British Strategic Review

Monetarism & the Real Economy

Executive summary

Hambrook Publishing Company

2022

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This edition of the BSR acknowledges collaboration with the following entities:

The Cambridge Economics Network, Mutual Technologies (Mutec.uk)
and the use of the resources & archives of the following entities:
The Boolean Library, Charter House Essays in Political Economy
Development Intelligence, Real Incomes Approach to Economics

A special acknowledgment is made to the main sponsors of this initiative:
Agence Presse Européenne
and the assistance of the
APEurope Economics Correspondents' Pool

All monies received for this publication are donated to the Sustainable Development Facility (SDF). The SDF funds the development and dissemination of a Sustainable Development Goals Toolkit (SDGToolkit) that provides a set of essential analytical tools for practitioners to design sustainable food production projects in low income countries. The SDF was set up by the George Boole Foundation in 2021 to provide grants to subsidise the use of SDGToolkit

Title: Monetarism and the real economy
Main cover title: British Strategic Review
Date: Q1, 2022
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Production: Decision Analysis Group, SEEL-Systems Engineering
Economics Lab a division of The George Boole Foundation Limited

Published by
HPC
Hambrook Publishing
www.hambrookpublishing.com

Also syndicated to: Development Intelligence Review,
BENECON 2022, Emancipation & Real News online.
ISBN
(printed edition): 978-0-907833-49-9
(e-book): 978-0-907833-58-1

Oxford eBooks
eBook production
by Oxford eBooks Ltd.
www.oxford-ebooks.com

Executive Summary

Monetarism and The Real Economy

This Review was prepared to describe and analyze the impacts of the growing dominance of monetarism in macroeconomic policies in Britain, on the wellbeing of the British constituency. The switch to monetarism started with Denis Healey's abandonment of Keynesianism in 1975. It was intensified as a result of IMF loan conditions in 1976. The following Thatcher government found the conditions imposed to be a match for what was largely an ideological conviction of the value of monetarism. During the 47 years following Healey's decision, all British governments have pursued monetarism as their principle policy paradigm.

This summary outlines the main findings of this Review which are centred around the evidence that the political justifications of monetary decisions rest on very weak theoretical grounds. The early decisions on the way the policy instruments of interest rates, monetary injections, government loans and taxation were always couched in terms of the balance of payments, unemployment levels, inflation and the cost of living. The main focus of constituents was on the cost of living items of the unit prices of goods and services relative to nominal wages and employment.

Between 1945 and 1965, Britain experienced unprecedented economic growth, full employment, rising real incomes and a fall in income disparity while the National Health Service was established; all within a relatively short period.

In 1960 Walt Rostow published a book entitled "*The Stages of Economic Growth*" based on the British economic development model up to that time assuming it had reached its final stage of development. However, a more assiduous review of hegemonic cycles, which are based on systems approach to economic development, would have exposed the fact that Britain had not completed the whole cycle. Based on all known cycles, these all end in increasing financial speculation and domestic crises. After the publication of Rostow's book Britain initiated this final spiral downwards between 1973 and 2008, as in all previous hegemonic cycles characterized by financialization and a decline in international status.

Following the 1973 price hike in international petroleum prices which were to rise seven-fold within just a decade, there followed a period of 20 years of slumpflation, a condition exacerbated by the IMF and private bank "solution" which maintained petroleum prices on an upward trend.

The focus of central banks changed from giving lip service to the cost of living concerns while injecting money into the economy to uphold the prices of assets. While professing a monetary policy of a 2% ideal inflation rate for supply side output, the central banks issued funds in an increasing trend with the intent of raising the prices of assets. These were not subject to any 2% target rate of inflation but were allowed to rise by 10%, 20%, or recently even more. The reason these prices or values have risen even more steeply is the result of banks changing their lending strategies to emulate hedge fund operations.

What has become very apparent is that monetary theory is no longer valid, in fact it is flawed. This is because, taking the Quantity Theory of Money which only sets out a highly theoretical identity between the volume of money and supply side prices omits those economic activities where, under quantitative easing, the most significant price impacts were recorded in some eight encapsulated assets markets. Since something like 90% of quantitative easing funds flowed into these markets and not into supply side investment, the QTM could not predict this outcome; the theoretical identity is wrong.

This Review describes the correct identity to replace the QTM. It is surprisingly simple. However, this fact is a matter of concern since it reflects on the degree of understanding by monetarists on how the economy works. Their theory is devoid of the mechanisms that operate “on the ground”. In reality the past referral to the logic of the QTM in rationalizing monetary policy decisions by central banks was never a valid exercise.

As observed in this Review, Milton Friedman, a leading monetarist, could never explain the mechanism of how money volumes translate into supply side unit price inflation. His “explanation” was that, *”it happens in the long run*” which is not an explanation of any mechanism. However, as can be observed in the modified QTM renamed Real Money Theory (RMT) it is evident that the mechanism is as follows. All of the assets which happen to also be used as inputs to the supply side are subject to price rises as a result of speculation and hoarding. As a result, over time there is a buildup of input cost rises which create a cost-push inflationary pressure within the supply side. All supply side unit prices in a competitive market are set by the companies themselves and under such conditions, price-setting will tend to rise to higher levels in order to maintain rates of return.

It is notable that monetarists always avoided this explanation because while they rationalized monetary decisions in terms of supply side output prices but they never mentioned that their policy focus on asset values, becomes the main driver of a cost-push inflation within the supply side. Obvious examples are commodities and energy as well as land and real estate all of which suffer price rises as a result of speculative injections of money secured from central bank monetary injections. Thus, typical price trends, well in excess of the declared central bank target of 2% inflation each year are found in the rises in the prices or rentals for houses, apartments, commercial premised, retail units, offices, industrial units, warehouses and infrastructure. The land and real estate impacts not only impact supply side production companies but also wage-earners creating a housing crisis.

In reviewing the current central bank positions held to justify monetarism, each component of that bank “narrative” is shown to be wrong. Largely related to the type of oversight that renders the QTM to be a useless identify.

By far the most serious result of monetarism has been the decline in the British balance of payments to the second lowest in the world, with the USA being the lowest. The world’s top balance of payments are to be found in the Eurozone, Germany, the European Union, Japan and China. Although the financial services sector enthusiastically assert that the financial services activities help reduce the negative balance of payments, it is important to understand why Britain and the USA have such a poor performance.

Germany, Japan and China’s export success in supply side products is directly related to their ability to have maintained a constant advance of their state-of-the-art tacit and explicit knowledge in the industrial arts, that is, the ability make things on an increasing proficient basis.

A short section explores how the United Kingdom’s educational system, both private and public has not been fit for purpose in the context of the preparation of young children, secondary school pupils and university students for the contemporary and evolving world to maximize their and the nation’s prospects in the future.

Since 1975 and Denis Healey’s abandonment of Keynesianism and an industrial policy, monetarism has encouraged an increasing flow of funds into offshore production and assets at the expense of national industry and manufacturing. This resulted in falling employment, the deskilling of the workforce and a decline in the wages available in alternative employment.

The maintenance of the advance in tacit and explicit knowledge within a workforce requires expanding activity to help people descend their learning curves and contribute to shop floor innovations and increasing productivity. UK policies were resulting in this essential process being marginalized. In 1975 Nicholas Kaldor an economist with immense experience in development economics and, in particular, in the study of the impact of technology on economic growth, was an adviser to the Labour government. He withdrew his services in 1976 in response to Healey's switch to monetarism. Kaldor became the leading critic of the following Thatcher government's intensification of monetary policies and relaxation of financial regulations. All of Kaldor's dire predictions of the likely impact of monetarist policies on the country all proved to be correct.

Monetarism has had a damaging impact of constitutional issues within the United Kingdom. Because policy has greatly enhanced the wealth of asset holders and traders it has at the same time, prejudiced the opportunities and wellbeing of wage earners. The constitutional issue is that justifications, to date, for monetary policy decisions have been founded on the flawed logic of monetarism. In political economy, legislation and regulations establish the rules while economics provides the strategies to be pursued by constituents to pursue their objectives. Unfortunately, the rules are prejudicial to 98% of the voters who are wage-earners, and have been for some time, and they favour those whose income is proportional to asset values. In both cases economic provides an easy rise for those living off assets while providing few opportunities for wage-earners, whose options to maintain a standard of living defaults to increasing debt.

This constitutional crisis has been voiced by many but what has been missing is the mechanism whereby this unjust state of affairs is maintained largely because most do not understand monetary policy, imagining it to be a domain of erudite economists who happen to believe in monetarism as a macroeconomic policy.

What has contributed to this mystique surrounding monetarism was Gordon Brown's decision to make the Bank of England independent in 1997. This was justified on the basis of an attempt to instill a level of ethical and due diligence decision making by experts concerning monetary policy decisions. However, in reality, it seems to have had a dual purpose. One was to convince the City to trust a Labour government with the economy. The second, perhaps more significant, was that Brown wished to avoid the fiasco that caused the Conservatives to lose the election in 1997. This was the act of raising interest rates to absurd levels leading to almost a million individuals losing their homes. Making the Bank independent was a political survival insurance policy.

However, making the Bank of England independent also removed a more direct oversight of monetary policy by introducing an unjustified level of confidence that monetary policy was in the hands of "experts" and by the same token, protected the Bank from public questioning and debate. Therefore, with the 2008 financial crisis there was very little parliamentary analysis of the solution in the form of quantitative easing (QE) which referred to flawed monetary theory to justify it. QE was a fix between banks, hedge funds, the Bank of England and the Chancellor Gordon Brown under the mantra that the banks "were too big to fail". The explosion in assets values which followed exacerbated the state of wage-earners. Although a "temporary solution" to permit banks sort out their balance sheets, the following coalition and Conservative governments, intensified QE as a key driver of austerity to drive down public services, numbers of doctors, nurses and beds in the National Health Service, and the staffing of police and fire brigades and ignoring rising care and mental health requirements..

In 1975 an inappropriate policy decision by a Labour government was intensified by an ideologically driven Conservative government. So, it was, following a Labour government's introduction of quantitative easing as a temporary solution, that this was also intensified and remained in place for over 13 years following an ideologically driven austerity by the

Conservative government, ably assisted by the Bank of England, to reduce the size of the public sector.

At the time of going to print, the rate of inflation in Britain is increasing and most notably linked to housing and energy as well as some food products. The soothing language from central banks such as US Federal Reserve is that this is a temporary phenomenon linked to Covid supply chain disruptions. However, whereas these disruptions have contributed to price spikes it is in important to note that monetarism and relaxations in financial regulations resulted in banks and hedge funds being able to receive very low interest funds to purchase “assets” and to hoard them to force up prices. Because of the cash-diplomacy emanating from the USA and Middle East, politicians have been facilitating the continuation of high energy prices, as in the case of the 1973 flurry of recirculated petrodollars. Now as then such actions are in the interests of political party financial support and prospects of some politicians. As a result, the offer of very low-cost long-term gas contracts via, for example, the Russian North Stream 2 to Germany, has seen the project sanctioned and certifications stalled while the gas spot market prices are over three times the price available under Russian contracts. In the meantime, wage-earners throughout Europe and the UK suffer the consequences of poor political decisions by their own governments.

The final sections of this Review make some proposals for how to escape the conditions created by monetarism.

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31st January, 2022