Inflation: the endless farce

Every Prime Minister since the War has pledged himself or herself to tackle inflation as a top priority but rising prices have been with us continuously for half a century. Every year since 1938 prices have gone up and are still going up. The price level on average is about 24 times what it was before the war.

It was not always so. From 1850 to 1914 prices were stable; there were moderate fluctuations but the price level in 1914 was almost exactly the same as it had been 64 years earlier. And in 1919 the government decided to bring prices down and there was a fall of over 30 per cent between 1920 and 1925.

One of the rules of the game is that the party in opposition blames the government; that is, until it becomes the government itself, when it blames someone else, the greedy workers or the greedy shopkeepers and manufacturers; or the lenders of money not being greedy enough (according to the Chancellor of the Exchequer it is low interest rates that cause inflation).

There is a short answer to these glib excuses. Between 1850 and 1914 average wage rates went up by nearly 90 per cent, more than keeping up with the steadily rising productivity in industry - but no inflation.

If shop-keepers and manufacturers have the power, as well as the will to push up prices, why no inflation before 1914? And how come they allowed prices to fall heavily between 1920 and 1925?

As for interest rates, compared with the present 15 per cent bank minimum lending rate, the rates before 1914 were mostly between 3 per cent and 5 per cent - but no inflation.

Control of currency issue the key

It was not an accident that governments before 1914 and in the year 1919 knew how to stabilise prices, how to raise them and how to lower them. They, or their advisers, knew that the key to the situation is the amount of currency (notes and coins) in circulation. If this is kept in line with the needs of the growth of production, population, etc. prices will be stabilised. If currency is arbitrarily increased prices will go up. If arbitrarily reduced, prices will go down.

Before 1914 stability was maintained through the gold standard which closely controlled the issue of currency by the Bank of England. In 1920-25, on government instructions, the currency in circulation was cut. (The Bank burned £66 millions worth of notes).

Since 1938 there has been no control. Additional notes and coin have been issued in a continuous stream. The amount of currency in circulation with the public in 1938 was £442 million. It is now more than thirty times as much, at £14,388 million, and is still steadily increasing. The bath has been slopping over for fifty years and one dotty thing the Labour and Tory plumbers have been agreed about is that they need not turn off the tap. So why couldn't they ask their professional advisers what to do? They did, but those advisers had all picked up the same dotty notion from the same original source.

As early as 1923, in his *Monetary Reform*, the economist J. M. Keynes had argued that it is not necessary to have direct control of the amount of notes and coin.

Degeneration of Monetary theory

How monetary theory degenerated was told by Edwin Cannan, at that time Emeritus Professor of Political Economy at the University of London, in his *Modern Currency and the Regulation of its Value* [1931). Referring to what he called "the bank-deposit theory of prices", he wrote (p.88):

"Within, I think, the last forty years a practice has grown up among the people who talk and write on such subjects, of regarding the amount which bankers are bound to pay to their customers on demand or at short notice as a mass of 'bank-money' or of 'credit' which must be added to the total of the currency (of notes and coin) whenever variations in the quantity of money are being thought of as influencing prices. This is one of the most obstructive of all modern monetary delusions."

Cannan went on to show that this alleged mass of "bank-money" does not exist:

"with the exception of a small amount of currency which they keep ready to meet any likely demands on the part of their customers, the banks have ... paid away money as they receive it, buying land and buildings for the conduct of their business with some of it, and investing or lending all the rest."

Cannan's warning was not listened to. In the same year, 1931, the bank-deposit theory of prices received official endorsement from the MacMillan Committee *Report of the Committee of Finance and Industry* (p.34). In its report the Committee rejected the idea that deposits in banks are cash deposited by customers, and argued that:

"the bulk of the deposits arise out of the action of the banks themselves, for by granting loans, allowing money to be drawn on overdraft ... a bank creates a credit in its books which is the equivalent of a deposit."

Keynes was a member of the Committee and was credited with having drafted that section of the Report.

The Committee "proved" that, on a deposit of only £1,000 cash, a bank could lend £9,000. Their method of proof was a masterpiece of rigged argument. They assumed that only one bank existed. This, they argued, really made no material difference. But also, and without saying that they were doing so, they assumed a prolonged series of lending operations which would take several months and in all that time no-one ever withdrew cash from the bank. Cash was assumed to go into the bank but no depositor or borrower took any cash out. It was a kind of bank that never existed in the real world.

If the doctrine had been based on reality its significance in relation to prices would be obvious. If an individual with £1,000 spent it or lent it the measure of its influence on prices would be just £1,000. If lent to a bank which re-lent it, its influence on prices would be multiplied by nine. What is more the MacMillan Committee's arithmetic was related to the 10 per cent cash reserve banks ordinarily maintained at that time. As the bank cash reserve is now only about 1 per cent of total deposits the multiplier now would be not nine, but ninety-nine.

In recent years there has been a seeming conflict of views on inflation between the followers of Keynes and their rivals, the so-called monetarists. It is a phoney war. The high-priest of Monetarism, Professor Milton Friedman, suffers from the same delusion about the mystical powers of the banks as did Keynes, as will be seen in *Free to Choose* (by Milton and Rose Friedman, p.298).

Unlike the politicians and many economists, the professional bankers ridiculed the Keynes-MacMillan Committee monetary doctrine. They knew that banks do not have this fanciful power to "create deposits". One banker, Walter Leaf, Chairman of the Westminster Bank, had this to say:

"The banks can lend no more than they can borrow - in fact not nearly so much. If anyone in the deposit banking system can be called a 'creator of credit' it is the depositor; for the banks are strictly limited in their operations by the amount which the depositor thinks fit to leave with them." (*Banking*, Home University Library, p.102).

Walter Leaf's Westminster Bank is now the National Westminster. In the *Financial Times* (9 April 1984) it published as an advertisement a survey of its operations during 1983. Under the heading "Financial Highlights 1983" the following item appeared:

Money Lodged	£55,200 Million
Money Lent	£45,200 Million

No nonsense about receiving £55,000 million from depositors and lending 9 or 99 times as much.

Confusion about money supply

Government monetary policies have gone through several phases. From 1945 to the 1970s the Labour and Tory Parties both believed, with Keynes, that the cure for unemployment is for the government to run a budget surplus. (The present Tory government policy of using a big budget surplus to pay off the national debt is what the former Labour Prime Minister Lord Wilson specified in 1957 as the cure for inflation).

In 1977 the Callaghan Labour government, faced with prices and unemployment both rising fast, and the obvious impossibility of running a budget deficit and a budget surplus at the same time, threw overboard the Keynesian doctrine and adopted as their price policy studying the movements of what they call "money supply".

The favourite for several years was the index called M3 which is made up predominantly of bank deposits though it also included the relatively minor element of the currency. The latest M3 figures are:

Bank Deposits	£225,260 millions
Currency	£14,384 millions
Total	£239,644 millions

Eventually the Thatcher government lost confidence in the usefulness of M3 and the Treasury has just decided to stop publication. The Thatcher government's interest was then transferred to M0, which, unlike M3, is predominantly made up of the currency.

But the government and its advisers have quite failed to see the point of the achievement of stable prices by the gold standard, and the reduction of prices in 1920-1925. It is not a question of just "watching" M0 but of actually restricting the issue of notes and coin, something the government is not doing and has not indicated the intention of doing. The amount of currency in circulation is still going up.

The politician who has for years taken an active interest in inflation is Enoch Powell. His line has been to criticise governments for their refusal to recognise that they and they alone are responsible for inflation. He argues that the prime cause of inflation is that government expenditure is too high:

"Nobody knows so well as the Bank of England ... that the expenditure of Government itself is the prime factor in causing mounting inflation" (from a speech on 11 November 1966).

He resigned from the Tory government in 1958 over that issue, though he served as a Minister again from 1960 to 1963. And during all the period 1955-1963 the government was pumping out more and more currency, pushing up prices. So Powell was just as much responsible for inflation as any other Minister. He has never understood the real cause of inflation. He shares the same delusion about banks' supposed power to create deposits as Keynes and Professor Milton Friedman. He claims to see a difference between the government borrowing from "the public" and borrowing from the banks. In an article in *Intercity* (July/August 1989) he wrote:

"Only the banking system can provide purchasing power to one section of the public without the equivalent purchasing power having been transferred to it by another section."

This is nonsense. The banks can't create purchasing power. As Walter Leaf rightly pointed out, the only way the banks can be enabled to lend is to persuade "the public" to lend to the banks, in the form of deposits.

Why inflation started

The question arises why do governments go in for inflation. In this country the three big inflations have started in wars, the Napoleonic wars and the two world wars.

It is a mistake to think that the British government's interest in inflation is to provide revenue by printing notes, though this could happen as it has in some other countries. What happened in the three wars was that the government had to call in all the gold in circulation and in bank vaults to pay for desperately needed imports of food and war materials, which made continuation of a gold-backed currency impossible. The amounts of revenue the government actually gets from increasing the note issue is too trivial to count in relation to government expenditure. In the current year the £800 million from additional notes in circulation is less than one half of one per cent of Government expenditure of £181,000 millions.

Another issue of interest is who gains by inflation and who loses. Long experience supports the view that borrowers, including the industrial capitalists, gain under inflation by repaying loans in depreciating currency, and lenders do well from deflation. Bankers being both borrowers and lenders, generally prefer stable prices. Some property-owners to whom inflation has been disastrous are those who bought

and held certain government and local government stocks the market price for which is now only £30 for each £100 nominal.

It is an error to suppose that inflation is bad for the workers. It is no harder (and no easier) for organised workers to raise their standard of living when prices are rising than when they are falling or stable: it all depends on the varying conditions in the labour market. In the great majority of years in the half-century of inflation wage rates have risen more than prices. And it happened when prices were falling sharply between 1920 and 1925 that wages fell more than prices. The workers were worse off.

One last word about the supposed evils or benefits that will flow from ending inflation. It will not have the effect either of causing unemployment and trade depression or of preventing them. Capitalism goes its own way irrespective of governments' monetary policies.

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