THE CHANCE OF PROSPERITY

A series of three articles by A. J. CARTER

1. THE FALSE DILEMMA

"The current suggestion that the economy must somehow steer a careful course between inflation and stagnation is a misguided and defeatist view of the situation."

OUR reforming Conservative government has been reduced to managing the economy in just the same way as its predecessors. Faced with the choice of stimulating economic growth and risking further inflation or attacking inflation by stern measures of restraint it has decided to steer a middle course. Presented with the alternatives as the pundits see them, a sensible and humane government could probably do little else.

The pundits, however, are no longer to be trusted. For years their remedy for inflation was an increase in unemployment. Now we have had the unemployment but the rise in money wages was steeper than ever. The pundits made the extraordinary mistake of regarding the economy as a free market and ignoring the monopoly power of the trade unions to force the price of labour up, but in any event the level of unemployment has no effect on the rate of inflation for wage increases are a symptom of the disease not the disease itself.

Inflation is an increase in the supply of money. The responsibility for it lies with those who are responsible for the supply of money. When a company agrees to a wage increase it does not create money out of thin air with which to pay it. Nor does it apply in triplicate to the Bank of England for some extra cash. It may borrow from a bank, but if it does the loan has to be repaid. The odds are that it will increase the price of its goods. If it cannot do this it must meet the charge from its own resources, by an improvement in efficiency or a reduction in dividends or retained profits.

Do price increases constitute inflation? Like the employer, the consumer does not manufacture money, or if he does he will soon find his consumption limited by the walls of one of Her Majesty's prisons. He does not queue at the Bank of England for a handout. If he borrows he must repay. Either he seeks to maintain his standard of living by asking for a wage increase or he must reduce the extent of his consumption.

One can see clearly enough the tendency for wage increases to lead to price increases and price increases to lead to further wage increases, or perhaps we should say (for no one can detect the start of the process) for price increases to lead to wage increases and wage increases to lead to further price increases. It is a spiral with which we are despairingly familiar, but a spiral that can take place only if the supply of money into the economic system allows it to. If the amount of money in circulation is X, then other things being equal the overall level of wages and prices can double only if the amount of money in circulation becomes 2X. Without an increase in the supply of money the wage-price or price-wage spiral must come to a halt.

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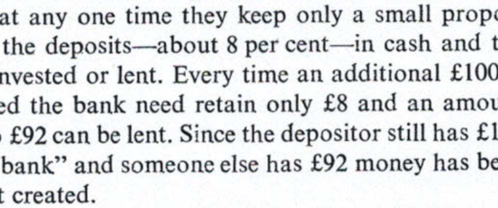
Who then increases the supply of money if it is not the employers or the consumers? The banks are often looked on as the villains, for money includes credit and the banks are the principal lenders.

If all a bank's depositors wanted to withdraw their money simultaneously the banks would not be able to meet the demand. Because they know that in practice only a small number of depositors are likely to want their money at any one time they keep only a small proportion of the deposits—about 8 per cent—in cash and the rest is invested or lent. Every time an additional £100 is deposited the bank need retain only £8 and an amount of up to £92 can be lent. Since the depositor still has £100 "in the bank" and someone else has £92 money has been in effect created.

There are two comments to be made on this. First, an increase in bank deposits may come about because more people are using the banking system, but this in itself is nothing to do with wage or price increases. Wage and price increases redistribute the money in circulation. If there is an increase in wages in the motor industry and it is met by an increase in the price of cars, then the workers in the motor industry may be putting more in the bank but the buyers of new cars will be putting in correspondingly less.

Secondly, what the bank lends must be repaid, and as it is repaid so there is a destruction of money cancelling out its creation. As it is repaid so it can be relent, but this process of creation and destruction of money can



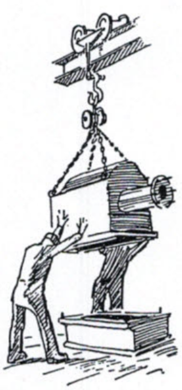
continue only as long as the deposit of £100 is immobilized. The bank can only use its £8 and the borrower his £92 if the depositor does not use his £100. If the depositor wants to put his £100 to use he must withdraw it and as soon as he does so the bank loses its £8 and reduces its lending by £92. Although, therefore, banks create money in name they do not create money for use except in direct substitution for money the use of which is renounced.

Commercial banks in England can no longer issue their own currency. That august body the Bank of England, founded in 1694 and nationalized in 1946 reserves that function for itself. Only the Bank can feed money as note and coin into the economy, and it does so not in response to some abstract assessment of what the banking system needs or by issuing pound notes to clamant employers, consumers, or banks, but through the monetization of government debt.

The traditional concept of a balanced budget is old hat today. It is no longer thought necessary or even desirable for governments to confine their expenditure within the income they can raise by taxation and borrowing from the public. If their proposed expenditure exceeds their estimated income from these sources the balance—the "net borrowing requirement"—is met through the Bank of England. The government issues securities to the banking department of the Bank and in return the Bank's issue department prints and supplies the government with money. The securities remain in the Bank and need never be redeemed; the money is spent into circulation by the government, so causing inflation.

Inflation of the currency is the necessary condition for the wage-price or price-wage spiral, and to stop inflation and the spiral that embodies it, all that is required is that government shall cease to practise it—that is, that they shall balance their budgets and not resort to deficit financing by means of the printing press.

At this point we find ourselves back with the level of employment, for inflation is not only an easy way out for spendthrift governments but also a deliberate policy, with the backing of economic theory, to help maintain full



employment. Inflation is a method of stimulating the economy by financing public spending without the corresponding reduction in private spending that would be caused by taxation. In addition, rising prices (the inevitable result of inflation) boost consumption in two other ways: first, there is a fall in the real value of saving so it is more attractive to spend than to save; second, because goods will cost more tomorrow than they do today there is an incentive to buy now rather than later.

Inflation seems, at least until recently, to have been

broadly successful in keeping the demand for goods buoyant and industry busy. Even now unemployment, although serious, is not of the same order as in the thirties. The consequences of inflation are, however, very damaging. The cost of living goes up, the scramble for higher wages leaves some behind, and those on fixed incomes are hurt hard. Because saving is less worth while there is a shortage of investment funds. Borrowing, the longer term the better, is encouraged (for every pound borrowed will be worth less when it is repaid), and interest rates rise to compensate the lenders. Above all, there are the psychological effects—the get-what-you-can, live-now-pay-later philosophy and the deep-seated mental insecurity that comes from an unstable currency.

Is inflation then a desirable cure for mass unemployment? To believe this is not only to accept that there is no less harmful cure but to make the deeper assumption that periodic mass unemployment is inevitable in a capitalist system unless corrective action is taken. The soundest method of maintaining full employment is to ensure that the economy thrives and continues to thrive without recurring recessions or the paralytic contraction of a slump. If this can be achieved without the need for inflation—and I shall argue in the next article that it can—then all justification for inflation falls away and it should be stopped immediately.

There is no need for an agonized choice between growth with inflation on the one hand and stagnation on the other, and the current suggestion that the economy must somehow steer a careful course between inflation and stagnation is a misguided and defeatist view of the situation. The opposite is true: if we can get the growth we can stop the inflation.

E.E.C. GOOD FOR LANDOWNERS

"The support measures in Europe tend to become capitalised in land values. With current land values in the United Kingdom substantially lower than in Europe the British farmer can look not only to a lift in farm income but a sharp rise in the growth of his land assets."

Laurence Gould in the *Daily Telegraph.*