SHERMAN

(F)

HIGHLY CONFIDENTIAL

To the Prime Minister

Monetarism is Not Enough.

High Government spending is generating an inflationary recession which threatens to erode the Prime Minister's political base.

The disturbing monetary figures should have surprised no one. They follow ineluctably from government measures of the past year.

Unless there is a radical change in policy, attempts to stem inflationary pressures by means of "monetary targets" will intensify our endemic inflationary recession (misleadingly called slumpflation). This, in turn, is already predictably generating strong pressures from inside industry and its sympathisers for a reversal of monetary policies.

These pressures will grow. Decision to "stand firm" will come under increasing strain as the economic ground beneath our feet crumbles with lay-offs, closures, liquidations, etc. Only strong cuts in state expenditure now can avert a pincer movement from industry and the unions, all backed by Labour, the quality press and (one can foresee) the so-called "anti-monetarist", i.e. anti-economic wing of our own party.

I refer to my previous memos: "Statutory Indexation of OAP's Sow a Whirlwind for 1983/4", January 1980; "Camparability is Odious", February 1980; "Amicus Plato sed Magis Amica Veritas", March 1980; "Monetarism is Not Enough" by K.J. in 1976. Also two Daily Telegraph articles on indexation and the built-in inflationary treadmill. Copies enclosed.

As I see it, the government is continuing to follow "British Socialist Keynesian" policies, while using monetarist catch-phrases and hence being regarded as monetarist. "Monetary Targets" can no more contain inflation than could "incomes policy" before it. To have thought otherwise is simply an exercise in circle-squaring. As "Monetarism is not enough" pointed out, in 1976, cuts in the public sector are simply paper cuts, while squeezes on the private sector are for real. Each "go" expands the public sector; each "stop" contracts the private sector.

Our monetary policies will work only if they are in tandem with measures to restore the private wealth-producing sector at the expense of the state and subsidised sectors. So long as the state sector is not actually cut back, monetary squeeze will simply buckle the productive base on which all else rests. As it is squeezed, the private sector is left with no alternative but to call for reflationary policies in order to survive in the short term. It is no use asking them to stand firm while Carey St. looms, the more so if they do not believe the cure to be real anyway. As KJ wrote

in 1976 "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, leaving anti-inflationeers isolated".
This is now beginning to happen again. My contention is that our Treasury ministers have permitted the civil servants - who believe that their past policies were right - to continue using Keynesian mechanisms, i.e. interest rates, credit restriction, with monetarist jargon.

As a result, monetarism is being widely discredited without even being tried. By my arithmetic, given a GDP of some £125 b. and an inflation rate of the order of magnitude of 20% created by government excessive borrowing, government spending would have needed to be cut by several billion to have any effect. Everything else - corsets, interest-rates, special schemes - are pure circle-squaring. With most of the state-sector spending indexed, inflation feeds on itself.

Talk about "medium term monetary targets" was simply shadow-boxing from the outset. The monetary supply is a function of government spending and borrowing and the level of activity in the wealth-creating sector. Unless government spending, a large part of which is unproductive or counter-productive, is cut, the "targets" remain as unreal as George Brown's famous plan, whistling in the dark. The civil servants are happy to see this happen, so that they can step in when erosion progresses, and throw their weight onto the U-Turn band-waggon.

Then, there is the trade union dimension. I do not think that any monetary policy, even backed by real decision to cut government expenditure, can work unless the imbalance of trade union power - with its vast political dimensions - is tackled. But the Bill shirks this, deliberately, because Prior explicitly declines to "go against the grain of traditional and organised trade union practice" or to "provoke a trade union campaign" - i.e. to clip the unions' wings. So, instead, we "print" and apply Keynesian squeezes while talking monetarism.

To sum up: so long as inflation is being generated by the public sector, to try to abate it by squeezing the private sector is both unworkable and unfair. Either you cut the parasitic public sector, or inflationary recession intensifies. I do not underestimate the political frictions entailed in reform. But if this is politically "not on", then can national recovery be "on"?