

THE MARXIAN THEORY OF INFLATION

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NOTES ON INFLATION AND THE CURRENCY

I. Various factors which affect prices

1. The basic factor underlying all prices is value – the average number of hours of labour socially necessary to produce a commodity. (Thus a commodity needing 20 hours will represent value double that of one needing 10 hours, and the price will be affected accordingly).
2. The rise or fall of value of a commodity will affect its price, though price and value are not necessarily identical.
3. Changes of supply and demand in the market will affect individual prices including the special case of monopoly.
4. Government subsidies can keep the price of a commodity below the level which, but for the subsidy, it would sell.
5. These (and some other factors) affect individual prices, but one factor which affects the general price level centres round the currency – notes and coin.
6. To prevent confusion the term *inflation* is confined here to that aspect, as used to be the general practice. Inflation is depreciation of the currency.
7. One other factor also affects the general price level. This is the rise which takes place at a certain stage in the cycle of expansion, boom, crisis, depression; and the fall which takes place in another phase. When, with the prospect of rising sales and profits, manufacturers and others are competing for raw materials, machinery, plant, etc, prices rise. When sales slump and many are trying to get cash in order to avoid insolvency, prices fall. (Wages, the price of labour-power, are similarly affected in both directions). These upward and downward movements are limited in extent. During the 19th century in Britain they never exceeded 25 per cent, and the general price level in 1914 was no higher than in 1814.

II. The Money Commodity (Gold)

8. Through long experience a selected money commodity came to serve as “universal equivalent”. In Britain and many other countries it was gold.
9. The money commodity could function as universal equivalent for the exchange of all other commodities only because it, like them, embodied a given number of hours of socially necessary labour. If 1 ounce of gold needed the same number of hours of

labour as a bicycle they would represent equal values.

10. In Britain, the 19th century standard coin the “sovereign” was, by law, fixed at about $\frac{1}{4}$ oz. of gold and this determined the basis of the price of all other commodities. Four sovereigns, or £4, or 80/-, would be the price of a bicycle in our example.

11. It is important to notice that if by law the £1 had been fixed at $\frac{1}{2}$ oz instead of $\frac{1}{4}$ oz, 1 oz would be the equivalent of £2, not £4, and the price of the bicycle (equal to 1 oz. of gold) would have been £2, not £4.

12. If, on the other hand, £1 had been fixed at $\frac{1}{8}$ oz of gold the price of the bicycle would have been £8, not £4.

13. The prices of all commodities, and therefore the general price level, would be similarly affected by the weight of gold fixed by law for the sovereign (£1, or 20/-).

14. One reason why gold came to be the money commodity is that over long periods of time its value changes little.

III. How much currency is needed?

15. As each note and coin is used over and over again to make payments of various kinds the total amount of notes and coin needed is only a fraction of the total of buying and selling transactions carried out by means of notes and coin.

16. The total amount of notes and coin needed to be held by individuals, shops, etc. is influenced by various factors. The growth of population and production will increase it. The growing use of cheques will reduce it. At busy periods(Christmas for example) people with bank deposits withdraw extra notes and coins, and these find their way back again afterwards.

17. Notes and coin also circulate more rapidly in periods of heightened business activity than at other times.

18. All of these factors have operated since 1938, notably the increase of population, the increase of total production (something like twice the volume), and the growth of the use of cheques.

19. In accordance with the Marxist labour theory of value the starting point for consideration of inflation is the average amount of gold coin that would be needed as currency if only gold coin circulated, that total of gold representing a total of value.

IV. Currency depreciation (inflation)

20. The Marxist explanation of currency depreciation(inflation) is that it takes place, and causes a general rise of prices, if a paper currency replacing gold exceeds the amount of gold that would circulate if not so replaced. (See article “Marx’s Theory of Inflation” later in this issue) .

21. It is not the mere replacement of gold by paper currency but its issue in excess that matters.

22. In 19th century Britain Bank of England notes, gold and other coin all circulated side by side.

23. The total was prevented from being in excess by the law which made the notes convertible into gold on demand, at the fixed rate of about $\frac{1}{4}$ oz. of gold to every £1 of notes. (Bank of England notes were in consequence always “as good as gold”).

24. The Bank of England was also compelled to buy and hold in its vaults gold equivalent to any issue of any notes above a fixed limit.

25. It is of course possible for a government to have in circulation an inconvertible paper currency but to restrict its issue so that it is not in excess. This was the position in the 1920's. By government intervention a ceiling was imposed on the note issue.

26. Since the war there has been no effective limit on the note issue and it is far in excess of the amount of gold that would be needed.

27. According to official figures the amount of notes and coin in the hands of the public in December 1938 was £48 million, and in December 1972 £4,090 million.

28. The retail price level in 1972 was about five times the level of 1938, an increase of 400 per cent; a major part of this increase being due to currency depreciation (inflation).

29. At current prices of gold in the market the £448 million of notes and coin in 1938 was the equivalent of about 100 million ounces of gold; and the £4,090 million of notes and coin in 1972 represented a rather larger weight of gold.

V. Why currency depreciation inflation causes prices to rise

30. The basic reason why inflation causes prices to rise is that an inconvertible paper currency can never represent a greater total of value than that of the gold it replaces, and the same applies to the individual commodity.

31. In the example of the bicycle, if its value is equal to that of 1 oz. of gold, its price would be £4 when, by law, each £1 was fixed at about $\frac{1}{4}$ oz. of gold. If the gold is replaced by inconvertible notes and if the total of notes is double the amount of gold replaced, then the price of the bicycle will be about £8 instead of £4. If the note issue is three times the amount of gold, the price will be about £12 instead of £4.

32. In practice it takes the form of prices rising in response to buyers offering larger amounts of money, in the same way that prices of accommodation and other things rise in holiday resorts in the summer season when holidaymakers come in large numbers.

33. In many of the past inflations (for example Germany in the 1920's) the government, instead of raising revenue by taxation, meets its expenditure by simply printing notes in ever-increasing quantities,

34. Commenting on this the economist F.W. Paish notes that in this country the method has been indirect though the result is the same: “Nowadays, in a country such as Great Britain, the Government would borrow from the banks, printing more notes to enable the banks to maintain their cash reserves” (Benham’s Economics, Pitman, 1967, p.465). (See the article “How The Government causes Inflation” later in this issue) .

35. This indirect method was used in Great Britain in the inflation of 1914-1920 and the Treasury did indeed argue that the effect on prices would be different according to whether the note issue was increased by the direct or the indirect method. To which the answer is that it is the excess issue of notes which causes prices to rise, irrespective of the method.

36. The 1920 inflation was brought to an end when the government, ignoring that Treasury view, decided to restrict the note issue, which was followed by a continuous fall of prices for over ten years.

VI. The time factor in price changes

37. The objection is sometimes raised to the Marxian explanation of inflation that price rises do not immediately follow increases of the note issue, and indeed often precede them.

38. The reason is that when manufacturers and traders, etc. have become used to a settled government policy of inflation they take it for granted that past experience will go on being repeated, and that prices will go on rising.

39. The reverse is also true, the reversal of government policy in 1920 over the restriction of the note issue did not immediately cause the price rise to cease.

VII. Why governments go in for inflation

40. There are several reasons why governments have at different times followed a policy of depreciating the currency.

41. Some governments (particularly in war-time) adopt it because it is a simple way of raising revenue without recourse to taxation.

42. Sometimes (as in Germany in the 1920’s) the policy is favoured by industrial capitalists and indeed by the government and local authorities as a means of paying off loans in depreciated currency and consequently at only a fraction of the original cost of the loans.

43. In recent years the main reason is the widespread acceptance of the erroneous belief that inflation is a means of maintaining “full employment”.

44. Inflation, it should be noted, also makes devaluations inevitable. When prices have been pushed up to the point that exports are endangered the foreign exchange rate of the currency is reduced in order to cheapen exports again in terms of foreign currencies

MARX'S THEORY OF INFLATION

The word *inflation* has come to be used very loosely in recent years to mean any rise in prices, so that it has in fact almost become a synonym for *price increase*. Words are of course always changing their meaning in line with changed social practices and ideas. We can't complain about that. But this particular change reflects an underlying confusion, amongst professional economists and the general public alike, about the cause of the enormous rise in prices that has taken place since the beginning of the last world war.

First, let us distinguish between a rise in the price of a particular Commodity and a rise in the prices of all commodities, between a rise in *individual* prices and a rise in the *general* price level. This is not always easy in practice since a rise in the general price level will also of course involve a rise in individual prices. But there is a real distinction here which it is essential to make .

A rise in the general price level can be defined as a rise in the prices of all commodities such that their prices relative to each other remain unchanged. Individual prices, on the other hand, can rise for a number of reasons besides as part of a rise in the general price level. The demand for a commodity might temporarily exceed its supply; monopoly conditions might exist; its cost of production might go up. All these no doubt have operated since the war to cause particular prices to rise at particular times, but then at other times other forces – supply exceeding demand, falling costs, government subsidies – will have worked to reduce particular prices. But in any event none of these could explain a general rise in the prices of all commodities.

What could cause such a rise? Only, it will be argued here, some change in the standard of price, some monetary change. A general rise in prices, or inflation in its strict sense, is a purely monetary phenomenon. Marx was amongst those who recognised this.

Marx deals with money in Chapter III of *Capital*, and also in his *Critique of Political Economy*, but his theory of money cannot be fully grasped without first having understood the previous two chapters on commodities. Marx defines a commodity as an item of wealth produced to be exchanged for other items of wealth, and proceeds to examine what determines the proportions in which commodities exchange for each other. After showing that the only objectively measurable thing all commodities have in common is in being products of human labour, Marx concludes that in the ideal conditions of simple commodity production, commodities exchange in proportion to the amount of socially necessary labour time spent on producing them. This he calls their *value*¹.

Money arises out of commodity-exchange when one particular commodity emerges as the one which is universally acceptable in exchange for any other. With barter this is not the case: exchange can only take place if the two commodity-exchangers have matched wants, if they each want what the other has to exchange. With money this inconvenience is eliminated as everyone accepts the money-commodity in exchange

¹ Under capitalism the highest form of commodity-production, commodities do not in fact, except accidentally, exchange at their values, as Marx explains in Volume III of *Capital*. This is because of the averaging of the rate of profit.

for their sure in the knowledge that they can then exchange it for whatever they do want.

To fulfil this role money must itself be a commodity, must have a value in its own right. Various commodities have functioned as money, but in the end it has been the precious metals gold and silver that have proved the most convenient².

With money, other commodities acquire a price, which expresses how much of the money-commodity they will exchange for. Originally prices were expressed in amounts of the money-commodity (weights of gold or silver), but over time this has come to be obscured. For various reasons. First, governments issued coins, pieces of gold or silver, of guaranteed weight. Then, through among other things governments issuing underweight coins, the conventional names for the money-units came to differ from the conventional names for weight-units. So prices come to be expressed in money-units rather than weight-units.

The fact that the names of the money-units are purely conventional, being established and altered³ by law, has often given rise to the illusion that money itself is just a useful invention whose value is purely conventional. But this is an illusion because the money-commodity (which from here on we shall assume is gold) is itself the product of socially-necessary labour and itself has a definite value independent of the will of governments. There is an underlying value-relationship between money and all other commodities. If the value of money alters then this will affect all prices – obviously since, as we saw, the price of a commodity is the expression of its value in terms of amounts of the money commodity. If the value of gold were to fall (say through more efficient productive methods being used) then the general price level would rise because, the values of all other commodities remaining the same, they would now be equal in value – and exchange for – a greater amount of gold. On the other hand, if the value of gold were to, rise then the general price level would fall. In short, the general price level and the value of the money-commodity are inversely related.

We have now identified one way in which a rise in the general price level (or inflation) can occur: through a fall in the value of the money-commodity.

The general price level will also rise if the government debases the coinage. The great advantage of coining is that you don't have to weigh out amounts of the money-commodity for every buying and selling transaction; you can assume that the coin will be of a certain weight thanks to the government stamp. But the monopoly of minting coins possessed by governments has often proved too much of a temptation. As an easy way of raising revenue governments often issued underweight coins, Let us see what happens when they do this.

Assume that the word *pound* is the conventional name for $\frac{1}{4}$ oz of gold⁴, and that the government issues coins weighing $\frac{1}{8}$ oz stamped "one pound". The market will not be fooled. Prices expressed in terms of *weights* of gold will continue to exchange for

² For a good account of the evolution of money out of barter see *The Evolution of Culture* by Leslie A. White, McGraw Hill paperback, 1959, pp. 338-343.

³ As, for instance, the British government did in 1971 when it introduced decimal currency in place of shillings and (old) pennies.

⁴ As it approximately was in Marx's day, and indeed right up till 1939.

¼ of gold. But instead of as before exchanging for one gold coin stamped “one pound” it will now exchange for two such coins. In other words, its price in terms of the conventional money-unit, together with the prices of all other commodities, will double. Despite the government’s wishes, economic forces will alter the word *pound* from being the conventional name of ¼ oz gold to being the conventional name of 1/8 oz. In this way will the underlying value-relationship between the money commodity and all other commodities assert itself.

Marx also examined what determined the amount of the money-commodity in circulation. For him it was determined in the first instance by the sum of the prices to be realised. But since coins can be used to realise more than one price this was not a straight relationship. Taking this velocity of circulation of Money into account, Marx formulated the following economic law:

“If the velocity of circulation is given, then the quantity of the means of circulation is simply determined by the prices of commodities. Prices are thus high or low not because more or less money is in circulation, but there is more or less money in circulation because prices are high or low. (*Critique of Political Economy*, Lawrence and Wishart, 1971, p.105)

This is a decisive rejection of the Quantity Theory of Money as put forward by Hume and Ricardo (who did argue that prices were high or low because more or less money was in circulation) and an assertion that it is the level of economic transactions (Marx later introduces settling of debts as well as realising prices) that determines how much money circulates. For a given level of production and trade, only a given amount of the money-commodity is needed and hence will be called into use as money.

So far we have been assuming that the money-commodity itself circulates as coin for buying goods or settling debts. But this need not happen. Gold can be replaced in the actual process of circulation by tokens, whether made of other less valuable metals or of almost worthless paper. As long as these are backed by gold and are freely convertible into it (at a fixed rate) this makes no difference to the above economic law: the quantity of money, including now money-tokens, in circulation is determined by the demands of the economy (the sum of prices to be realised, the number of debts to be settled, etc.).

Marx went on to discuss what happens when there is “inconvertible paper money issued by the State and having compulsory circulation”. The pieces of paper put into circulation are merely tokens for real money (gold) so, says Marx, their purchasing power is determined solely by their quantity in relation to the amount of gold they are supposed to represent. As Marx points out, this reverses the position when gold itself is circulating; the quantity theory of money now becomes valid..

“The number of pieces of paper is thus determined by the quantity of gold currency which they represent in circulation, and as they are tokens of value only in so far as they take the place of gold currency, their value is simply determined by their quantity. Whereas, therefore, the quantity of gold in circulation depends on the prices of commodities, the value of the paper in circulation, on the other hand, depends solely on its own quantity” (*Critique of Political Economy*, p.119. Marx’s emphasis).

Since inconvertible paper money has “compulsory circulation” there is nothing to stop States issuing as much of it as they like. In fact governments are faced with the same temptation here as over debasing the coinage: to print paper money is an easy way of raising revenue at least in the short r~. Suppose again that the word *pound* is the name of ¼ oz of gold and that the amount of gold demanded by the workings of the economy is £14m., what would happen if the government issues paper notes with a face-value of £210m., fifteen times greater? Let Marx explain:

“Let us assume that £14 million is the amount of gold required for the circulation of commodities and that the State throws 210 million notes each called £1 into circulation: these 210 million would then stand for total of gold worth £14 million. The effect would be the same as if the notes issued by the State were to represent a metal whose value was one-fifteenth that of gold or that each note was intended to represent one-fifteenth of the previous weight of gold. This would have changed nothing but the nomenclature of the standard prices, which is of course purely conventional, quite irrespective of whether it is brought about directly by a change in the monetary standard or indirectly by an increase in the number of paper notes issued in accordance with a new lower standard. As the name pound-sterling would now indicate one-fifteenth of the previous .. quantity of gold, all commodity-prices would be fifteen times higher and 210 million pound notes would now be indeed just as necessary as 14 million had previously been. The decrease in the quantity of gold which each individual token of value represented would be proportional to the increased aggregate value of these tokens. *The rise in prices would be merely a reaction of the process of circulation, which forcibly placed the token of value on a par with the quantity of gold which they are supposed to replace in the sphere of circulation.*” (*Critique of Political Economy*, p. 120, emphasis added).⁵

In *Capital* (the first three chapters of which are largely a re-write of the *Critique of Political Economy* Marx formulates the following law, what might be called the Quantity Theory of Inconvertible Paper Money:

“The issue of paper money must not exceed in amount the gold (or silver as the case may be) which would actually circulate if not replaced by symbols ... If the paper money exceed its proper limit, which is the amount of gold coins of the like denomination that can actually be current, it would, apart from the danger of falling into general disrepute, represent only that quantity of gold, which, in accordance with the laws of the circulation of commodities, is required and is alone capable of being represented by paper. If the quantity of paper money issued be double what it ought to be, then, as a matter of fact, £1 would be the money-name not of ¼ of an ounce, but of 1/8 of an ounce of gold. The effect would be the same as if an alteration had taken place in the function of gold as a standard of prices. Those values that were previously expressed by the price of £1 would now be expressed by the price of £2” (*Capital*, Vol I, Moscow, 1961, pp.127-8).

This makes Marx sound like a “monetarist”, and he is indeed saying that inflation (as a rise in the general price level) will be the inevitable result of an excessive supply of

⁵ Marx chose the factor of fifteen because in his day the ratio of the value of gold to the value of silver was 15:1.

an inconvertible paper currency. But there is a fundamental difference: whereas a man like Enoch Powell (who sees well enough that inflation is a purely monetary phenomenon and cannot be caused by monopolies, trade unions or taxes) tries to explain everything in terms of supply and demand, Marx's explanation is solidly based on the labour theory of value. The monetarists have no theory as to what would be the right amount of paper money that would need to be issued to avoid inflation. Marx has, and it is based on the underlying value-relation between the money-commodity (gold) and all other commodities⁶.

So to sum up, for Marx prices are ultimately reducible to weights of gold. Given the level of production and trade, there is a given amount of gold needed as money. This is determined by economic factors independent of the will of governments. Governments can replace gold in circulation by paper and metallic tokens. They can also issue, if they choose, tokens with a higher face-value than the needed amount of gold expressed in the same conventional money-unit. But if a government does do this, the effect will be the same as with debasing the currency: real economic forces, independent of their will, will change the weight of gold named by the money-unit or, as Marx put it, will forcibly place "the tokens of value on a par with the quantity of gold which they are supposed to replace in the sphere of circulation". Another name for this process, which results in a general rise in prices, is *inflation*.

Further Reading

"Inflation and Prices", *Socialist Standard*, July, August, Sept., Oct., 1965.

"From Marx to Milton Friedman", *Socialist Standard*, November 1970.

"Enoch Powell on Inflation", *Socialist Standard*, February 1971.

"Marx's Critique of Political Economy", *Socialist Standard*, Nov. 1971.

"Wage claims, wage awards, strikes, do not cause rising prices, inflation, for one simple but sufficient reason – they cannot. There never was a strike yet which caused inflation, and there never will be. The most powerful unions, or groups of unions, which was ever invented is powerless to cause prices generally to rise ... in the matter of inflation, the unions and their members are sinned against, not sinning. In the matter of inflation, the unions and their members are as innocent as lambs, pure white as the driven snow". – Enoch Powell, 20 November 1970.

HOW THE GOVERNMENT CAUSES INFLATION

Although inflation is caused by an excessive issue of inconvertible paper money over and above the amount of gold which would otherwise circulate, in Britain the government does not simply print more notes and use them to pay for its activities. The effect of what they do do is much the same though, but it works in a much more roundabout way.

⁶ Not that Marx wished to tell governments what monetary policy they should pursue. His aim was to analyse how capitalism worked not to propose remedies to reform it. He was fully aware that workers would have to struggle to realise the value of their labour-power even if there was no inflation (currency depreciation).

Government expenditure is financed first of all by taxation, then by borrowing and finally, as we shall show, by issuing more inconvertible notes. In Britain in recent years there has always been a budget surplus, i.e. tax receipts have always exceeded the government's *current* expenditure on defence, social services, costs of administration, etc. But this surplus has never been sufficient to fully cover the government's *capital* expenditure (which is not included in the budget) on loans to nationalised industries and local authorities to finance long-term investment projects. Therefore the government has had to resort to borrowing. This it does by selling government bonds, including interest-bearing Treasury Bills. These Treasury Bills are repayable after a very short periods, normally three months; they play a key role in the overissue of inconvertible paper money in Britain. But before explaining how, we must first examine in more detail the various monetary institutions involved: the Bank of England, the commercial banks and the discount houses.

The *Bank of England* has a monopoly of issuing bank notes in England and Wales (and what the Scottish and Northern Irish banks can issue on their own is very limited). Under the Bank Charter Act of 1844 the Bank of England is obliged to keep its note-issuing work separate from its banking work, and so is divided into an Issue Department and a Banking Department.

The banking activities of the Bank of England are those of a central bank, acting as banker for the government and for the commercial banks. The commercial banks themselves have deposits at the Bank of England, but they get no interest on them⁷. These deposits are, however, instantly convertible on demand into notes and coins. This is why, in the literature on the subject, they are lumped together with the actual notes and coins in the tills and vaults of the banks and known as "cash". Cash in this sense, it should be noted, is *not* the same as its everyday meaning of notes and coin; it is these plus the deposits of the commercial banks (and of the discount houses) at the Bank of England.

The *commercial banks* (the main ones being the Big Four: Midland, Barclays, National Westminster and Lloyds) make their profits by borrowing money from the public and then lending it, at a higher rate of interest, to others. The banks lend their depositors' money to capitalist institutions and other members of the public (advances), to the government (by buying government bonds) and to the discount houses ("money at call"). Some – about 8 per cent – they keep as non-interest bearing cash, partly as notes and coins and partly as balances at the Bank of England.

The *discount houses*, like the commercial banks, make their profits by borrowing money and re-lending it at a higher rate of interest. Their original activity was, as their name suggests, discounting commercial bills of exchange, i.e. buying them below their face value and then selling them later at a higher price. But nowadays their main business is discounting Treasury Bills, and this is what concerns us here. The discount houses have an arrangement with the government whereby they agree to buy any Treasury Bills the government can't get rid of at its weekly sales. This ensures that the government can always borrow, through Treasury Bills, the amount of money it wishes. In return the Bank of England offers the discount houses something it offers no other financial institutions, not even the commercial banks: to lend them "cash"

⁷ Not to be confused with the "Special Deposits" which the government demands from time to time and on which the banks are paid interest.

when they can get it nowhere else. The rate of interest charged on such loans is what used to be known as “the Bank Rate”, but is now called “the minimum lending rate”.

Normally, the discount houses borrow money to buy Treasury Bills from the commercial banks – this is the “money at call” we mentioned earlier, so called because it can be turned into cash at very short notice. The commercial banks do not themselves buy newly-issued Treasury Bills, though they do acquire them later. If the discount houses cannot borrow enough money from the commercial banks to purchase Treasury Bills, then they must go to the Bank of England.

One way in which the commercial banks can come to be short of money to lend to the discount houses is through the government selling bonds. Most of these are sold to the banks, who have to use up some of their cash to buy them. To do this they may have to recall their money lent to the discount houses, and in any event will have less to lend them. Government sales of bonds in fact is one way the government can force the discount houses to borrow from the Bank of England, and so begin a process which will lead to more notes being put into circulation.

Let us consider this in more detail since it is the roundabout alternative way of inflating the currency to simply printing more paper money and putting it directly into circulation. Very simply, the government borrows money from the discount houses by selling them Treasury Bills; the discount houses borrow money to pay for these bills from the commercial banks; but if, maybe because the government has depleted the banks’ cash by selling them bonds, the discount houses can’t borrow enough money from the banks, then they can go to the Bank of England for it. So, in this way, *the government supplies the cash for the discount houses and through them the commercial banks, to lend back to them.*

This “cash” is not, as we saw, just notes and coins, but notes and coins are a part of it. And any increase in the cash the Bank of England makes available will ultimately reflect itself as an increased demand for notes and coins too. Since, on its own admission, the Bank of England’s role in issuing notes is “passive” (*Report of the Committee on the Working of the Monetary System* (Radcliffe Report), Cmnd. 827, 1959, para 4), this increased demand for notes will automatically be met by setting the printing presses in motion.

Normally, such an increased demand for currency will come through the commercial banks converting into actual notes and coin some of their deposits with the Banking Department of the Bank of England. The Banking Department maintains a stock on unissued notes (acquired from the Issue Department) against just such contingencies.

The Issue Department is concerned with the actual printing and issuing of the paper currency (coinage is the responsibility of another government department, the Royal Mint). The Bank Charter Act of 1844 forbade the Bank of England to issue more than a limited amount of paper money which was not backed by gold in its vaults. This unbacked paper money was known as the “fiduciary issue”. Since at that time Bank of England notes were convertible, on demand, into a fixed weight of gold there was a very real incentive to limit the fiduciary issue. Bank of England notes have not been convertible into gold since 1931, but even in 1939 some 60 per cent of the note issue was backed by gold. From 1939 to 1971 the gold backing was merely nominal, more

than 99 per cent of the note issue being fiduciary. Since 1971 the whole note issue has been fiduciary.

When the Banking Department's stock of unused notes runs down, then procedures are set in motion for more notes to be printed by the Issue Department. The Treasury and the Bank of England get together, decide how many more notes should be issued, print and exchange them for government bonds with the Banking Department, and then inform Parliament. Compared with even sixty years ago parliamentary control over the fiduciary issue is very lax, not to say non-existent. The Currency and Bank Notes Act of 1954 limits the fiduciary issue to £1,575m. But the monetary authorities are permitted to vary (in practice, apart from small seasonal reductions as after Christmas, to increase) this amount from time to time, informing Parliament afterwards by means of a Treasury Minute. Every two years the excess of the fiduciary issue over £1,575m. has to be confirmed and renewed by a Statutory Instrument (a regulation having the force of law) but of the sort that automatically comes into force without even a discussion unless some MP proposes a motion to annul it. The last time this happened was in 1962, though it was then treated as something of a joke. The fiduciary issue had reached £4,608m. by July 1973.

The Banking Department, as we mentioned, acquires more notes as and when it needs them from the Issue Department. This it does in exchange for government bonds. Put another way, *the Issue Department buys government bonds off the Banking Department paying for them with newly printed money.* This means that the extra purchasing power represented by such increases in the fiduciary issue is put at the disposal of the government to help finance its spending. And it is a not unimportant source of government finance. The 1959 Radcliffe Report pointed out that "the increases in the fiduciary issue which have taken place in fact contributed £700mn. towards the meeting of the authorities' financial problems during the period 1951-52 to 1957-58" (Cmnd. 827, para 100).. Increasing the fiduciary issue still helps today. During the ten years 1963-1972 the government raised £2,239m. this way, £578m. of this alone in 1972 (see *National Income and Expenditure 1973*, Table 38, p.44).

So this is what happens: The Bank of England, as lender of the last resort to the discount houses, actively makes available enough cash for the banking system to be always able to lend the government the money it wants. An increase in cash in the banking system means, sooner or later, an increased demand for currency (notes and coins). This the Bank of England, as the note-issuing authority, passively makes available.

In effect, then, the government *does* finance a part of its expenditure by recourse to the printing press, even if in the roundabout way we have described. The inevitable result of this is – to the extent of course that the increased note issue does not reflect a genuine need for more currency as for instance through increased population or production – inflation.