

Monetarism is Not Enough

By **The Rt Hon Sir Keith Joseph Bt MP**

with a foreword by

The Rt Hon Mrs Margaret Thatcher MP

The Centre for Policy Studies was founded in 1974 by Sir Keith Joseph (Chairman) and the Rt Hon Mrs Margaret Thatcher (President). Its aim is to secure fuller understanding of the methods available to improve the standard of living, the quality of life and the freedom of choice of the British people, with particular attention to social market policies.

price 50p

Published by Barry Rose (Publishers) Ltd, Chichester & London
for **Centre for Policy Studies** London SW1

Centre for Policy Studies
8 Wilfred Street London SW1E 6PL
Telephone 01-828 1176

Published by Barry Rose (Publishers) Ltd, Chichester & London

SBN 85992 061 5

Printed in Great Britain by
Lowe & Brydone Printers Ltd, Thetford, Norfolk

Foreword

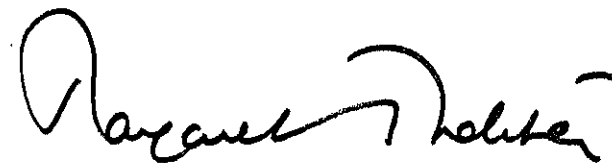
by The Rt Hon
Mrs Margaret Thatcher MP

It is now widely realised that many of our present economic ills stem from a cardinal error, the belief that inflation and unemployment presented a choice of evils. We have learned to our cost that inflationary measures designed in good faith to abate unemployment have eventually intensified it, leaving us with the worst of both worlds.

This new awareness, which is now common ground between Government and Opposition, owes much to Sir Keith Joseph's forceful expositions which had to brave considerable opprobrium before the tide of opinion was finally turned.

But – Sir Keith now argues in his 'Stockton Lecture' – there is a danger that the old errors will creep back in new form, with vast state expenditures maintained on the pretext that their reduction could cause much worse unemployment. His case is that this expenditure is financed largely at the expense of the small and medium businesses and unsubsidised larger firms which together remain our main source of employment and national wealth. So – he argues – for every job artificially maintained by public money, several workers go on to short-time working or lose their job altogether, as the private sector is squeezed harder.

I recommend this booklet, not only to Conservatives but to all who wish to grasp this crucial element in our complex social equation.



A handwritten signature in black ink, appearing to read 'Margaret Thatcher', written in a cursive style. Below the signature is a horizontal line with an arrowhead pointing to the right.

Monetarism is Not Enough

The Stockton Lecture 1976

My theme is that monetarism is not enough; perhaps I should say 'so-called' monetarism, because the word is a verbal snare implying a non-existent antithesis between monetarists and some other non-monetarist kind of economist. But every economist is by definition a monetarist in that he accepts that the supply of money impinges on price levels in almost all circumstances. Monetarism as now used normally refers to the policy of trying to move towards and then maintain a stable growth in money supply closely related to the probable growth in output capacity, as most likely to create the conditions for prosperity and high employment in freedom.

The false antithesis between monetarists and some so-called Keynesians really hides the antithesis between those economists who believe that monetary policies should be used to tackle monetary problems on the one hand and those on the other hand who believe that monetary policies can master non-monetary problems – such as union obstruction, lack of skills, overmanning, housing rigidity, lack of confidence – and non-monetary policies – like control of wages, prices and dividends – can master the monetary problem of inflation. This is precisely the opposite of what is needed. Whether you try to use excess monetary demand as a means of overcoming real obstacles to full employment and growth, or use deflationary pressures to achieve specific non-monetary objectives, you are mis-using monetary policy. The greatest advocates of this mistaken approach in the post-war world have been some pseudo-Keynesians.

Exegetical arguments about what Keynes really meant cover a great deal of paper. I am not qualified to follow them, except to say that it seems to me that Keynes was certainly not a Keynesian, and that he *was* a monetarist by any reasonable definition of the term. The essential difference between some of those who arrogate to themselves the term Keynesian and those against whom the

epithet 'monetarist' is brandished in order to frighten us off, is that the so-called monetarist rejects wonder-cures. True, we have been accused of advocating deflation as the cure-all, but the facts do not bear this out.

I put my position, as a so-called monetarist, on this matter in the following terms in my speech at Preston in September 1974:¹

'The monetarist thesis has been caricatured as implying that if we get the flow of money spending right, everything will be right. This is not – repeat not – my belief. What I believe is that if we get the money supply wrong – too high or too low – nothing will come right. Monetary control is a pre-essential for everything else we need and want to do; an opportunity to tackle the real problems – labour shortage in one place, unemployment in another; exaggerated expectations; inefficiencies, frictions and distortions; hard-core unemployment; the hundreds of thousands who need training or retraining or persuading to move if they are to have steady, satisfactory jobs; unstable world prices. There is no magic cure for these problems; we have to cope with them as best we can.'

I will try to restate this view in even broader terms: monetary stability provides a framework within which the individual can best serve his own – and therefore, if the laws and taxes are appropriately designed, the nation's – interests.

Needless to say, applying monetary policies even for appropriate purposes and particularly after a period of inordinacy requires very active government, great skill and strong nerves, readiness to make judgements and face dilemmas. We have much to learn from the latest stage of Germany's success story. Having insulated themselves from imported monetary inflation by floating the mark, the German Government and the Central Bank kept down the growth of the money supply to the level they had prescribed and thereby, as we can see, kept inflation within bounds. I refer you to Dr Emminger's notable speech² at the World Banking Conference here in London five weeks ago on December 10.

If we desire a monetary framework within which steady growth and high levels of employment can be achieved, we have no alternative but to maintain a stable money supply eschewing the use of demand creation as a short cut to growth and full employment. And to achieve this we must educate public opinion in the need for it.

And yet I still insist that monetarism is not enough; there are other parallel imperatives which will perhaps become clearer if we

¹ 'Inflation is Caused by Governments', p. 31, *Reversing the Trend*, Barry Rose, 1975.

² 'The Role of the Central Banker', *Second World Banking Conference, Financial Times*, 1976.

consider some aspects of the background to our present difficulties.

In explaining our fall from grace, we don't need to go back today beyond 1919. At that time, the monetary and economic policy-makers did not grasp the extent of the harm inflicted on the British and world economy by the blood-letting of the first world war and its repercussions.

The emotionally attractive idea of 'back to normal' was formulated in that year by the Cunliffe Committee¹ and accepted by the Government. After five years of deliberate deflation we returned to gold at the unrealistically high value of our pre-war parity.² The result was heavy strain on the economy, intensified by the short-sighted intervention of the monetary authorities and the Treasury. Much of the economic history of the inter-war period has been rewritten by socialists and Keynesians.³ The truth is not that the inter-war Governments followed '*laissez-faire*' policies and applied orthodox economics, as a whole generation has been misled into believing. The parity decision and all that flowed from it was interventionism – 'looking the dollar in the face' – in conflict with orthodox economic theory and a far cry from *laissez-faire*.

We were as a country in a transitional stage from world industrial primacy, and our need was in fact to adjust to new realities. The technological decline of our old staple industries, now having to face fierce competition from other countries, was not sufficiently offset by the growth of our new industries, particularly as depression and protection dramatically cut world trade. The response of government, industry, trades unions, advisers was to move rather to work-sharing cartels, rationalisation and restrictive trade oligopolies than to modernisation and competition.

In short, they tried to thwart change rather than smooth a path for it.

Their task was not made easier by the unions and their members which were deeply conservative – with a small 'c' – but had come increasingly to rationalise this conservatism by the use of heroic socialist phraseology. Their restrictive practices and wage-demands were incompatible with changed world-market conditions, even without an exchange rate 10 *per cent* too high. Britain was thereby made more vulnerable than it need have been to the German and Wall Street crashes.

Much of the damage was later undone by the financial policies of the National Government, which corrected the over-valuing of

¹ *Currency and Foreign Exchanges*, HMSO, 1918 and 1919.

² \$4.86 to the £.

³ The following books and their bibliographical references. *Economists and Policy: A Historical Study*, Donald Winch, Hodder & Stoughton, 1973; *Economic Survey 1919–1939*, W. Arthur Lewis, Allen & Unwin, 1949; *The Gold Standard and Employment Policies Between Wars*, Sidney Pollard, Methuen, 1970; *The Great Slump: Capitalism in Crisis, 1929–33*, Goronwi Roes, Weidenfeld & Nicolson, 1970.

the pound when it was forced off gold in 1931 and simply relinquished many of the interventionist measures, maintained a 2 per cent interest rate and let the economy look after itself, with occasional bouts of *dirigisme*, none of any great magnitude.¹

It is often forgotten that the thirties was a period of growth, expanding employment, rising living standards for a majority of manual workers.² Our growth rate was higher in the 1930s than that of other countries such as the USA, Germany and France. We could not reach full employment because the world was in depression – indeed, the same constraint applies to us with even more force now that we are comparatively weaker economically than we were then – but relatively, Britain was successful. The rate of expansion of building for home ownership was phenomenal.³

There was very serious deprivation in the older industrial areas, which suffered most from the combination of structural obsolescence and decapitalisation. But by and large, Britain was on its way forward again in the early thirties well before Keynes published his General Theory.⁴ It was later, during the war and early post-war years, that the history of the inter-war years came to be rewritten and the syncretism of Marxism and Keynesism, whose basic incompatibility was happily ignored by many, the easy answers, the panaceas found an eager audience. We tend to underestimate the impact of war on our institutions and economies. The first world war – in whose genesis the great pre-capitalist dynasties of the Romanovs, Hohenzollerns and Hapsburgs played so large a part – struck a far stronger blow against the economic and socio-psychological basis of the British capitalist democracy than was appreciated at the time, or for that matter now. The second world war continued this process, in several ways.

It not only further increased the actual role of the state, but also increased belief in the efficacy, indeed the virtual omniscience of state intervention. The closing victorious years of the second world war were euphoric. The war had helped re-establish much of the social solidarity which had been undermined by the blood-letting of the first and the subsequent impoverishment and depression. Wars are times of full employment, of national purpose, of an expanded role for government. It was only natural that the socialist-Keynesian theses on the capacity of government to solve social and economic problems should find the climate congenial.

I may seem to excuse everything by explaining everything, but this is not my intention. A few brave and percipient souls spoke

1 *The Future of Sterling*, A. C. L. Day, Oxford University Press, 1954.

2 Between 1930-3 money incomes rose by 6 per cent and real incomes 8 per cent. *Abstract of British Historical Statistics*, B. R. Mitchell, Cambridge University Press, 1962.

3 More houses were built in the second half of the 1930s than the first half of the 1970s. *Ibid.*, and *Housing and Construction Statistics*, HMSO, 1975.

4 *Macmillan*, February 4 1936.

out.¹ But most of us were part of the new climate. We wanted to believe that full employment, high growth rates, stability, etc., were all within our grasp if only we wished. My own party was strongly influenced by those who held such beliefs; in the political auction then taking place, outright scepticism seemed unprofitable.

We had other inhibitions, too. There was guilt. We came increasingly to be thought of as the party of the well-off, though millions who were not well-off preferred to vote for us rather than for Labour. We found it hard to avoid the feeling that somehow the lean and tight-lipped muffled men in the 1930s dole queue were at least partly our fault. And so paradoxically we were inhibited from questioning the misleading unemployment statistics of our own times since the last war which exaggerate the numbers of those who were unemployed – in the sense that an expansion of economic activity would permanently absorb them into productive employment – and understate the numbers of vacancies. It was as though we were trying to make amends to the unemployed of a generation back by exaggerating unemployment in our own time.

As a result, we based our judgements and our policies on an unsound statistical basis.² Even while we were encouraging or at least justifying mass immigration of workers first from Commonwealth, later from non-Commonwealth third world countries on grounds of labour shortage, we found nothing incompatible in risking inflation by expanding demand on grounds of the need to achieve fuller employment.

Because we failed to examine the implications of full employment policies, and the Welfare State, as well as the high taxation that accompanied them, we were inhibited from recognising the symptoms of failure when they appeared.

Although our post-war growth rate has been historically fast until recently,³ in retrospect it can be seen that the post-war policies of stimulating demand and high taxation began to eat away the sinews of the economy. This was not immediately evident – though we should have reacted to the skew in favour of consumption and against investment which has long been known. The resulting decapitalisation affected not only the range and effectiveness of our productive capacity, but also our infrastructure and the stock of savings.⁴ Undated War Loan, for example, now stands at not more than a tenth of its original purchase value, which means that someone else has consumed the other nine-tenths. The same holds good for most other outstanding monetary debt. Whole sections of the population,

1 W. H. Hutt, Friedrich Hayek; Lord Robbins, Sir Arnold Plant and Theodore Gregory.

2 *How Much Unemployment?: How Little Unemployment*, John B. Wood, Institute of Economic Affairs, 1972 and 1975; 'What the Unemployment Figures Really Show', Centre for Policy Studies, published each month.

3 *National Income and Expenditure (Blue Book)*, 1967 and 1974 (Tables 6, 8, 14), HMSO, 1968 and 1975.

4 *Ibid.*

including many of the most valuable, came to accept erosion of their living standards, property and savings. Many important branches of industry and construction suffered slower growth rate, stagnation and then actual de-capitalisation, though this was partly masked by the effects of inflation, and inflation-blind accounting.

Among the first symptoms of the failure was relative economic sluggishness. Those Keynesians,¹ or pseudo-Keynesians as it would be more correct to call them, who turned Keynesian economics into a new kind of magic, prescribed their wonder-drug: demand. It seemed to work at first, but, as we had been warned by the wise, the effects soon wore off and left the economy with the original symptoms, only in a more severe form than before. More demand was then tried. It created a balance of payments imbalance, an imbalance of payments. This in turn called for a 'stop'. We refused to believe that it was the drug which had caused the need for a stop, hence we still say 'stop-go', but it is the go which causes the stop, not vice-versa. True, the stop causes withdrawal symptoms which lead to pleas for more of the drug. But there are better ways of curing them.

Finally, a new stage in dependence arrived with what came to be called 'stagflation'. We were mystified by it, but there was no real cause for mystification. What had happened was that the economy had become more vulnerable through inflation-generated debilitation. We did not realise it. We were convinced that there must be some way of expanding demand while preventing the inflationary consequences. For all that happened was that to provide the same stimulus, the dose needed grew steadily.

In this new stage of dependency the economy reacts to demand expansion differently. As people anticipate inflation, the quantum of additional demand needed to stimulate the demand for labour to the desired level moves through an economy shackled with price controls and inflation-blind accounting procedures fast enough to create its depressant effects on activity and employment almost simultaneously with its stimulus, instead of subsequently, as hitherto.

This is a qualitatively new stage, not just an intensification of the previous stage, when progressively increasing levels of demand were needed to maintain a given employment rate. This finds the government trapped. If it does not increase demand, the withdrawal symptoms increase: bankruptcies, lay-offs, etc. If it expands demand, it also causes economic haemorrhage even while it stimulates the blood supply. It is no longer just stagnation and inflation which co-exist, but recession and inflation, or slump

¹ Joan Robinson, Lord Kahn, Lord Kaldor, Lord Balogh, Sir Roy Harrod, G. D. N. Worswick, Piero Sraffa, Roger Opie, Robert Nield.

and inflation, 'slumflation' perhaps – one notch worse than the 'slumpflation' invented by the *Economist*.¹

The second symptom of failure has been the declining birth rate of new enterprises as reported by the Bolton Committee.² Risk-taking has little appeal these days: the upward potential is small: the downward risk is almost unlimited.

And all this while those pseudo-Keynesian economists who have advised the politicians have been claiming for pseudo-Keynesian policies the credit for the full employment and the growth in post-war Britain. But Japan, Germany, France and, up until recently, the United States all had full employment and in the first three cases phenomenal growth rates – and yet they had hardly heard of Keynes, and generally applied orthodox fiscal and monetary policies. So did the wonder economies of Hong Kong, Singapore and Malaysia. Note what has happened to the United States since the application of Keynesian remedies from 1964 onwards.³ Kennedy had tried to apply them but had failed to persuade Congress. Johnson, carrying on with the same advisers and strategies, did manage to get these proposals through Congress. The inflationary results were exported for as long as faith in the dollar persisted, and then erupted into the American economic crisis and the world inflation of the late 1960s and 1970s.⁴

There is another important factor to consider. Despite our pioneering of the industrial revolution business has never been as esteemed or as attractive to the very talented as in rival countries. Perhaps this in part explains the lack of enterprise in British management so widely observed at the turn of the century and earlier. The first world war with all its demands had infused a fresh surge of vitality into British management, but decades of cartelisation, rationalisation and second world war controls had, not surprisingly, diminished what zest for enterprise and risk-taking we had as compared with businessmen in other advanced countries.

On top of this lesser business vigour and on top of all the well-meant but debilitating demand-management, we have added our socialist anti-enterprise climate: indifference, ignorance and distaste on the part of politicians, civil servants and communicators for the processes of wealth-creation and entrepreneurship; high taxation; very high marginal rates of taxation; perhaps most important of all – increasing capital taxation on the makers of wealth – whether self-employed, small, medium or large.⁵ It was Keynes himself who stressed the importance of the animal spirits of businessmen.⁶ Business

¹ 'Banking in Slumpflation', May 3 1975.

² *Small Firms Committee of Inquiry*, Cmnd. 4811, HMSO, 1971.

³ Professor Alan A. Walters, 'Keynesian Policies', Letters to the Editor, *The Times*, January 24 1976.

⁴ *United States: Economic Survey*, OECD, July 1975.

⁵ *Select Committee on a Wealth Tax*, Vols I-IV, HMSO, 1975; *How Much Inequality*, John B. Wood and George Polanyi, Institute of Economic Affairs, 1974.

⁶ 'The State of Long-Term Expectation', Ch. 12, *General Theory*, Macmillan, 1936.

involves risks as well as opportunities for power and wealth. By taxation, by inflation, by the remorseless flood of regulations and legislation, by controls and by the constant and arbitrary interventions of authority, successive governments since the war have cumulatively taken away both the pleasure and the rewards that once made risk-taking worthwhile.

By this attitude we have driven out some wealth-creators; discouraged others; shrivelled the impulse to expand and throttled enterprise. Unions have their share in responsibility by their short-sighted resistance to change, by the strike-threat and by over-manning. No one can measure the loss of wealth that would have benefitted all – repeat all – that this combination of influences has caused.

It is here in Britain that pseudo-Keynesian policies of demand management and deficit financing coupled with socialist attitudes to wealth-creation have since the war been put most sustainedly into action. The results can be seen in the attached chart. They can be summarised all too briefly: among industrial countries we have nearly always been at the top of the inflation and at the bottom of the growth league.

The result has been that our standard of living, our resources for defence and social services and all else have been less than they could have been. We have been surpassed by the performance of all other industrial countries.

This would seem therefore to be a time for governments and advisers to take thought. To a limited extent, this has been happening. But much more needs to be learnt and attitudes changed if there is to be hope of prosperity and sustained growth and high employment again. New ideas, the way out, will have to come from outside the treadmill. At the moment, we are still inside.

I have dealt with inflation, so far, as a monetary phenomenon; it is other things besides. Inflation, as you will be aware, alters the balance of the economy in a number of dimensions; between the state and the private sectors; between consumption and investment; between profitable and tax-borne activities; this changed balance, in turn, creates new monetary pressures.¹

Perhaps I can here touch on the particular discouragement of the manufacturing sector. Normally in a balanced economy we need not worry about the direction of enterprise – primary, secondary or tertiary sectors, farming, manufacture or services – because the advantages and disadvantages are market questions – and enterprise will go where there is demand for it. But the choice is no longer balanced: legislation, taxation, inflation, union

¹ *The Current Inflation*, Harry G. Johnson and A. R. Nobay (eds), Macmillan, 1971; *Inflation: Economy and Society*, twelve papers by economists, businessmen and politicians on causes, consequences and cures. Institute of Economic Affairs, 1972; *Full Employment at Any Price*, F. A. Hayek, Institute of Economic Affairs, 1975.

attitudes all make the employment of labour and the risks of manufacture more and more disproportionate to the potential rewards. So the balance has been shifted sharply in favour of service activity – and the consequent loss of manufacturing enterprise narrows the base on which all depends.

The changed balance between the state and private sector is crucial, both in itself – in the sense that it impinges on the kind of society we have as well as on economic efficiency – and because it reacts on the level of inflation. However, the division between state and private must be supplemented by a parallel division between subsidised and self-sustaining sectors. The point about state activity is not that the shares are owned by government, but that its existence does not depend on its ability to earn in the market an income to match its out-goings. The state sector – the public services from defence to education and health and the rest – is dependent, sustained either wholly or partly from taxation or other imposts. This is true of nearly all nationalised industries and the subsidised private firms.¹

I grant at once that price control by governments has imposed a heavy toll of losses. But in electricity, gas and the others, insofar as they enjoy monopolies granted by law, then it might still be true even if their charges covered their cost, since their statutory monopoly permits them to charge higher prices than competition might allow. This public sector is relatively insensitive to economic conditions; it does not spontaneously adapt; it exerts a huge force of not merely inertia but also of impetus. This matters little when the insensitive public sector is relatively small, but now that nearly two-thirds of our national activity flows in some way from the government, its insensitivity can be disastrous.²

However, just as in a predominantly free market economy, the market tends to set its stamp on all other institutions, so, in a state-dominated society, the state tends to set its stamp on nominally private institutions. In our case we see this proceeding along several axes. One is that in order to deal with the state bureaucracy, the man-made environment of licences and permits, planning permissions and regulations, grants and write-offs, premiums and taxes, forms and forms and forms, business has become increasingly bureaucratised. Whether retired civil servants are taken on strength, or whether recruits are trained to imitate them, the state re-makes private industry in its own image.

As we know, the right to work has come to mean the right not to work, the right to go on receiving wages, usually high wages, unrelated to economic contribution. In the name of the right to

¹ *Failing the Nation: Record of the Nationalised Industries*, George and Priscilla Polanyi, Fraser Ansbacher, 1974; *How Much Subsidy?*, A. R. Prest, Institute of Economic Affairs, 1974.

² In 1974 Public Sector Expenditure, which includes the Current and Capital accounts of the Central Government and the local authorities together with the Capital account of the Nationalised Industries, together with Debt Interest of all these categories was 56 per cent of GD at factor cost in 1974. *Economic Trends Annual Supplement No 1*, HMSO, 1975, pages 5 and 113. According to OECD estimates of GDP and recent trends in public spending the figure could reach 62 per cent in 1975.

work, some large private firms have come to receive heavy and open-ended subsidies to keep them going. I do not wish to discuss the economic or social rationale of overmanning, except to say that none of the arguments in favour stand up to rational examination, and that the practice fits neither capitalist nor socialist economics and ethics, but is simply opportunist.

To criticise opportunistic make-work subsidies to overmanned or economically obsolete enterprises in no way implies that policies should not be designed to maximise employment. On the contrary, short, medium and long term stability of employment, particularly the medium and long term, are legitimate and rational policy objectives. My criticism of the lame-duck breeding measures – the Chrysler, British Rail, steel-style intervention, is that they are not at all calculated to maximise employment, but on the contrary, precisely that they in fact erode employment while nurturing highly-paid concealed unemployment.¹

Had the present Government said, in effect, that given the fall in aggregate demand inherent in counter-inflationary monetary policies, it would need to watch very carefully the effects of its policies on employment opportunities at a given level of aggregate demand, it would in consequence have followed a far different path. For by subsidising the least efficient and most capital-intensive firms (fixed and working capital), eg, British Leyland, Chrysler, Govan shipbuilders, at the expense of industry as a whole, the Government could not help decreasing employment many times over in the more efficient and basically healthy small and medium private firms, which provide far more employment per unit of capital. For every job preserved in British Leyland, Chrysler and other foci of highly-paid outdoor relief, several jobs are destroyed up and down the country. If Ministers and union leaders were genuinely concerned to prevent unemployment and to safeguard productive employment, they would not have acted as they have done. On the contrary, they would have helped slim down these costly giants so greedy of resources, and done everything possible to improve the economic climate in which the small and medium firms live.

Given a policy of contracting the real money supply, Mr Healey could have saved more jobs by not supporting overmanning than by supporting it.

So much for the difference between job protection and expanded employment opportunities. What concerns me here is the interaction between inflation and the inter-sectoral balance.

We note that inflation and a changed inter-sectoral balance show marked correlation, whether we define the sectors as state

¹ Sir Keith Joseph, 'This is Not the Time to be Mealy-Mouthed: Intervention is Destroying Us', *Reversing the Trend*, Barry Rose, 1975.

and private, subsidised and unsubsidised, or wealth-creating and wealth-consuming.

The second chart shows that increased Government spending, *pace* Mr Healey, reduces the capacity of the corporate sector to renew itself by natural regeneration.

I have argued that the expansion of the state sector and other segments of the subsidised sector throws an increased burden on the private sector, to a point where segments which would otherwise survive collapse. They then either fall by the wayside or in turn draw subsidies to keep alive, thereby increasing the total burden imposed on the shrinking private unsubsidised sector. Since the mid-1950s, the silver-age of Churchill's post-war administration, the relation between the state and subsidised and private unsubsidised sectors has changed decisively. Then, a wealth-creating sector which accounted for three-fifths of the GNP carried on its back a state and subsidised sector equal to the remaining two-fifths. This was heavy enough, too heavy perhaps to be borne easily in the long-term through a turbulent world economy. But at least then the private wealth-producing horse was still larger, stronger, heavier than its state rider.

By now, the proportions are reversed. When you take the division of the national product, let alone the hidden obligations – eg local government and public sector undisclosed pension-supplement liabilities, undisclosed deficits all of which must be made good from the public purse – it transpires that the state and subsidised sector now accounts for some two-thirds, and the private wealth-producing sector the other third.¹ The rider is now twice as heavy as the horse instead of only two-thirds as heavy.

This is a qualitative change. It is also a self-perpetuating change, unless we step in to reverse it. For the burden is so heavy that the process would continue by its own momentum even were it not accelerated by further nationalisation measures which turn profitable firms into losers.

It also fuels inflation, since the shrinkage of the private self-supporting sector automatically reduces the tax base, and the Government in order to finance concealed unemployment and to support inefficiency is tempted even more strongly to create new money to meet its growing obligation.

Look at what has been happening. During the 'go' phase of the cycle we have expanded demand and government expenditure, either hoping for the best or trying to suppress inflationary symptoms by controls on prices and wages. But during the 'stop' phase, successive governments have acted by monetary and fiscal

¹ *Op. cit.*, *National Income and Expenditure, 1964-74 (Blue Book)*.

measures which impinge principally on the private sector. Though, it is true, there is always talk of cutting public expenditure, it has remained almost entirely talk. Cutting public expenditure has come to mean juggling with figures, 'cutting increased expenditure', ie, increasing public expenditure by less than it would otherwise have been increased. When you study the expenditure figures *ex post*, you will see that for yourselves.¹

But whereas cuts in public expenditure rarely eventuate, squeezes on the private sector are 'for real'. The interest rate is increased, bank lending is contracted, taxes are raised, other old-fashioned deflationary measures are used. The private sector is punished for the state sector's profligacy.

So, each 'go' expands the state sector. Each 'stop' squeezes the private sector. And, as we have seen, when the squeeze comes, some enterprises go to the wall – or to the Government. The large ones go to the Government for aid. This is nothing to do with their intrinsic merits, though one can cook up an argument in favour of any decision once it is taken. It is their size hence their concentration of workers, hence their power in union and electoral and media terms, hence the Government's temptation to buy peace.

By and large, these concentrations of unionised workers in large enterprises correspond to high concentrations of capital, fixed and working capital, higher than average. In other words, as I argued earlier, it takes much more money to employ each worker than it does in the smaller enterprises, which are rarely able to bring the kind of pressures to bear to maintain overmanned uneconomic plants. So, when the squeeze is on, those enterprises which are not only least profitable and least economic generally, but those which will need the greatest amount of help per job saved – however temporarily – come to the top of the queue automatically, by virtue of these very characteristics.

So the inflationary spiral is given another turn. This can be seen to be a linked spiral, with the squeeze of private sector, growth of state-supported sector, greater burden on residual wealth-producing sector.

If this squeeze continues the productive base on which all else rests will buckle. So, our monetary policies must be designed to save the private sector while cutting the state-cum-subsidised sector. For if we do not, inflation will be intensified anyway, by the workings of the mechanisms I have traced. Moreover, unless the squeeze is directed against the wealth-consuming sector, the private sector will be left with no alternative but to call for

¹ *The Financing of Public Expenditure*, Vol I – Report, Vol II, Minutes of Evidence and Appendix, HMSO, 1975.

reflationary policies, whatever their middle-term effects, in order to survive in the short term. In other words, monetary policies on their own place the private employers and their workforce willy nilly on the side of the wealth-consuming sector, in creating political pressures in favour of more wasteful policies, and leaves the anti-inflationeers isolated.

Cuts in state spending are essential both to make way for the revival of the wealth-creating sector and to achieve a deceleration of the growth of the money supply. Cuts in state spending of sufficient magnitude to reduce inflation substantially will require strong nerves. But the alternative would be accelerating decline in standard of living and in employment within the next few years.

To hold down the growth of the money supply to a level commensurate with the expected growth in productive capacity, and to keep it there, is part of the cure for inflation.¹ If the whole economy were private, then all firms would be subject to the resulting constriction – and only the unsound would need to go. But the whole economy is not private. Nearly two-thirds is statist, and insensitive in itself to contraction of the money supply. It is fed with money which is expanded automatically to maintain given levels of expenditure in real terms – 'funny money', as Samuel Brittan calls it. Indeed, while money supply is contracting, budgetary spending is expanding.

So the state sector bids up interest rates, bids off funds, bids away manpower and leaves the force of the monetary contraction focussed on the private sector. While the activity rate is low, and stocks have run down, as now, the private sector feels the pinch of lower demand and increased costs but, though there are record levels of bankruptcies, the sector as a whole can temporarily increase its liquidity.

When the upturn comes and world prices lift, stocks are rebuilt, and investment begins to surge, the spare liquidity will be needed for industry. Then what will become of money supply contraction? The contraction will either become a garotte, strangulating expansion of our trading base, or to counteract this, there will be an explosion in the money supply. Then the next cycle of boom-and-bust will be at even higher Latin-American rates first of inflation and then of inflationary unemployment.

In other words, the monetary process is both a cause of inflation and a link in a wider chain of cause and effect. Monetary contraction in a mixed economy strangles the private sector unless the state sector contracts with it and reduces its take from the national income.

¹ *Crisis '75* . . . ? Sir John Hicks and others, Occasional Paper 43, Institute of Economic Affairs, 1975. In particular the essay 'Turning Point or Moment of Danger?', E. Victor Morgan.

Hence my title 'Monetarism is Not Enough'. Detaxing and the restoration of bold incentives and encouragements to business and industry are necessary too. Until the state contracts, and indeed until enterprise is encouraged both by this contraction together with some assurance that it will stay contracted, and by less destructive taxation and intervention, there will not be the confidence nor the climate for entrepreneurship and risk-taking that will alone secure prosperity, high employment and economic health.

Cuts mean cuts. At present, we have learned, actual government expenditure has outrun projected by several percent of the GNP. We shall need to cut it back by several percent. Pseudo-cuts of future programmes will not be enough. We shall need to cut state employment and subsidies to rail, steel, housing and the supported sector. We shall need to explain that subsidised employment is not really saving jobs because the subsidies have to be paid for and the paying for them loses more jobs than are saved. We must demonstrate that state spending – including subsidies – is a cause of many smaller firms cutting their labour force or going out of business.

Let me emphasise: to say that 'monetarism is not enough' is not in any sense to retreat from monetarism. On the contrary, it is to advance from monetarism. It is to recognise that our argument has gone a long way towards winning, but it will not be enough to have reduced inflation if we do not enable the private sector to revive when we have won the battle.

For in economics, there are no ultimate causes, only proximate causes. Every cause is itself an effect, a symptom, every effect becomes a cause. Our present irrational economy, which cannot last because it is undermining its own foundations, throws up problems of its own which are variants of more general problems. Our monetary problems reflect the underlying weakness of this man-made chaos, the divorce of work from production, of cost from benefit, of reward from performance, the greatest government spending spree of all time which is designed primarily to keep people busy instead of useful. In a sense, we are moving into the make-believe economy where, instead of digging holes and filling them in again, we make motor cars that no one wants, put three men on a train – which we cannot fill anyway – when only one man is needed.

This is going through the motions, keeping up appearances, window dressing a fraudulent facade. Behind the facade, the private sector that produces the goods which people want is

restricted by controls, over-taxed by local and central government and harassed by officials. Our monetary arrangements are bound to reflect this dichotomy. Hence the public sector's 'funny money', which, we now learn belatedly, has led to massive state over-spending,¹ while the ever more constricted wealth-producing sector has to conduct its accounts, taxes and dividends in terms of an increasingly threadbare pound.

For the continually constricted private sector the unit of account was increasingly threadbare pound sterling, good to borrow, less good to hold, meaning less and less as firms which have shown good profits on paper year after year – to howls from socialists – suddenly find that they are somehow on the verge of bankruptcy, and have been for years, without knowing it. The private sector has the unfunny money.

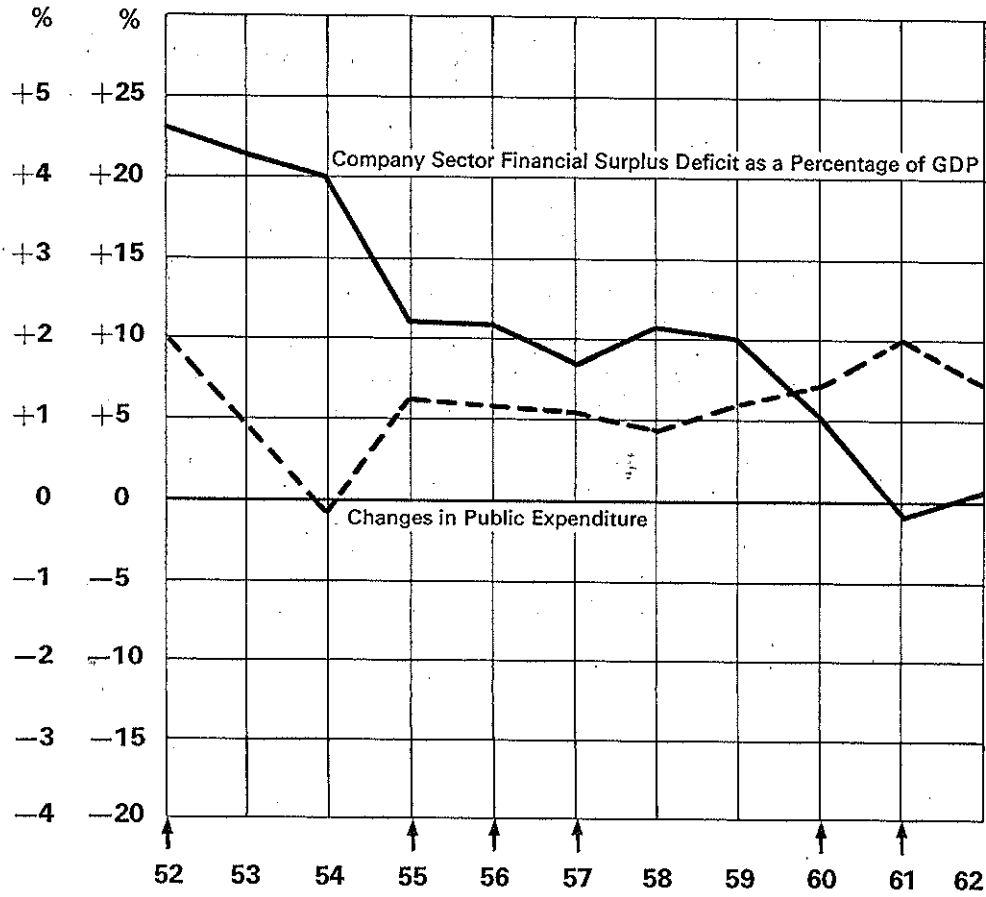
Monetarism is not enough. This is not intended as a counsel of despair, but a warning note. Government's intention to contract the money supply is welcome and potentially beneficial to all. But it is not enough unless there is also the essential reduction of the state sector and the essential encouragement of enterprise. We are over-governed, over-spent, over-taxed, over-borrowed and over-manned. If we shirk the cure, the after-effects of continued over-taxation will be worse than anything we have endured hitherto. Our ability to distinguish between economic reality and economic make-believe will decline further. We shall experience accelerated worsening of job prospects, the growing flight of those with professional skills, talent and ability to other countries, and an increase in the shabbiness and squalor of everyday lives.

That is why, by itself, the strict and unflinching control of money supply though essential is not enough. We must also have substantial cuts in tax and public spending and bold incentives and encouragements to the wealth creators, without whose renewed efforts we shall all grow poorer.

¹ During 1974-5 the public-sector borrowing requirement exceeded its budget estimate by some £3,000 million (or 4 per cent of gross domestic product). Op. cit., Financing of Public Expenditure.

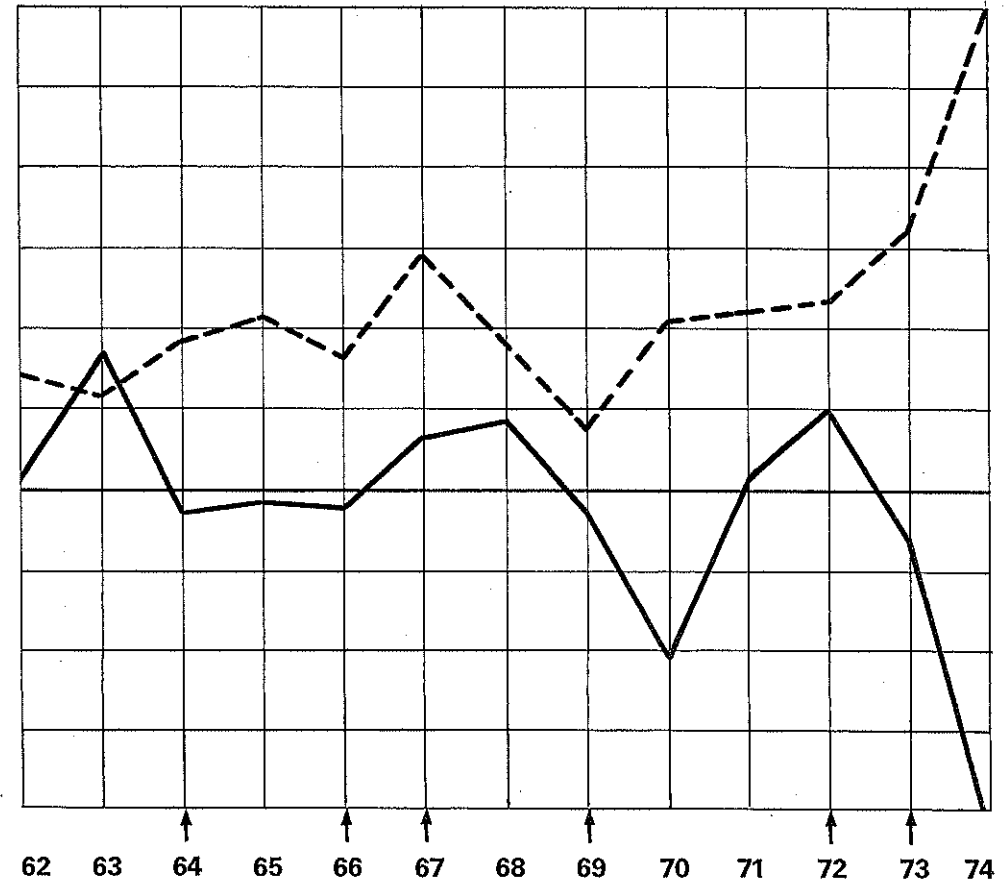
CHANGES IN PUBLIC EXPENDITURE.

CHANGES IN COMPANY SECTOR FINANCIAL SURPLUS DEFICIT AS A PERCENTAGE OF GDP



NOTES: The years in which the Bank Rate was increased are marked with an arrow. The +5 per cent -4 per cent scale applies to the Company Sector Financial Deficit and the +25 per cent -20 per cent scale to Public Expenditure.

SOURCE: Bank of England Statistical Abstract Vols. 1 and 2: Economical Trends Annual Supplement 1975.



	Changes in Bank Rate & Minimum Lending Rate	Domestic Credit Expansion £m	Public Sector Borrowing Requirement £m		
1950	2			1950	
1951	2½			1951	
1952	4	+ 51	771	1952	
1953	3½	+ 293	591	1953	
1954	3	+ 342	397	1954	
1955	3½, 4½	- 92	469	1955	
1956	5½	+ 75	564	1956	
1957	5, 7	+ 201	486	1957	
1958	6, 5½, 5, 4½, 4	+ 103	491	1958	
1959	No Change	+ 746	571	1959	
1960	5, 6, 5½, 5	+ 385	710	1960	
1961	7, 6½, 6	+ 513	704	1961	
1962	5, 4½	+ 275	547	1962	
1963	4	+1040	842	1963	
1964	5, 7	+1514	989	1964	
1965	6	+1130	1205	1965	
1966	7	+ 790	961	1966	
1967	6½, 6, 5½, 6, 8	+1766	1862	1967	
1968	7½, 7	+1908	+2001	1279	1968
1969	8	- 181	- 147	- 446	1969
1970	7½, 7		+1041	- 18	1970
1971	6, 5		+1141	1371	1971
1972	6, 7½, 9		+6878	2054	1972
1973	8½, 8½, 8½, 7½, 7½, 11½, 11½, 13		+8616	4218	1973
1974	12½, 12½, 12, 11½, 11½	+7660	6325	1974	

SOURCES: Economic Trends Annual Supplement 1975
Bank of England Statistical Abstract Vols I & II
Hansard, House of Commons Reports

CHRONOLOGY: Samuel Brittan: The Treasury under The Tories
G. E. Wadsworth ed: The Banks and the Monetary System in the UK 1959-71
Bank Rate BMLR Month End Figures

FINANCIAL CHRONOLOGY

		Percent Changes in Real GDP	Percent Changes in Money GDP	Percent Changes in Public Expenditure	Company Sector Financial Surplus/Deficit +/- £m	Company Sector Financial Surplus/Deficit +/- as a percentage of GDP at factor cost	Public Expenditure as a percentage of GDP at factor cost	Year on Year increases in Retail Prices %
	Oct:							
	Jan:	3.3	4.0	1.3*				
50	Jan:	3.6	11.3	19.9			42.78	3.2
51	Nov:						46.07	9.1
	Jan:							
52	Mar:	0.0	9.1	10.3	+ 640	+4.64	46.55	9.1
	Apr:							
53	Apr:	4.7	7.9	4.0*	+ 646	+4.34	44.88	3.0
54	Apr:	3.6	5.7	- 0.9*	+ 627	+3.99	42.09	2.0
	Aug:							
55	Feb:							
	Apr:							
	Jul:	3.5	7.3	6.5*	+ 395	+2.34	41.77	4.4
	Oct:							
56	Feb:							
	Apr:	1.9	8.3	6.3*	+ 399	+2.18	41.02	4.9
	Dec:							
57	Apr:							
	Aug:	2.0	6.1	5.4*	+ 309	+1.60	40.79	3.7
	Sep:							
58	Jan:							
	Apr:							
	Jul:	-0.3	4.3	4.6	+ 450	+2.23	40.92	3.1
	Oct:							
59	Apr:	3.5	5.2	6.0	+ 421	+1.98	41.25	0.5
50	Jan:							
	Apr:	4.7	6.5	7.2	+ 223	+0.99	41.51	1.1
	Jun:							
	Oct to Dec:							
51	Jan:							
	Apr:	3.6	7.0	9.8	- 57	-0.24	42.58	3.4
	Jul:							
52	Feb:							
	Apr:							
	Jun:	1.0	4.4	6.7	+ 20	+0.08	43.54	4.3
	Jul:							
	Oct:							
53	Jan:	4.0	6.3	5.9*	+ 421	+1.57	43.38	1.9
	Apr:							
54	Apr:	6.1	8.8	9.4	- 126	-0.43	43.61	3.3
55	Dec:							
56	Apr:	2.5	6.8	10.8	- 62	-0.20	45.27	4.9
57	Feb:							
58	May:	2.0	6.1	8.3	- 94	-0.28	46.22	3.9
	Jul:							
59	Jan:							
60	Jan:							
61	Nov:	2.5	5.5	14.4	+ 211	+0.60	50.15	2.5
62	Jan:							
63	Mar:	3.6	7.2	9.0	+ 279	+0.75	51.00	4.7
64	Apr:							
65	Apr:	1.4	5.1	3.6*	- 142	-0.36	50.26	5.4
66	Oct:	1.9	9.8	10.5	- 899	-2.08	50.59	6.4
67	Mar:							
68	Mar:	2.2	12.8	11.4*	+ 75	+0.15	49.95	9.4
69		1.7	12.1	12.3	+ 553	+1.01	50.12	7.1
70		5.3	15.1	16.9	- 418	-0.66	51.10	9.2
71								
72		1.0	15.4	29.7	-3259	-4.49	57.29	16.0

NOTES: In 1968-69 there is a break in the series Domestic Credit Expansion.
In 1963 there is a break in the series Company Sector Financial Surplus/Deficit. See Material.

* Year in which Public Expenditure expanded less rapidly than money GDP.