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DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

Secretary of State for Industry

31 July 1981

Mike Pattison Esq
Private Secretary to the
Prime Minister
10 Downing Street
London SW1

Prime Minister

MR 31/VII

Dear Mike

PROFESSOR ROSE

As you know, my Secretary of State has gone into hospital but before he went he asked me to ensure that the Prime Minister's attention is drawn to the attached article which Professor Harold Rose, who acts as Sir Keith's occasional economic adviser, has submitted to the Times. The Times have apparently "lost" the original copy of the article which was submitted to them but Professor Rose is continuing to press for publication.

I am copying this letter to Professor Walters, to Peter Jenkins (Treasury) and to David Hayhoe (CDL).

Yours ever

Ian

I K C ELLISON
Private Secretary

BARCLAYS

PROFESSOR H. B. ROSE
GROUP ECONOMIC ADVISER

BARCLAYS BANK LIMITED
54 Lombard Street London, EC3P 3AH
Telephone: 01-626 1567

27 July 1981

Sir Keith Joseph
Secretary of State for Industry
Department of Industry
Ashdown House
123 Victoria Street
LONDON SW1E 6RB

Dear Secretary of State,

The Times apparently lost the article that I was asked to write, and I do not know whether it will ever see the light of day. However, you asked for a copy, which I am enclosing. It says nothing new.

A further - political - point that might be worth making is that, whatever the merits of the case for incomes policy, and they are few, the proposed change in the Labour Party's method of electing its Leader, which gives the trade unions more ~~powers~~ power, makes it most unlikely that the Labour Party would ever dare to restrain the trade unions for long. Perhaps the Party, and especially Mr Healey, could be challenged by reference to this aspect of the Labour Party's coy statement and to Mr Healey's evasiveness, in particular, on incomes policy.

I note that today's Telegraph (Economic Commentary - page 14) contains yet another reference to work by reputable economists on the responsibility of real-wage resistance for the growth in unemployment.

Good luck.

Yours ever,

Harold,

Cc to Hans Liesner

THE DEATH OF MONETARISM?

David Blake, The Times' Economics Editor, alleges that "monetarism" has failed in Britain, that other countries have rejected the policy and that the 1980's will see the theory "pushed back in to the economic history section of the world's textbooks" (The Times, 15 July). These two last contentions are contradicted by the statement accepted by Ministers attending the June OECD meeting that: "In all countries monetary and fiscal policies need to remain steadfastly non-accommodating, conducted with a medium-term focus and in a complementary fashion so as to avoid financial market pressures".

No better summary could be made of the basic monetarist prescription. Indeed, it reads like an advertisment for the Government's Medium-Term Financial Strategy; and if the OECD communique is representative, far from Mr. Blake being right, "we are all monetarists now", if by monetarism is meant merely a belief in the need for sustained monetary restraint.

In Britain "monetarism" and "anti-monetarism" have become associated with political conflict. In other countries this is not so, and there the existence of a link between money supply growth and future inflation is in less dispute. Of course there is professional disagreement over the timing and predictability of that link and over the pace at which money supply growth should be reduced; but this is equally true of other policy instruments. Exaggerated claims tend to be made for all policies.

The most controversial question remains the extent to which the effect of monetary restriction falls on output and employment in the short- run as well on prices and wages. This question turns on the so-called flexibility of the latter, "so-called" because what is at issue today is the extent to which the rate of increase of prices and wages can be reduced, and not, as in the interwar Keynesian debate, their absolute level. Monetarists are usually well in the van of those calling for supplementary policies to make labour and other markets more competitive and flexible, as the letter by Lord Harris (23 July) makes plain. The now-familiar contention that "monetarism is not enough" does not mean that "monetarism is unnecessary". The real criticism that should be levelled at the Government's policy, apart from its mistaken tactics in 1979, is that it has moved too slowly in the direction of union law reform and of the removal of other obstacles to a competitive labour market. It is this, rather than an excessively tight monetary policy, that has made unemployment unnecessarily high.

Indeed, after allowing for the effects of the "corset", no significant deceleration is discernible at all in the wider monetary aggregates during 1979 and 1980. The control of the money supply has undoubtedly proved more difficult than many had expected. Those who believe that policy was tighter than the statistics suggest argue that the rise in interest rates in 1979-80 itself led investors to want to hold more interest-bearing deposits, which account for over 50 per cent of sterling M3. If more attention had been directed at the margin between deposit rates and yields on competing assets, the argument runs, the absolute level of rates as a whole need not have been so high.

This may be so, but in real terms short-term rates did not become positive at all until the spring of 1980 and remained high for only a matter of months. Moreover, monetarists would argue that interest rates also rose to high levels because of the Government's failure to reduce its 'discretionary' expenditure. The link between government borrowing and interest rates may be denied by anti-monetarists but is not by OECD Ministers, judging by the statements made both at the June meeting in Paris and, more recently, at Ottawa.

Mr Blake's contention that "monetarism" has failed is presumably not directed at our inflation rate, which until the drop in the exchange rate had fallen faster than had been widely predicted. Moreover, one should note the contrast between the price increase of some 20 per cent still prevailing in the public sector and the figure of about 7 per cent for private sector goods and services. Even allowing for the impact of special factors such as energy prices, the contrast is indicative of where the most important obstacles to wage and price adjustments really lie.

The allegation that "monetarism" bears the major responsibility for Britain's appallingly high unemployment looks misplaced in the light of the moderate degree of monetary restriction actually achieved. Today's unemployment is partly the result of a long history of indifferent management, union restrictive practices and structural decline, culminating in a long overdue reduction of excess manning. The exchange rate floated upwards on North Sea oil, and the world recession is now delaying economic recovery. The main direct cause, however, was the 22 per cent increase in wages in the 1979-80 pay round. This not only confronted the Government, like its predecessor, with the need to pursue restrictive policies but also brought about a fall in industrial profitability from a level that was already low. The most important avoidable cause of the increase in Britain's unemployment - which rose by 750,000 even with relatively little demanning under the last Government - has been the excessive rise in real wages following the oil price shocks of 1973 and 1979.

According to OECD, a fall in real pre-tax wages of 5-6 per cent, relative to labour productivity, is needed in Britain merely to return the share of profits in national income to its low level at the beginning of 1978. No policy that fails to do this will reduce unemployment for long. The crucial role of real wages is probably accepted by most anti-monetarist economists, but they are doing a dis-service to the unemployed by not declaring openly that it is union wage pressure rather than monetary restraint as such that is at bottom responsible for the plight of the unemployed.

Instead, anti-monetarist economists and journalists seem content to assume the implementation of effective incomes policies - which are merely one way of checking union power - without saying how they can be sustained (and by means that do not reduce productivity as well). It is sometimes argued that unions will agree to an incomes policy to avoid a mutually frustrating wage race; but this is not so. The TUC-Labour Party statement on reflationary policy calls for price controls but is significantly evasive regarding wage restraint, a combination that could only aggravate the problem of profitability and unemployment. It is to this quarter that The Times should be directing its funeral oration.

Harold Rose
London Business School