



cc: PS/MST (L)

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MR BURNS

THE MONEY SUPPLY AND INFLATION

.... The Chancellor would be grateful for your views on the attached note which the Minister of State (L) has written about the relationship between the money supply and inflation.

R.I.T.

R.I. TOLKIEN
28th January 1981

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*I am. No agreed
clearly deserves
careful consideration
by Mr Burns, et al.*

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CHANCELLOR OF THE EXCHEQUER

THE MONEY SUPPLY AND INFLATION

1. I am prompted to write this note by a question I had to answer in the House today asking whether the current upsurge in the money supply will be followed in 1982 by a corresponding rise in the rate of inflation.
2. It has always seemed to me that there are two quite different chains of causation connecting money supply and inflation. The result of this is not only to produce a complex situation such as we have at present but at the same time seriously to affect the time lags.
3. People talk of Governments printing money as if they did this of their own volition or as a matter of policy. This did indeed happen during Tony Barber's tenure of the Treasury when there was massive credit creation and people were almost begged to take the stuff. In circumstances such as these a substantial time lag between creation of the money and its reflection in higher prices is understandable. This too is the text book example of the way that it is the expansion of the money supply which leads to inflation.
4. But now let us look at the reverse process. Inflation is high and the Government decide to squeeze the money supply. The Trade Unions do not believe in the connection between the money supply and inflation: more generally they do not believe in

the connection between cause and effect. Therefore they put in excessive wage claims. The employers don't believe in the connection either so they concede the claims. I have argued right from the beginning that all the talk about "transmission mechanisms" is misconceived. Control of the money operates through the simple but brutal means of butchering company profits. Ultimately insolvency and unemployment teach employers and workers alike that they need to behave reasonably and sensibly. At some stage in this process the Banks who naturally enough have more sympathy with their customers than with the Government start creating sufficient credit to enable their customers to survive. This creates a drain on their reserve assets and the risk of a sharp rise in interest rates. The Bank of England then make reserve assets available thus removing the last puny restraint on the creation of sufficient money to pay the higher level of wages.

5. This is precisely what happened in 1974. It is I suspect also what happened in 1980. If this is a correct analysis of the situation then a large part of the excess growth in the money supply this summer was merely validating ex post facto the vast wage increases of the year mid 1979 to mid 1980. Two things follow from this. First so far as this element is concerned there is no time lag at all - indeed it is the growth in the money supply which follows the reduction in the level of profitability which in turn follows the excessive wage settlements. Second this element in the growth in the money supply has no implications for the future: its potential for future trouble was exhausted even before it was created. This would also explain the very high level of personal savings without the need for calling in aid esoteric arguments about maintaining the real value of cash balances. All that in fact happens is that although they have the money in their pockets to pay the higher prices,

people are not initially prepared to pay them because by past standards they represent poor value. Putting it another way they believe that their wage increase should buy more: they regard rising prices as cheating them out of what they have, often painfully, won and their reaction is to refuse to buy.

6. I notice that in para 14 of his minute of 9 January Terry Burns also refers to the possibility of ex post validation of price increases, but he does so only in the context of the VAT increase and possibly increases in nationalised industry prices. But in my view it goes much wider than that. What we have seen this summer past is a massive ex post validation of the excessive wage increases of the pay round which ended last autumn.

7. Two conclusions flow from this. It is pointless and probably impossible to recoup or eliminate that part of the growth in the money stock which has validated past price increases. Second a very much tougher line needs to be taken in relation to future growth. We must not be prepared to validate future wage increases exceeding whatever level we have judged ex ante to be appropriate. With the decline in the level of settlements this should be much easier to do.

A.C.

LORD COCKFIELD

21 January 1981