If that judgment is unfavourable, as it is likely to be in the case of any Government with ever vaguely socialist aspirations, then it is the Government which must give way and so adjust its policies as to produce a favourable verdict from the markets.

Government policy is therefore placed upon a familiar treadmill. The myth has been established that the success or failure of monetary policy is to be measured in terms of the monthly M3 figures. " M3 " is shorthand for a measure for the volume of deposits held by the banking sector, which in turn determines the amount of money available for them to lend, and hence the total volume of money in circulation. This figure is determined by the willingness or otherwise of the institutions to hold Government debt it is the money market which effectively determines monetary policy and thus the country's economic strategy. A good example of this can be seen following the 1978 budget. The Chancellor, with almost universal approval, had introduced a mildly reflationary set of measures but was forced to reverse direction when the money markets, in a typically conservative reaction, decided that interest rates were too low for comfort and that deflation rather than reflation was called for. By the simple expedient of refusing to buy gilts for two or three weeks they produced a sudden increase in the M3 figure. The Chancellor was then hoist on his own petard. Because he had himself stressed the importance of M3, he was forced to respond when it appeared to be going out of control. Yet all that had happened was that the money markets had expressed a judgment unfavourable to his budget.

The position is similar when one looks at the foreign exchange market. The Chancellor again gave a hostage to fortune by announcing that the maintenance of a stable (not to say overvalued) exchange rate was central to his economic strategy This allowed the exchange markets to exercise a veto over anything which the Chancellor might do of which they might take an unfavourable view. As has been the case so often in the past, a Labour Chancellor was thus effectively inhibited from doing anything which might destroy " confidence " in the pound.

The third reason for the near unanimous support for monetarism in the City is that it is of course a doctrine which operates very much in the interest of bankers and others who hold and deal in money. From a short term and practical viewpoint, it is worth noting that when the money markets manipulate the money supply and the sale of Government securities or gilts on which it is based, they are able to force up interest rates as they did in February 1979.

The scramble which subsequently followed for gilts showed just how successful the financial institutions were in creating a buyers' market. In the long term, monetarism is a useful reinforcement for the traditional principle of British economic management which is that the interests of those who hold and deal in money are to be preferred to the interests of those who actually make and sell things. It is the holders of money who want stability at whatever cost to the real economy. It is those who make and sell things who need the prospect of growth which is, however, destroyed by a monetarist policy. Monetarism means quite simply that the Government has chosen once again to put the City and its interests ahead of manufacturing industry.

Finally, monetarism is widely supported because it is a matter of fashion. Monetarism is not a new or sophisticated doctrine; indeed in many ways it is essentially primitive in nature. It has the great advantage, however, that it offers, in an uncertain world, a feeling of certainty and simplicity which makes a powerful appeal to those who have no opportunity or incentive to appreciate the true complexity of our problems. This is particularly so when that simplicity and certainty are attractive politically as well as economically.

## labour and monetarism

The claims of the monetarists ought to have been resisted by the Labour Party. The problems of the British economy do not lie in the growth of trade union power, or the rise of expenditure, or any of the other politically inspired explanations. The real problem lies in the perennial attachment of a conservative financial establishment to the doctrines of financial orthodoxy which have meant a constant recourse to deflation as a means of trying to escape from our difficulties. Monetarism is simply the latest manifestation of this theme, which has run so strongly and damagingly throughout British economic policy for the better part of a century.

We believe that policies for growth are not a reward to be gained after we have solved our problems, but are in fact the only essential means by which these problems can be solved. Only by abandoning our preoccupation with deflation and financial orthodoxy can we begin to grow and thereby obtain the improved productivity which we need to be able to compete internationally. The lesson to be learnt from our own and others' experience is that growth is the precondition of improved productivity and not the other way round. Only if we give priority to the needs of the real economy and free it from the constraints imposed by financial orthodoxy can we hope to break out of the vicious circle which threatens to destroy British industry and the British economy.

# 2. the Labour government

It would be churlish not to acknowledge the achievements of the last two or three years of the last Labour Government. The rate of inflation was substantially reduced. Unemployment was at least not getting much worse. Investment in new plant and machinery was higher during the first part of 1979 than it had been a couple of years previously and living standards were rising over the last months before the General Election.

None of this should obscure, however, the fact that all our basic problems remain unresolved. The fall in inflation owes a great deal to the success of a pay policy which is now in tatters, and to the stability of world commodity prices which are now likely to rise sharply. Unemployment, while not as high as some might have feared, has nevertheless been held down by a variety of costly and essentially short term (though none the less socially valuable) government subsidies. Output, investment and living standards have risen recently, but only back to the levels which were achieved four or five years ago. Imports of manufactured goods continue to rise two and a half times as fast as exports of manufactures, and every week thousands of jobs are lost as countless factories in one sector after another in British industry are closed down by foreign competition at home and abroad.

The result of the General Election has of course made the immediate prospects bleaker still. The Conservative approach to our economic problems is not only much less sympathetic to those who are vulnerable but also just as blinkered about the efficacy of deflation as a solution to our difficulties as the last Labour administration. It is now clear that in 1979, even on the basis of some heroically optimistic assumptions; inflation will rise again, unemployment will grow, and our manufacturing industry will become even more vulnerable to foreign competition. In other words, having gone through the whole gamut of monetarist policies, and having endured all the political, social and financial difficulties associated with them, we are faced again in 1979 with all our familiar problems. In the wake of yet another debilitating twist of the deflationary screw, we are even less able to deal with them.

## North Sea oil

All of this would have been made much clearer to us if it were not that our difficulties have been masked by the fortuitous advent of North Sea oil. It is North Sea oil which has allowed us, together with the restoration through tax cuts of money which need never have been taken out of the economy in the first place, to push up living standards once again though only to 1973 levels. It is North Sea oil which makes our national income figures anything like respectable and which allows us to conceal the fact that our manufacturing output is still more than 5 per cent lower than it was six years ago.

It is North Sea oil, in particular which has enabled us to pay for our swollen imports. If it were not for the £3.2 billion benefit which North Sea oil brought to our current trade account in 1978—to say nothing of North Sea gas—we should have been in deficit by a terrifying amount. North Sea oil, being finite, should be regarded as a capital asset. It is one measure of the failure of the economic orthodoxy that, despite all the brave words about not wasting the opportunity it provides, current policies have inevitably meant that North Sea wealth is being squandered in buying consumer goods. Goods which would have been supplied by British industry if the appreciation of sterling as a result of the saving on North Sea oil had not made them uncompetitive.

If North Sea oil is one huge opportunity which has been totally wasted by current economic policies, the other is pay policy. The first two rounds of pay policy played a major part in reducing inflation. However, because it was accompanied by massive deflation which reduced living standards and employment, trade union leaders and their members became disillusioned with it. The policy was " sold " to them in 1976 on the basis that resources had to be transferred from consumption to exports and capital investment, but the balance of trade in manufactured goods has actually deteriorated and investment in productive industry is not much higher now than it was in 1976.

There can be little prospect of sustaining a pay policy which is seen by those subjected to it simply as a means of holding down their purchasing power without any corresponding advantage in terms of employment prospects and possibilities of growth. Nor can they be expected to take seriously the Government's warnings about pricing themselves out of jobs when this is being done very effectively by the Government's own policies.

There is of course an important role for pay policy; but a pay policy can only be successful and sustainable if it is used as a platform for growth rather than as a means of deflation. The tragedy is that each abuse of the trade unions' willingness to embrace a pay policy makes it that much less likely that they will co-operate when a pay policy could genuinely be used to their advantage. It is ironic that when a pay policy breaks down it is the trade unions, rather than the Government's policies, which take the blame.

# 3. what is monetarism?

Monetarism, which has both a domestic and an international variant, has become fashionable over the past few years because it offers an apparently simple solution to an increasingly important and intractable problem—the control of inflation. The essence of the monetarists' position is that increases in prices and wages can be held in check by nothing more complicated than controlling the amount of money in circulation. Ideally, a condition of nil inflation is achieved when the increase in the money supply equals the increase in real output in the economy, and prices are stable. Since both wage and price increases require extra money to finance them, if no more money is made available increases will not take place. If attempts are made by firms or wage earners to gain an advantage by putting up the costs of their goods and services on the one hand, or labour rates on the other, then with a constant money supply the result for the firm will be unsold goods and services and; for labour; pricing itself out of a job. Thus as long as the Government is prepared to keep the money supply down everyone will see it as being in his interest to exercise restraint, and inflation will be reduced to whatever level is deemed acceptable.

## domestic monetarism

The crude version of this theory was first given popular expression in this country by an article in *The Times* of 13 July 1976 in which the editor, Mr William Rees-Mogg, argued that an increase of 9.4 per cent in the " excess " money supply in the nine years 1965/73 had resulted in an average increase of 9.4 per cent in prices in the nine years 1967/75. He concluded from this, as Professor Milton Friedman had done before him, that there is a two year time lag between an increase in the money supply and a corresponding increase in the level of prices.

A careful reader would immediately have been struck by the suspiciously neat fit between the two sets of figures produced by Mr Rees-Mogg. Only a little further research would have been needed to demonstrate that the exact match which he produced between money supply figures and inflation rates could only be achieved by a careful definition of " excess money supply ", and by concentrating attention on the particular nine year period selected by Mr Rees-Mogg rather than on a different nine year period or indeed on a shorter or longer period. In other words, Mr Rees-Mogg's calculation, accurate to a decimal point and with a neat two year time lag, bears all the hallmarks of a statistical fluke.

## what is money ?

The first doubt which must be raised concerns the definition of money itself. There are few questions which have caused economists greater difficulty than that of deciding what should fall within the definition of money. It is therefore inherently implausible that any one of several generally accepted definitions could be used as a consistently reliable barometer of inflation regardless of changes in the economic climate. The Government nevertheless pinned its colours to a particular definition of money, M3, which is not used by many other countries and which may have emerged simply because it included the kind of money which the Bank of England is concerned with in the management of the Government's debt.

It is equally unlikely that, even if a definition were useful at any given moment, it would remain so for very long; new forms of money have always been introduced precisely in order to circumvent attempts to control the money supply, and this was particularly so under the gold standard, which Mr Rees-Mogg thinks was the epitome of monetarist virtue. Over recent months even the high priests of monetarism have begun to express doubts about the reliability of M3 as a definitation of money. Gordon Pepper, a partner in a firm of City stockbrokers, has, for example, shown how the banking system can arrange its books so as to escape the full rigours of the Bank of England's attempts to enforce monetary targets against the wishes of the market. This has had the incidental effect of limiting the damage which those targets might have inflicted on the real economy, but Gordon Pepper's point reinforces the doubts which must accompany the use of any single monetary measure.

## the demand for money

Even if everyone could agree, however, on a comprehensive and universally appropriate definition of money and on the accuracy of the means we use to measure it, there remains the fundamental question of whether such a measurement is or can be relevant and meaningful in isolation from other factors. The mere adding up of the quantity of money tells us very little unless we know to what use the money is put, or in other words, how much demand there is for it. This is not a new point. The principle elements in this argument are all to be found in the report of the Select Committee of the House of Commons on *The High Price of Bullion,* written as long ago as 1810. The Committee pointed out that " the mere numerical return of the amount of bank notes in circulation cannot be considered as at all deciding the question whether such paper is or is not excessive . . . the quantity of currency bears no fixed relation to the quantity of commodities . . . and any inferences proceeding on such a supposition would be entirely erroneous ". They concluded that " the effective currency of a country depends on the quickness of circulation . . . as well as on the numerical account " and that " all the circumstances which have a tendency to quicken or to retard the rate of circulation render the same amount of currency more or less adequate to the wants of trade ".

The force of this important point can best be seen by looking at the changes which have taken place recently in the ratio between the national income and the money supply over the last few years. This ratio is a measure of the rate or " velocity " of circulation. From the third quarter of 1971 until the first quarter of 1974, the velocity fell quarter by quarter from 3.111 times per annum to 2.345, as the supply of money increased. When the Labour Government came to office and the increase in money supply slowed down, the velocity of circulation increased quarter by quarter to 3.094 in the third quarter of 1977.

In other words the demand for money did not increase or fall by as much as the change in its supply. When the supply was increasing rapidly the velocity fell, but as soon as the supply fell short of the " wants of trade " the velocity increased as traders accommodated themselves to the change in circumstances. No consideration of the efficacy of monetary policy could possibly be complete without taking account of this point. Yet those who are currently applauding the application of strict monetary targets do so in terms of the simple measure of quantity, a practice which was condemned as naive as long ago as 1810. Their problem is that they dare not admit that the demand for money moves independently of the supply because that would concentrate attention on the demand side of the equation, and lead to the conclusion that a restrictive monetary policy is only appropriate in the case where " too much money is chasing too few goods ". This is plainly not the case at the present time with vast unused capacity in industry and a million and a half unemployed.

This conclusion is reinforced by the realisation by even leading monetarists, among them Professor Milton Friedman of the University of Chicago, that the connection which they postulate between money supply and inflation rates is subject to time lags which are both variable and unpredictable, and by the failure of monetarists to demonstrate convincingly just how increases in the money supply actually cause an increase in the rate of inflation. A number of possible transmission mechanisms have been considered and propounded by monetarist economists. The candidate advanced by the international as opposed to the domestic monetarist school is the exchange rate and this will be considered later. Another major contender is the notion that an increase in the money supply increases the real demand for goods which in turn affects prices. However, as Tarling and Wilkinson have demonstrated (" Inflation and the Money Supply", *Cambridge Review No. 56,* 1978) the connections between money supply and real demand, and between real demand and prices, cannot be made to stand up. There is therefore a gaping hole in the theoretical basis of monetarism and monetarists are reduced to simple assertions that there must be a connection between money supply and the rate of inflation.

It may well be that there is such a connection but the monetarists' difficulty in showing how the transmission mechanism works suggests that the connection may not be the causal one which they assert. When other factors in the real economy cause prices to rise, the money supply may rise in order to accommodate those factors. The relationship would then, however, no longer be one in which increases in the money supply caused inflation, but rather the other way round.

## the real economy

Monetarists are easily led into mistakes in matters such as this because of their preoccupation with money and their refusal to acknowledge that other factors may also play a part. We can take two examples. According to monetarists the very high inflation rates of 1973/75 were entirely the result of the substantial increase in the money supply which had been allowed under the notorious " Heath/Barber boom ". A more rigorous interpretation of events would, however, reveal that there was an explosion in world commodity prices in 1973, of which the fourfold increase in oil prices was only the most obvious and dramatic; that we began to feel the first impact of the increase in food prices as a result of our joining the EEC; that the exchange rate was at a relatively low real level which increased demand for goods and services; and that Mr Heath introduced, unluckily for him, a wage indexation scheme at the very moment when it was most likely to transmit these externally produced cost increases directly through into domestic prices.

None of these factors can be realistically ignored in trying to assess the reasons for the inflation rate of 1973-75, but as soon as they are admitted to consideration, the monetarist case falls to the ground. The increase in the money supply is then seen as only one amongst a number of contributory factors and by no means the sole determinant of events.

A similar approach can be adopted in respect of the fall in inflation rate from 1976-78. Again, according to monetarist orthodoxy, the inflation rate fell because the Chancellor had introduced a tight control over the money supply. However, other and more plausible explanations include the comparative success of the first two rounds of pay policy; the dramatic fall in interest rates from the high levels of 1976 which did much to restore confidence in the future; the reduction of as much as 5 per cent in the price of fuel and materials supplied to manufacturing industry; and the continuous increase in the real value of the pound which kept prices down, albeit at the cost of encouraging imports and discouraging exports.

That monetarists recognise the potency of these real factors is well demonstrated by our current situation. If the inflation rate were determined solely by the rate of growth in the money supply we should have little to fear from the breakdown of an incomes policy or from the renewed rise in world commodity prices. In practice, however, monetarists are now running for cover because they know that these factors are likely to override the supposed influence of the money supply on the rate of inflation.

Another, and at first sight paradoxical, aspect of the monetarists' preoccupation with the financial as opposed to the real economy, is their belief that the real economy is in the end largely beyond the control of government. They postulate, for example, for each economy a " minimum sustainable level of unemployment ". They argue that any attempt based on

Keynesian principles to increase the money supply so as to reduce the rate of unemployment below this level will be counter productive. This is so because it would raise the rate of inflation to a level which would inevitably result in corrective measures which would be far more damaging to output and employment than if nothing had been done in the first place. What is not explained is why the trade-off between unemployment and inflation cannot be changed within any particular country, for example by pay policy as clearly was the case in Britain over the last few years.

Nor do international comparisons give any credence to the monetarist case. The German experience, for example, certainly shows that a rapidly increasing money supply does not necessarily lead to more inflation. As IMF statistics show, in the five year period 1974-1978 prices in Britain rose on average 11.5 per cent more each year than in Germany, but the money supply in Germany grew on average 3.3 per cent more each year than in Britain. Some part of the difference is of course accounted for by the much higher rate of growth in Germany, but there is no doubt that the supply of money in Germany exceeds the demand and this has of course pushed interest rates down to a level which has greatly facilitated the recovery there which is now well underway.

# 4. monetarism and growth

There is one point on which politicians and economists of almost every view are agreed and that is that there is a " virtuous circle " of productivity and growth which we must break into if we are to resolve our problems. The nature of this " virtuous circle " was well described by the Treasury in the *Economic Progress Report* of December 1977. They said there that " productivity is a key element in what is often described as the ' virtuous circle ' of high growth ; increased productivity—briefly and in summary, a reduction in the labour cost of producing any given amount of goods—provides cheaper products ; increased demand for these cheaper products increases employment and is an incentive for investment in expansion, at the same time providing the funds for this investment ; expansion enables higher levels of output and employment to be sustained while additional investment enables further improvements in productivity. And so the ' circle ' begins again at a higher level of output and employment : economic growth becomes self sustaining ".

## productivity

Although there is this wide agreement on the nature of the virtuous circle, it seems to be a peculiarly British assumption that the way to break into it is through increased productivity, and that only after productivity has been increased will growth be achieved. This assumption has been central to British economic management for the past century or more ; one Chancellor after another has felt obliged to defer policies for growth until productivity has improved. The difficulty is that we have never discovered the means to improve productivity in the absence of growth. It is not that we have been unaware of our deficiencies in productivity ; we have been making speeches of an exhoratatory nature about it for the past 100 years. An endless succession of meetings, conferences and plans has been organised with the object of talking our way into increased productivity (the industrial strategy is in many ways simply the latest manifestation of this approach) but the improvement in productivity which we are assured is the necessary pre-condition of growth still continues to elude us. Despite a century of hand wringing, we are no nearer than we ever were to breaking into the " virtuous circle " ; indeed that prospect is becoming more remote.

The truth is that productivity is a function of growth and not the other way round. This is the unmistakable message to be derived from the available evidence. The following table compares the average annual increase in output per worker in the principal industrial countries between 1965/73 and 1973/77.

ANNUAL AVERAGE INCREASE IN OUTPUT PER WORKER

| | 1965-73 | 1973-77 |
|---|---|---|
| Japan | 9.0 | 2.7 |
| Italy | 5.5 | −0.3 |
| France | 4.9 | 2.3 |
| Germany | 4.5 | 3.2 |
| UK | 2.9 | 0.1 |
| USA | 1.4 | 0.3 |

*Source* : OECD

The difference between the two periods, for every country, is strikingly clear. The point to be noted is that even in countries with enviable records of productivity growth, and where the docility of the labour unions is legendary, productivity fell quickly as the growth rate fell.

The point is also well illustrated from our own recent experience. During the much maligned " Barber boom ", output per head in manufacturing industry increased by almost 18 per cent in the period from the first quarter of 1971 to the third quarter of 1973, compared to an increase of little more than 2 per cent for the rest of the economy. The deflation which followed reduced output per head in manufacturing by nearly 7 per cent in the 21 months to the second quarter of 1975 ,even though productivity in the rest of the economy continued to increase at about the same rate as before.

The difficulty with a restrictive monetary policy designed to keep price rises in check, when applied to an economy which is already very understretched, is that it cannot restrain a rise in the inflation rate without destroying the possibility of economic growth. In our case, with a small growth rate and a substantial inflation rate, we are likely to have completely extinguished growth long before we have eliminated inflation. Monetarists counter this by arguing that a tight money policy will indeed extinguish growth in the short term, but that once inflation has been conquered and monetary stability restored, the conditions for a high and sustained rate of economic growth will have been established.

The problem with this approach is that there is no transmission mechanism between monetary stability and economic growth. All depends on the nature of the conditions which are stabilised. If stability can be achieved in conditions of increasing competitiveness and productivity, well and good. Otherwise, however, stability can rapidly become the stability of the morgue. There are many examples from our own experience in the 1920s and 1960s, and that of other countries (compare the 30 years of stability and stagnation of Salazar's Portugal with the high inflation accompanied by high growth rate in Brazil) to show that monetary stability is not of itself either a necessary or a sufficient precondition of economic growth.

In the end, a tight monetary policy suffers from exactly the same logical defect as destroys every attempt to deflate our way out of our problems. It is a necessary precondition for the success of deflationary policy that a certain proportion of resources should be kept out of use. However, in these circumstances, growth can never be achieved, because as soon as the underutilised resources are drawn into use the necessary precondition for success has been destroyed. Those managing the economy will be compelled by the logic of their own theories to intervene to restrict growth—or, to use the currently fashionable terminology, the money supply—to prevent what they describe as " crowding out ". This is the familiar recipe for " stop go ". The damaging increases in the Minimum Lending Rate (MLR) on basic interest rate during 1978 and the early months of 1979 are an example of the price which has to be paid for the kind of stability to which monetarist policymakers aspire.

The most ironic aspect of monetarist policies is that they are not even particularly effective as counter-inflationary measures. Recent reductions in the rate of inflation have had much more to do with other factors such as the stability of world commodity prices and the comparative success of the pay policy. Furthermore, the contribution of monetarist policies to the battle against inflation has been a mixed one to say the least. Trade Unions are hardly likely to moderate wage demands at a time when the Government is itself pushing up the cost of living through increased taxes and interest rates. Indeed it is precisely in the conditions of nil or slow growth engendered by deflationary policies that a pay policy is most difficult to sustain. Since there is no room for a real increase in wages the pressure for a money increase is so much greater. When output is static or falling unit costs are unlikely to be reduced and every small increase in costs becomes inflationary. Hence the failure of the Government's 5 per cent pay norm during the 1978/79 pay round.

The rigid application of monetarist policies therefore produces the worst of all possible worlds. The economy will simultaneously be delibitated by the cancer of unemployment and inflamed by inflation. Wage costs rise rapidly in the non-traded sector where trade unions, spurred on by Government-imposed increases in taxes and interest rates, have the muscle to obtain large wage increases, while the traded sector grinds to a halt under the impact of the Government's own deflationary policies.

The conclusion must be therefore that monetarist policies can be supported only by those who suffer from tunnel vision in looking at the panorama of our economic situation. The whole doctrine is based on an arbitrary definition of money and pays no attention to the demand for money. Even if these difficulties could be ignored, the consequences of applying monetarist policies in isolation from other objectives is simply to deflate the economy to a dangerous degree and to bring about not stability but paralysis.

# 5. international monetarism

Recent economic policy in Britain appears to have been heavily influenced not just by conventional monetarist dectrines, but also by the international monetarist theories propounded by the London Business School. This version of monetarism attaches great importance to the impossibility of improving our economic performance by lowering the exchange rate. What is asserted is that the effect of exchange rate depreciation is to create a surplus on the balance of payments which will increase the money supply as more money comes into the country in payment for exports than goes out in payment for imports. This in turn will have the effect of raising all prices, both in the traded and non-traded sectors of the economy, so as to nullify in a short period of time any competitive advantage that devalution may have produced. It follows from this that no improvement in the competitive position of British industry can be achieved by exchange rate depreciation, even if continuing loss of share in world trade indicates that the prices of British exports are too high. This is so since it is claimed that any price advantage will inevitably and very quickly be washed away by the higher domestic rates of inflation which better foreign trade performance itself induces. The supposed inability of the Government of any country to improve its foreign trade performance by exchange rate policy for these reasons is called the "Law of One Price".

## the exchange rate

The last Government, unfortunately, was apparently persuaded that these international monetarist theories as well as the domestic variety are correct. As far as one can tell, it still believed during the course of 1976 that the fall in the value of sterling, which it went to extreme lengths to resist, would provide a substantial benefit to competitiveness and that we could therefore look forward to export led growth. Indeed, the Chancellor made hardly a statement over a period of six months or more in which the phrase "export led growth" did not figure prominently. Our share of world trade in manufactures did increase in 1977, but the Chancellor seems to have lost faith in currency depreciation as a means of obtaining a price advantage as he was clearly increasingly impressed by the supposedly immediate and overwhelming inflationary consequences of devaluation. He increasingly took the view that a currency depreciation works its way through far more quickly into domestic prices than used to be the case and therefore the benefits to competitiveness are indeed marginal and short-lived.

There are two points to be made against this interpretation of events. First, the fall in the value of sterling in the last three quarters of 1976 did in fact produce a benefit to our competitiveness, and is undoubtedly the explanation for our relatively good showing in terms of our share of world trade in manufactures in the first nine months of 1977. This was one of the rare periods over the whole of this century in which we managed to retain, and indeed slightly increase, our share of trade in manufactures. Unfortunately, by pushing up the exchange rate at the first opportunity, the Bank of England guaranteed that this could not last.

Secondly, the fall in the value of sterling was not the cause of our high inflation rate but was in fact its consequence. In the fourth quarter of 1973 the exchange rate had fallen to 90.7 per cent of the 1970 level, but the Bank of England took advantage of the change of Government in 1974 to raise the rate each quarter until it reached 99.3 per cent in the first quarter of 1976. This was made possible by the inflow of Arab oil money into London. When this was withdrawn during the course of 1976, it was inevitable that the exchange rate would fall to reflect our substantially worsened competitive position.

More recently the situation has become worse still as the value of sterling has risen against other currencies even though our inflation rate has been higher than theirs. Taking the whole period from February 1974 we estimate that our export prices have gone up by 24 per cent more than those of our main competitors on average. Taking individual countries the figures are 13 per cent against France, 19 per cent against Germany and Italy, 21 per cent against the USA and a staggering 40 per cent against Japan. No wonder that our exporters are in desperate straits, while our import bill is soaring.

The truth is that Government policy totally failed as a result of money illusion to distinguish between an effective and a nominal devaluation. A devaluation is purely nominal when it represents no more than an adjustment to an already existing loss of competitiveness. A devaluation is effective, on the other hand, when it has the effect in real terms of making our exports cheaper and our imports more expensive.

The Labour Government seemed nevertheless to have been persuaded that changes in the exchange rate were ineffective. It presumably reached this conclusion because it accepted the essence of the international monetarist case which is expressed in the so called " Law of One Price ". If, as they claim, it is true that devaluation automatically generates increases in the money supply sufficient to finance price rises caused by higher import costs spreading through the economy on a scale which completely offsets the competitive advantage which depreciation brings about, then clearly no long term improvement will be achieved. After these price adjustments have all taken place our goods would be just as competitive or uncompetitive in price as they were before.

What evidence, apart from assertion, have international monetarists advanced to support their case? The first attempt in this country appears to have been made by Messrs Ball, Burns and Laury of the London Business School in an article in *The Economic Journal* in March 1977. Even they were forced to admit, however, that their apparently sophisticated model could not explain why, in the case of the UK, there was a persistent tendency under a system of fixed exchange rates for our prices to rise faster than those of our principal competitors. They could only suggest, contrary to all evidence and reason, that the devaluation of sterling in 1949 was excessive and had to be compensated for by a higher rate of inflation lasting until the mid sixties in order to wipe out the competitive advantage we had thereby gained.

A rather better attempt to measure the influence of exchange rate changes in prices has been made by Messrs Robinson, Webb and Townsend in a study (" The Difference of Exchange Rate Changes—a Study of 18 Industrial Countries ", *Economica,* 1979) financed by the *EEC.* The authors concluded from an analysis of the effects of exchange rate changes of various countries that relative domestic prices were *stable* under fixed exchange rates. They also found that export prices did not change in foreign currency terms, except in the short term, when there was a change in parity. They admitted, however, that the evidence did not show the link between export prices and domestic prices which is postulated by international monetarists.

Indeed, in the case of countries such as France, which had succeeded in changing their relative prices by devaluing, the evidence suggested that wholesale prices were not determined by world prices but could be affected by exchange rate changes. Recent studies by both the Bank of England and the National Institute of Economic and Social Research have also failed to confirm the " Law of One Price ".

This inability to establish the automatic connection between export and domestic prices, which is the essence of the international monetarist case, suggests that the exchange rate is not the elusive transmission mechanism which monetarists believe translates changes in the money supply to domestic prices. Our own interpretation of the evidence is even less charitable to international monetarism. In the first place, we do not accept that a change in relative export prices of up to 5 per cent over a five year period (which the study by Robinson *et al* found did occur under a regime of fixed exchange rates) can be disregarded as insignificant. It undoubtedly represents a significant departure from any so-called " world price ".

International monetarists are also in difficulties when it comes to the causal link between domestic money supply and the exchange rate. Their problems arise from the fact that, as we have seen, the rate of increase in the money supply in countries which have had the lowest rates of inflation and the most steadily appreciating currencies has sometimes been higher both than international monetarist theory would normally predict, and higher than has been the case in countries with rather less fortunate experiences of inflation and currency movements. They have circumvented this problem through the simple expedient of attaching a label to the phenomenon which contradicts their theory. They say that countries such as Germany have a natural propensity to require a higher money supply increase for a given rate of inflation than countries such as the United Kingdom. They therefore postulate for each country a " warranted " rate of monetary growth.

This is no more than an admission that, in order to finance growth and productivity on the German scale, a higher degree of monetary expansion is required than is currently permitted by monetarist doctrines in this country, and that it does not necessarily lead to higher inflation rates. This seems to be an excellent reason for abandoning a doctrine which is so deficient in theory and so lacking in practical evidence to support it. The notion of " warranted " growth in the money supply is not so much a theory as a description of the awkward fact (awkward that is for the international monetarist) that in some countries a high rate of increase in money supply means not a fall in the exchange rate and a rise in inflation, but the reverse. International monetarists are forced to explain this away by treating trends in productivity as though they are entirely independent on economic growth, a view which is contradicted by all the available evidence.

It is probably true to say that, as the theoretical and practical defects of international monetarism become more apparent, the heyday of its popularity is passing. Its significance lies in the fact that it is still widely accepted by the financial institutions which, by acting in accordance with its predictions, make its prophecies self-fulfilling, at least in the short term. If the exchange markets believe that the money supply determines the value of the currency, they will act accordingly and their belief and actions will appear to validate the theory. This is a classic case of an emperor without clothes. The nakedness of the doctrine will quickly become apparent though when the influence of real factors on the exchange rate (factors like the trade balance and comparative inflation) can no longer be resisted. In the short term, however, the views of international monetarists seem likely to be lent a spurious validity (at least so far as the exchange rate and its relationship with the money supply are concerned) by the impact of North Sea oil on the value of sterling—a striking example of the way in which monetarist theorists prefer a convoluted monetary explanation for a phenomenon which is more easily explained by reference to real economic factors.

# 6. the International Monetary Fund and Labour's policy

It is one of the great triumphs of prejudice over reason that most people, even those professionally involved in such matters, believe that the last Labour Government's monetarist policies are those which were imposed upon us as the price of obtaining the loan from the IMF in 1976. The truth is very different. If the Government had indeed pursued the policies recommended by the IMF and which the Chancellor undertook that he would pursue, we should by now have found ourselves in a very different and much more favourable position. Instead, the Government turned its back on two of the major recommendations of the IMF, with all too predictably serious consequences for the economy.

The first issue on which the undertakings given to the IMF were reversed concerned the exchange rate. The IMF, which believes in the effectiveness of changes in the real exchange rate, required the Government as was stated in the Chancellor's Letter of Intent, to " manage the exchange rate so as to preserve the competitiveness of British manufacturing industry ". This was a crucial undertaking. The fall in the value of sterling during the course of 1976, it should be recalled, had done no more than reflect the enormous deterioration in our competitive position brought about by our high rates of inflation in 1974/5.

The IMF's insistence, therefore, that we should preserve the competitiveness we enjoyed at that moment was of vital importance. However, the Bank of England, reversing this undertaking. The nominal exchange rate was pushed up at the beginning of 1977 and was then held stable for nine months, at a time when our costs were rising much faster than those of our competitors. Throughout this period our competitiveness consequently declined. Even so, because of the lagged effect of the fall in the real exchange rate in 1976, we managed to perform better over that nine month period in terms of our share of world trade than is normally the case. This provides a small insight into what could have been achieved if the real exchange rate had been kept at its autumn 1976 level. In the autumn of 1977, however, the Chancellor " uncapped " sterling and the rate has since risen substantially under the influence of North Sea oil. Our prices relative to those of our principal competitors are now nearly 20 per cent higher than they were in 1974, and when the IMF were here in 1976. There is now no pretence that we are complying with the IMF requirement or that there is any prospect of export-led growth.

One of the major reasons for the reversal of this exchange rate undertaking related to the interpretation put on the second major IMF requirement concerning the money supply. The IMF, it is true, insisted upon the adoption of strict money supply targets and it is this which has attracted so much attention from the commentators. What has escaped their attention, however, is that the targets were specified in terms of Domestic Credit Expansion (DCE) and not M3. The significance of this is that, provided any improvement in economic activity and any increase in the money supply had been brought about by a surplus on our balance of trade, no restriction on either need have been imposed. In other words, the export led growth which the IMF exchange rate policy was designed to bring about would have been accompanied by the monetary policy which they specified.

The Chancellor's decision to pursue a money supply policy based on M3 was therefore crucial to his decision to " uncap " sterling in the middle of 1977.

The Chancellor apparently feared that unless sterling were allowed to float upwards, the inflow of foreign money would continue and would increase the money supply defined in terms of M3. There were several peculiarities about this decision. *Firstly*, the Bank did everything possible to encourage the inflow by intervening in the market to put a floor under sterling. *Secondly*, no one paid any attention to the example of other countries, such as Germany, Switzerland and Japan, which have experienced very substantial inflows of capital and accretions to their reserves without apparently suffering any ill effects on their inflation rate.

*Thirdly,* at times when sterling has been under pressure, the Chancellor and his Bank of England advisors paid little heed to the argument that if an inflow of capital increases the money supply, an outflow of capital ought to reduce it and should therefore, according to monetarist theory, offset any inflationary effects of a falling exchange rate. *Fourthly,* and most importantly for the present context, the Chancellor seemed unaware of the fact that if he had adhered to the Domestic Credit Expansion basis of monetary policy, as recommended by the IMF, the movements in foreign capital would have had little effect on the figures and could safely have been ignored. To the extent that capital inflows found their way into the private sector, the effects would have been identical to those of a current account surplus, and to the extent that the effect was felt in the public sector, the increased demand for public sector debt would probably have reduced M3 rather than the reverse (R. Lomax and C. Mowl, " Balanced Payment Flows and the Monetary Aggregates in the UK, *Working Paper No 5,* HM Treasury, 1978).

None of this seems to have shaken the belief of most commentators that what they were seeing was a Government pursuing policies imposed on them by the IMF. A good deal of this self delusion was of course rooted in political prejudice. Many commentators, including the then Chancellor's political opponents in the Conservative Party, wholeheartedly approved of the rigour of his monetarist approach but they were faced with the dilemma that while they approved of the policies they did not wish to give any credit to a Labour Chancellor. They therefore propagated the myth (which some seem themselves to believe) that the origin of these policies was the IMF, despite the fact that the IMF insisted on a quite different strategy. The economic illiteracy of the Conservative front bench is nowhere better illustrated than by their loud approval both of the IMF's intervention in our affairs and of the policies subsequently pursued which ran directly counter to the IMF's recommendations.

# 7. an old song

Monetarist policies, like their predecessors, are entirely conventional in the sense that they command the full-hearted support of the establishment. However, the monetarists appear to believe that they have discovered a new solution to our problems. They believe that their theories provide them with a new tool of analysis, a new theoretical basis for action and a new range of policy options.

How true is this ? The first point to make is of course that monetarism is not a new doctrine but rather the revival of an old one. The only novel feature of the present versions of monetary policies is that they are even more rigidly and arbitrarily applied than were their predecessors. An excessive preoccupation with financial orthodoxy, to the detriment of the real economy, has been the recurring *motif* of British economic management for well over a century. We are sadly deluding ourselves if we believe that current policies differ in any essential respect from the policies which have been tried and which have failed in the past. The point can best be made by comparing the current policies with those which were pursued in two earlier eras—1924/31 and 1964/67. In January 1921, when wholesale prices had risen to 251 per cent of their 1913 level, it was decided that we should return to the Gold Standard at the pre-war parity and for four years the whole of the Bank of England's resources were devoted to getting wages and prices down to enable this to be done. They succeeded, but the effect on the economy was disastrous and of all industrial nations, we were the only one which did not share a high rate of growth in the 1920s with the rest of the world before the depression which began at the end of the decade. We were also the only country with a very high rate of unemployment and this, combined with the reduction in both money and real wages which the policy required, was responsible for the social stresses and strains which led as surely to the General Strike of 1926 as similar policies a century earlier had led to the Peterloo massacre.

The return to the Gold Standard and the policies which accompanied it were of course no more than the familiar attempt, still with us today, to deflate our way out of the problems created by an over valued exchange rate. There are ominous parallels between the position of the last Labour Government and that of Ramsay MacDonald's in 1929/31. MacDonald's Government fell, having inflicted great damage on the Labour movement, when the trade unions finally refused to cooperate with policies which would have meant cuts in real living standards, and in the interests of a financial orthodoxy to which it was thought that there was no alternative. Then, as now, it was the collective ignorance of a whole administration which led to the betrayal of the interests of the people they claimed to represent. As J H Thomas is said to have plaintively remarked when the National Government took office and left the Gold Standard, " Nobody told us we could do that ". One can well imagine a member of the 1974/79 Labour administration making a similar remark in relation to monetarist policy.

The second instructive comparison is with the policies pursued in the 1960s. The Labour Government, then as now, was reluctant to do anything which ran counter to the views of the money markkets. By advertising its readiness to die in the last ditch in order to preserve a particular parity, the Government found itself obliged to pursue the most severe deflationary policies in order to protect an over valued exchange rate. The theory then was that the exchange rate could be preserved, and the balance of payments kept in equilibrium, if only excess demand could be syphoned out of the economy. In pursuance of this view, severely deflationary policies were imposed in an attempt to hold costs down and prevent the balance of payments deficit from worsening.

We no longer talk about excess demand but instead policies are framed in terms of restraining the money supply. Despite this different theoretical basis, however, the practical effect of the currently favoured policies is indistinguishable from the deflation imposed in the past. Adhering to monetary targets has the same effect on the economy as that of simple deflation. There is in effect no difference except that whereas Jim Callaghan as Chancellor in the 1960's was himself deciding on the level of deflation required, Denis Healey handed this decision over to the money markets.

The truth then is that the current orthodoxy is simply a re-run, dressed up in fashionable language of the policies which have disfigured British economic performance for so long. We have been over this course so many times before, and always with such disastrous results, that it is only to be marvelled at that we are prepared to try it again.

## conclusion

The conclusion drawn is that the presently accepted monetarist policies, which are no more than a continuation of the policies which have failed us so often in the past, have once again led us into an even more disastrous cul-de-sac. We can only hope to reverse direction by running the economy at full speed and securing improvements in competitiveness and productivity as a consequence of the full utilisation of all the resources available. This means that we must abandon an arid and sterile adherence to monetary targets, as though they were the sole determinators of the economy's health, and concentrate instead on policies which will lead to real growth.

To the extent that we pay attention at all to monetary policies, they should be designed to accommodate, not constrain economic growth as has indeed been done in all the rapidly growing economies. We should be prepared for and positively welcome low interest rates and a fall in the value of sterling as a means of stimulating growth. Growth itself would then do a great deal to raise living standards, moderate inflation, increase employment and balance our trade. North Sea oil would then be simply a valuable and welcome bonus which would enable us to overcome any short term problems which might arise in the pursuit of this strategy. If it is argued by faint hearts that this strategy might involve risks, the only answer is that the prospects of its success must surely outweigh the certainty of failure if we continue as we are at present.

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The authors argue that the theoretical basis of monetarism is much weaker than is usually recognised and that the practical efficacy of tight money policies in restraining inflation has been greatly exagerated. The cost however in terms of unemployment and low investment have ben all too evident.

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