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Will monetarism lead to economic recovery?

BRIAN GRIFFITHS believes the Government must stick to its policies, however unpopular

THE list is endless. Opposition leaders, CBI chiefs, ex-Tory Prime Minister, trade unionists, Conservative backbenchers, Oxbridge economists, and journalists from almost very newspaper still in print. Hardly a day passes without some member of the corporate establishment taking a swipe at Mrs Thatcher's monetarist policies.

Despite the strong personal interests which all the above have in discrediting monetarism, there are three fundamental questions being asked of the Government's monetarist policies.

First, can we be sure that they will work? This involves two separate questions: does a progressive reduction in the growth of the money supply lead to a progressive reduction in inflation, and can the Government control money supply growth with a sufficient degree of precision to keep to its medium-term financial targets? I believe the answer to both questions is an unequivocal yes. Already the rate of inflation is coming down markedly. After rising to over 20 per cent. it is now 15 per cent. and falling. This success is the result of past monetary policy and gives lie to the suggestion that price and wage controls are necessary to reduce inflation. In fact, price inflation has been falling at a time when wage inflation has been rising. If the Government sticks to the medium-term monetary strategy which it has set itself, the rate of inflation by 1984 will be well below 5 per cent.

The question of money supply control is more complex. I have no doubt that the Bank of England, *if it so desired*, could have controlled money supply growth over the past year. What is now becoming patently obvious is that the Bank has made the level of interest rates, not money supply growth, the prime target of policy over the past year. But no central bank in the world can control interest rates *and* money supply growth. It can choose to target one, but then must accept the market's determination of the other.

The real problem is that the Bank of England no longer sees itself as the custodian of our national currency but of the level of exports, employment and manufacturing output. By attaching primary importance to controlling interest rates and accepting the consequence in terms of the money supply "explosion," the Bank of England has put at jeopardy and thoroughly d i s c r e d i t e d this Government's medium-term financial strategy. In its defence the Bank may claim that it has shielded British industry from having to cope with interest rate levels of 20 per cent. or more earlier this year. This is quite true. But these levels would have lasted only a few months at most. Witness the American experience.

The tragedy is that as a result of Bank of England behaviour we are now living with interest rate levels far higher than is necessary and that in 18 months or so we shall reap a bitter harvest when the rate of inflation starts rising again. The money supply can never be brought under control if the Bank of England is not brought under control. I once believed that giving independence to central banks would increase the probability of their pursuing sound money policies. I am now convinced that if this Government wishes to reduce inflation permanently its primary task is to assert its total supremacy over the making and execution of monetary policy and accept the consequence in terms of changed techniques and, if necessary, other changes too.

The next basic question about Mrs Thatcher's policy is whether the price demanded by monetarism is too high. Even before present policies were adopted no one, to my knowledge, has ever suggested that some costless way of reducing inflation exists. As a result, the choice is between the lesser of two evils so that we are bound to accept a temporary and small rise in unemployment if we are to reduce inflation. For politicians such as Mr. Foot and Mr Healey to stand up and hold out some other prospect is a display of either ignorance or dishonesty. However, the rapid increase in unemployment this year at a time when monetary policy has been very easy is far more than the cost of just tackling inflation. It results primarily from factors outside government control — the world recession, the high exchange rate following North Sea oil and high wage settlements — and also partly from the attempt to reduce inefficiency in the public sector.

What the problems of such firms as British Leyland, British Steel and British Airways show is the enormity of the disguised unemployment which has existed in this country for decades and which was allowed to get out of hand during the 'seventies. If the Government were to change course and place an upper limit on the feasible level of unemployment, it could only do so at the cost of accelerating inflation which in turn would destroy even more jobs over the next few years. The Government is absolutely right to give priority to reducing inflation and eliminating inefficiency in the national interest if we are to survive and prosper as a nation. To attempt to help the unemployed by short-term reflation would be to put popularity and short-term electoral interests in place of laying the foundations for future prosperity.

Although, therefore, the cost of reducing inflation to provide a basis for renewed prosperity is something we should be prepared to pay, nevertheless the C B I, and small businesses in particular, have a good point to make. Most of this cost has been borne by the private not the public sector.

The proper response to this is not a reckless reduction in the Minimum Lending Rate, which would be followed inevitably by an acceleration in money supply growth from its present inflated level, but a reduction in the demands of the public sector on our limited national resources. This involves further substantial cuts in public spending. As these take time and because it is imperative to reduce interest rates in a non-inflationary way over the next six months, the only option open to the Government to help the C B I over this next year is to have a winter-budget which raises personal income tax and reduces the National Insurance Surcharge. If these were complemented by expenditure cuts which took effect in the next financial year, then the Chancellor would once again be able to hold out the promise of lower direct taxation in the spring budget of 1982. The one thing the Government must not do is to jeopardise its medium-term strategy for the sake of short-term popularity — which if it fails to take this kind of action it will clearly be risking.

The final question is whether, as a result of present recession with increasing bankruptcies, closures and redundancies, we might be left as an economy without a viable manufacturing base? Although the present recession is severe all is not gloom. Oil and the financial sector are booming. In the same industry some firms flourish while others languish.

The moral is simply that despite high interest rates and a high exchange rate first-class management can still generate success. When money supply growth is seen by the investing public to be firmly under control, interest rates will fall; and when public sector spending is brought under control they will fall even further. Low interest rates and higher bond share prices will encourage expansion by existing companies, stimulate the setting up of new small businesses and attract foreign investment.

In a State planned economy it might be possible to pinpoint the source of recovery. In a market economy it is not. I suspect the emphasis will be more on high technology, quality products and services backed up by first-rate research and invention (at which we have always prided ourselves) rather than across-the-board manufacturing. The best the Government can do is to create a stable economic environment in which free enterprise can flourish.

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Dear Prime Minister,

I am writing to say how much I enjoyed yesterdays meeting on the subject of monetary policy and to encourage you to take as strong a line as is necessary with the Bank of England. I believe that the major loss of credibility is not due to fiscal policy (which most people instinctively realise must have overshot because of the magnitude of the recession) but to a monetary policy which has been very permissive. As I say in the enclosed article I cannot now see how monetary policy can be brought back on course without the Bank being forced to change its ways.

I also feel however that the current pessimism is overdrawn. Inflation is coming down. Private sector wage increases have fallen dramatically. The fall in inflation and interest rates will raise real income and wealth and spending should pick up of its own accord next year without any fiscal boost. With a higher real exchange rate, a restructuring of British industry and a world recession, unemployment would have risen largely regardless of whoever was in government. It is quite wrong for people to ascribe the rising unemployment to your own monetarist policies. If some other government would have allowed money supply to grow to accommodate the real changes which we have experienced this past year we would now have interest rates of well over 20% and could look forward to inflation reaching 40–50%.

In terms of the mechanics of monetary policy I hope to put my ideas on paper after Christmas. Meanwhile may I wish you a very happy Christmas indeed.

God bless you.

Yours very sincerely

Brian Griffiths.

P.S. Please excuse this letter being typed but public sector typists seem to ignore the last day of work before Christmas!