The Economic Future of Britain

Any attempt to forecast development over the next ten years or so is extremely difficult, even for economists that have a certain flair for intuitive judgements that sometimes turn out to be right. In seeking to adumbrate future developments in the United Kingdom economy, all one can really do is to identify some of the more probably significant or influential factors operating now or likely to be relevant in the years ahead.

Necessarily one must proceed on the basis of certain assumptions, which must have at least some degree of relevance. In this particular exercise, it is intended that the assumptions will be of two kinds:

(a) those deriving from an analysis of our recent experience in the economic field; and

(b) those deriving from prescriptions that one might put forward as sensible means of bringing the present inflationary process more under control.

More positively, it is maintained that, unless the most highly industrialised countries in the world do bring inflation under control, there will be a major financial and economic crash, which will result in heavy unemployment that is likely to persist for a period of years. Rather than run the risk that this might happen, it is assumed that the governments of the world's major economies will be prepared to take effective action calculated to eradicate inflation.

Furthermore, it is assumed — as is consistent with an inflationary situation — that there will be continuing pressure on the balance of payments. But this is a symptom rather than a cause of Britain's difficulties, even though in a very "open" economy the effects are obviously most direct. Nevertheless, it is argued that the main way in which to resolve the problem of continuing balance of payments deficits is to bring under control (e.g. by monetary and fiscal means) the inflationary pressures within the domestic economy. Other factors

may modify the situation — more aggressive selling of exports (e.g. by meeting delivery dates and providing better post-sales servicing arrangements), a greater emphasis on the domestic production of foods and feedstuffs, or the advent of North Sea oil — but the major attack must be by restoring to health the domestic economy. If that can be achieved, the balance of payments will look after itself.

In initiating an attempt to establish what kind of economic climate is likely to obtain in Britain over the next 10 to 20 years, the most sensible starting point will probably be our expectations with regard to the continuance of inflation. In this context, the most obvious expectation might have been further inflation and maintenance of the upward trend in world prices. Quite apart from the more recent impact of food and raw material shortages, the pressure on scarce resources that has been a characteristic of the whole post-World War II experience — especially up to the end of the 1960s — would be sufficient to explain much of the upward pressure on prices. Initially, there were the immense needs of post-war reconstruction to be met; latterly, it has been a pressure for higher standards of living. Over these years, societies have tended to become more affluent and, over much of the period, employment has been maintained at relatively high levels. In these circumstances, domestic consumption is also likely to be at high levels. This applies not only to the basic essentials of food [1] and clothing, but also to housing and all the incidental tools of living and gadgetry (indeed, in recent years, the more affluent have frequently acquired a second home and furnishings); again, there is the family car (and, until the energy crisis, increasingly a second car); and, in the public sector, expenditure on defence, the social services, hospitals, schools (and other educational establishments), not to mention a variety of social amenities (like opera and concert halls, community and sports centres, and libraries), as well as communications like sea and air ports and additional television and radio services. Moreover, if there is to be consumption, there must be investment — the use of goods for the production of further goods and services — the importance of which has been increasing partly because of a technological revolution and the incidence of obsolescence. This need to invest directly in the

1 The demand for the basic foods, it may be argued, is relatively inelastic, though this is less true of "convenience" foods. But there is also likely to be an upward pressure on food consumption due to an increasing world population.

industrial process (which includes agriculture) will be there whether or not industries are nationalised. Finally, there are the demands of the Third World. For all these reasons, in relation to the competing demands being made upon them, resources are scarce. In the capital markets, this means that there will be strong upward pressures on interest rates, modified perhaps at times when monetary and economic policy force up unemployment and create a situation of temporary relief from the upward pressure on prices. It was on these grounds that one was able to forecast over five years ago [2] that money rates of interest would move permanently to a higher level and, despite some fluctuation, would move for the foreseeable future within a higher band.[3]

Is there any reason why we should now modify this forecast? There are two possible reasons for doing so. First, there does seem to be less confidence about the future both in Britain and in key world economies like the United States of America and Japan.[4] Second, there is the possibility that we are at the beginning of the downward sweep of one of Kondratieff's "long waves".[5]

So far as Britain is concerned, the lack of confidence may only be a short- or at worst medium-term phenomenon. It may well be based as much as anything on a lack of political leadership. But there is clear evidence of gloom. For example, the Confederation of British Industry in surveying industrial prospects has spoken of "a striking collapse in business optimism" with a deterioration in investment intentions and the value of expected new orders "conspicuously weak".[6] This reading of the situation was subsequently confirmed by the Financial Times Monthly Survey of Business Opinion also published in August 1974 [7] and not materially amended by later surveys. Over the medium-term, the Organisation for

2 See J. S. G. Wilson, "The Long-Term Future of Interest Rates in a High Consumption Economy" published in *L'avenir de l'Epargne dans la société de consommation* by Groupement International pour l'Etude des Problèmes de l'Epargne, being proceedings of a Colloquium held at Munich in October 1969. Brussels, 1970, pp. 61-70.

3 In real terms, however, there has probably been some fall.

4 See, for example, "Inflation and Stagnation in Major Foreign Industrial Countries", in *Federal Reserve Bulletin*, Vol. 60, No. 10, October 1974.

5 See Gottfried Haberler, *Prosperity and Depression*, Third Enlarged Edition. (Geneva, 1941), pp. 272-4; also Joseph A. Schumpeter, *Business Cycles*, New York, 1939, Vol. I, pp. 164-5, and 170.

6 See *The Times* and *Financial Times* 2 August 1974.

7 *Financial Times* 5 August 1974.

Economic Co-operation and Development (OECD) had forecast in its bi-annual *Economic Outlook* a recession in Britain during the winter of 1974-75, with rising unemployment and record rates of inflation.[8] Meanwhile, in the United States, analysts at the National Bureau of Economic Research have been trying to gauge economic prospects over the next ten years or so. In their view, there will be a significant slowing down in economic expansion.

> "The overriding fact that emerges from various studies of the country's long-term economic outlook is that a marked slowdown in growth will occur late in the 1970s and continue well on into the 1980s".[9]

For major industries, the slowdown might be quite traumatic. One industry that is most likely to suffer is the United States automobile industry, which in addition to other factors will be affected by the likelihood of still higher fuel costs, the backlash of air pollution problems, and increasingly congested roads. Amongst the other factors of importance is the projected decline in the United States birth rate, which began in the late 1950s.[10] If this persists, the rate of growth in the labour force will fall to 1.5 per cent per annum in 1974-80 and to below 1 per cent per annum during the 1980-85 period (as compared with nearly 2 per cent per annum from 1965 to 1973). Not surprisingly, therefore, other industries where growth is expected to be slow include furniture, household appliances, and clothing. On the other hand, it was expected that the demand for housing would be maintained. About the same time, Japan was officially reported to be at "an historic turning point, because its miraculously high economic growth had come to an end". This was said to be largely due to the sharp rise in the prices of commodities that put an end to the nation's spectacular economic expansion. And the Economic Planning Agency, which put out the

8 See *The Times* 24 July 1974.

9 See *Financial Times* 9 August 1974.

10 In the United Kingdom, the population is unlikely to change very much from its present level of just over 56 million between 1974 and 1981 and, between 1981 and 2011, there is likely to be a slow increase which will result in a rise in the population to 60.75 million at the end of the period — a rise of about 8.5 per cent. (See The Registrar General's Quarterly Return for England and Wales, No. 501, Appendix F). But again for demographic reasons, there is likely to be some diminution in the rate of growth.

report in an economic White Paper, argued that Japan should transform its industrial structure (as may well be necessary also in the United States) with more emphasis on social welfare and economising in the use of resources.[11]

What now of the possibility that we are at the beginning of the downward sweep of one of Kondratieff's "long waves"? The evidence for these long waves is statistical; the reasons for them appear to be various. Indeed, they may be due to the impinging of a succession of exogenous forces, with little similarity of pattern from one period to the next, but inducing a reaction from the industrial system that results in fluctuations (be they in the form of the shorter inventory cycles or the nine to twelve year "business cycle") about a long wave trend of perhaps 50 years in length. If there is this 50-year recurring pattern with an upswing lasting some 20 years followed by 30 years on a receding wave, the evidence suggests that the United States (if not the rest of the world) is likely to be moving about 1975 on to the downward part of the long wave. The first of these great 50-year cycles as reflected in major indicators like the levels of production, wages, and prices began about the 1780s and ran to 1844-51. The second went to about 1890-96. The third cycle reached its peak with World War I, then slid into the Great Depression of the 1930s.[12] It should have ended in the 1950s, if the New Deal and World War II had not brought it to a premature end around 1940. But if we date the upswing from about 1950, the downward phase of the long wave begins about 1975 and will last much of the rest of the century. At first, there will be a moderation in the rate of increase of prices, followed by depression in the 1980s. And this is not too greatly different from some of the other forecasts for the United States economy, upon which the prosperity of much of the rest of the world depends.

This is interesting as far as it goes, but can we now find tangible reasons to support such a statistical projection? First, there are the

11 See *Financial Times* 10 August 1974.

12 "Historically, the first Kondratieff covered by our material means the industrial revolution, including the protracted process of its absorption. We date it from the eighties of the eighteenth century to 1842. The second stretches over what has been called the age of steam and steel. It runs its course between 1842 and 1897. And the third, the Kondratieff of electricity, chemistry, and motors, we date from 1898 on. These datings do not lack historical justification. Yet they are not only tentative, but also by nature merely approximate". SCHUMPETER, *op. cit.*, p. 170.

effects of a declining rate of population growth in the United States (and possibly in other countries); this would remove one of the most obvious of the stimulants to economic expansion and these effects can only be offset by a greater degree of restructuring of the economy (e.g. to meet the specific needs of an ageing population) than trade unions and industrialists will be willing — or able — to countenance, since few vested interests are in fact capable of reacting with sufficient speed to the requirements of structural change. Second, and on the side of Government, one of the results of the impact of inflation may well be the recognition by the authorities in a number of countries of the need for greater fiscal and monetary discipline. There may also be a tendency to accept some lowering of sights, if not some reduction in the material standard of living. Thus, there may be cut-backs in Government expenditure affecting defence, education, the social services, housing, and roads. This will obviously affect levels of demand, much of which is initiated by public expenditure. And this will in turn influence attitudes towards investment, without which the engine of growth will be missing. This may be offset to some extent by lower taxation, but in an uncertain world this may tend to be drained off into savings that are in excess of the investment being undertaken. Although it is unlikely that there would be a reduction in the rate at which innovations come forward, it is probable that there might be a disinclination to introduce them into the industrial process and to ensure that they will become commercially as well as technically viable. The disinclination to invest will also have been affected by the impact on costs of the energy crisis, resulting in Britain and Japan in some loss of competitiveness in export prices. It is this range of factors that seemingly has led to the failure of confidence and leadership that has persuaded industrialists and economists to become prophets of doom.

At the same time, if recent experience is any indication, the British (and possibly other) economies may not in fact wholly rid themselves of inflation even though they are prepared to accept measures of fiscal and monetary discipline. In short, they may find that, despite a measure of deflation and unemployment, they still experience an upward pressure on prices and continue to suffer from the phenomenon of "stagflation". This was the change that seemed to be in evidence from the early 1970s onwards. In Britain, a more optimistic note has latterly been struck, because of the anticipated favourable influence of North Sea oil. This will not really have all

that much effect until the early 1980s and it would in any case be unwise to expect this source of energy to resolve all our difficulties. Also, North Sea oil is already proving to be enormously expensive to develop, in addition to which there are the huge debts that Western countries are meanwile incurring to the oil producing nations. When North Sea oil finally comes on stream, there will be a lot of debt and capital to service and the oil may not turn out to be as cheap as has sometimes been assumed. In addition, there may have been some fall in oil prices by then, so that the returns against which to set off the costs may well be lower than anticipated. But oil revenues will remove a major pressure on the then current balance of payments.

It is pertinent, therefore, to look in a little more detail at this recent phenomenon of "stagflation", which may yet turn out to be consistent with a Kondratieff long wave theory that anticipates the probability that the entire Kondratieff cycle might be lifted on to a new plateau, such that future upward and downward waves will be at higher real levels of income than formerly. And within this context, the United States and other industrial countries might now look forward to a decade of more stable prices (it might be possible again to reduce the rate of increase in prices to more acceptable proportions), with balanced budgets and a slowing down of the rate of increase in the money supply, but with slowly rising percentages of unemployment.[13]

Probably not very many economists would today subscribe to the view that relatively high unemployment levels should be invoked as a means of applying discipline within the economy. Nor is it socially desirable that the weapon of unemployment should be so employed — not in this day and age. Yet greater fiscal and monetary discipline is likely to discourage investment and to induce higher levels of unemployment. At the same time, as we have seen in recent years, an economy may experience a significant amount of unemployment and still suffer from inflation.

In this connection, it is worth perhaps looking again at the theory that attempted to relate levels of unemployment to the rate of change in money wage rates and which was illustrated by the Phillips Curve. When the demand for labour is high and there are few unemployed, we should expect employers to bid up wages quite rapidly. Conversely, when the demand for labour is low and unem-

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13 See Paul Lewis in *Financial Times* 1 August 1974.

ployment is high, workers it was assumed would be reluctant to offer their services at less than the prevailing rates, so that wage rates fell only very slowly. Hence, the relation between unemployment and the rate of change of wage rates was likely to be highly non-linear. On the basis of statistical evidence over the period 1861-1957, Professor A. W. Phillips then proceeded to argue that, generally speaking, the rate of change of money wage rates could be explained by the level of unemployment. Furthermore, if one assumed an increase in productivity of 2 per cent per annum, Phillips suggested that stable prices would have been achieved over the period studied with a level of unemployment a little over 2½ per cent.[14] By implication, if levels of unemployment were higher than that, there should have been some tendency for prices to fall. And over recent years, we have at times had levels of unemployment higher than 2½ per cent, but we have also continued to experience a rising price level. Why?

Why, in other words, does unemployment no longer bite in the way it once used to? Almost certainly, it is because of changes that have taken place in our social fabric — changes which have considerably modified the bases on which the Phillips Curve was constructed. Whether unemployment is due to redundancy or strikes, the worker (and his family) are now protected in a variety of ways. If a man loses his employment — or declines to be employed — he will first of all become entitled to income tax rebates. If he is made "redundant", there are redundancy payments. In addition, on behalf of his wife and family, he is entitled to receive supplementary benefits (which cover rent and various other outgoings that can be financed at the discretion of the Supplementary Benefits Commission; there is also a scale rate to keep the wife, plus amounts that vary with the age of each child). Finally, and helping to maintain a minimum level of income, there are family allowances. This is not to argue against the social services; it is merely to remark on reasons why unemployment does not exert a downward pressure on wages and why the Phillips Curve may no longer apply.

In addition, in a situation where prices are rising fairly rapidly and persistently, the effects of expectations must be taken into account. Most simply, if prices have been rising in the past, there is

14 A. W. Phillips, "The Relation Between Unemployment and the Rate of Change of Money Wage Rates in the United Kingdom, 1861-1957", *Economica*, November 1958.

the expectation that they will go on rising in the future. As a result, people rush to get out of money and into goods. Indeed, if this process continues, ultimately money will be rejected altogether. Meanwhile, the expectation that prices will continue to rise results in a continuing upward pressure on wages — to offset or more than offset rising prices — and this is likely to happen whatever the unemployment situation might be.

Hence, there was a further major reason to expect a modification of the Phillips Curve analysis. And this was reflected in the development of economic theory during the second half of the 1960s. Account was now taken of the fact that although money wages are determined by negotiations within the framework of a competitive labour market, both sides in the labour market will be attempting to influence real wages. On this basis, certain economists[15] began to put forward the hypothesis that the rate of change in money wages will be equal to the expected rate of change in prices, *plus* a further adjustment that would depend on the degree to which there was an excess demand for labour (it would tend to increase the lower was the unemployment rate). Additional work by some of the Manchester monetary economists[16] suggested that expectations about price changes should be based on a wider range of experience that included both retail and domestic wholesale prices, export prices, income and payroll type taxes, and purchase taxes. Furthermore, they argued that expectations about inflation are formed by an "error learning" process, in which "the expected inflation rate at the time a wage decision is made is the same as that previously held plus some adjustment for the extent to which that previous expectation turned out to be wrong".[17] They also accepted the view, for which there was a lot of historical evidence in previous inflations, that if the economy is operating "with permanent excess demand, that is with unemployment permanently below its equilibrium level, then inflation will

15 See, in particular, Milton Friedman in *American Economic Review*, March 1968, pp. 11-17 and E. Phelps in *Economica*, August 1967, pp. 254-281.

16 See J. M. Parkin, M. T. Sumner and R. Ward, "Wage Behaviour in an Open Economy: Excess Demand, Generalised Expectations and Incomes Policies in the UK", University of Manchester Inflation Workshop Discussion Paper 7402; forthcoming in K. Brunner and A. H. Meltzer (eds.), *Proceedings of the Conference on Wage-Price Controls at Rochester University*, November 1973.

17 These hypotheses have now been tested empirically by Parkin and others and with some success. For a useful bibliography in this field, see *National Westminster Bank Quarterly Review*, May 1974, pp. 45-47.

not simply be persistent, *it will persistently accelerate* and, eventually, lead to money having no value at all ".[18]

If one looks at the problem of inflation realistically, there can be little doubt that one of the main causes is the progressive rise in money incomes derived from wages and salaries. There has at times been a lot of talk about cost-push inflation, but costs are also incomes to those who receive these payments. So that inflation is often quite as much demand-pull as cost-push. The two in fact go together, though the emphasis may be —and often is — more on the one than on the other. Again, one can attribute the current situation at least in part to the emergence of new social attitudes. This came with the affluent society of the post-war years, which stood out in sharp contrast against the grim days of the 1930s and the war years, and built up expectations of a happier world. To some extent, we have achieved a wealthier, if not a happier, world. The difficulty has been that much of the population expects income and wealth to go on increasing, but it is not always appreciated that for this to happen there must be positive action — both employees and managers must be prepared to work for it and there must be a related amount of new investment. In this respect, the world has not changed very much, but expectations have and these expectations are being disappointed. Frustration flares up into strikes and bloody-mindedness. Trade unions are prepared to tolerate a rather higher level of unemployment (whether voluntary or not) in order to increase — or at least maintain — the living standards of those in employment.

This is not the whole story. Related to it is the feeling in a growing number of sectors of the economy that wages are too low in relation to the importance of the work being done (e.g. in the hospitals and the schools) and to the cost of living. Much of this feeling is justified and, if a sense of fairness is to be imparted to the social contract, it is implied that the lowest levels of wages should be raised (there may indeed be a need to introduce a minimum wage to protect the interests of the lowest paid workers, which minimum should be adjusted from time to time with a view to maintaining its real value). Fairness would also imply some concern for the maintenance of differentials,[19] even though the trend is towards greater

18 Michael Parkin, " United Kingdom Inflation: The Policy Alternatives ", *National Westminster Bank Quarterly Review*, May 1974, p. 39.

19 If wages are linked to productivity (see below) there will necessarily be some erosion of differentials and, indeed, that is the long-term trend. At the same time, it is

equality within the framework of the wages structure, as a result of which many in the higher and perhaps middle income groups are likely to suffer some diminution of living standards. Indeed, relative wages is one of the most intractable of problems. Wages never do move upwards precisely in step. Some workers put in a claim earlier than others and for larger amounts. Some get rises earlier than others and for larger amounts. There is no easy way of keeping all these competing claims in line and still maintaining margins for skill and responsibility.

But if a sense of fairness is to be restored to society, we must attempt to synchronise wages claims and thereafter make arrangements for their regular revision. The most obvious way of doing this is a prices and incomes policy that relates increases in wages and salaries to achieved increases in productivity. It is true that not all jobs lend themselves to increases in productivity. Nursing and education probably do not. And there are others. But these callings could readily be accommodated within the framework of the policy outlined by awarding them regular increases in income that accorded with movements in a general productivity index for the economy as a whole. No problem is insuperable. It will be argued that this policy has been tried and failed. The truth of the matter is that it has never really been tried. When Mr. George Brown (now Lord George-Brown), the Socialist politician, attempted to introduce it in 1964, few realised what he was attempting to do. Most of the commentators — and many economists — regarded it as just another attempt to introduce a wages freeze. It was nothing of the sort. It was an attempt at revolution and there can be no long-term solution unless there is a revolution — a revolution in social attitudes and in thought.

It has been well said that the problem is one of social justice, not of economics. " If people accepted that wages and rewards were just and fair, a lot of the inflationary pressure would go. But to get such acceptance, great changes would be needed: the distribution of incomes would actually have to *be* more fair ".[20] The wages of the low paid would need to be raised; an attempt would have to be made to get relative wages on to some kind of acceptable basis, so that not too many workers were out of line; and there would probably have

agreed that some attention must be given to differential payments; otherwise, there may well be a marked falling off in the supply of skills and of people prepared to accept responsibility.

20 Bernard Crick in *The Observer* 4 August 1974.

to be some levelling down of top salaries. Then the distribution of incomes might be seen to be more fair. To assist in this Herculean task, we might well require some kind of independent Industrial Court, which would also be in a position to see that further increases in wages were only awarded when there were achieved increases in productivity to offset them. One could expect, too, that increases in productivity would tend to take place in industries which were expanding in response to changing patterns of demand.

Another means of ensuring fairness might be widespread resort to "indexation", whereby prices (like rents and rates of interest) and incomes (such as wages and salaries) would be revised to take into account changes in the cost of living.[21] This might well be supported by the widened use of "inflation accounting", which would, for example, attempt to calculate profits and depreciation allowances on a real basis and to deflate appropriately magnitudes stated in inflated monetary values.[22] It may be though that acceptance of "indexation" is an acknowledgement that inflation has come to stay — an admission of defeat, but it need not be. On a limited basis, indexation has been tried before. Thus, in Finland, which suffered from serious inflation throughout much of the earlier post-war period (indeed, the "real" rate of interest was negative for every year — except 1949 — from 1938 to 1951), the banks decided in 1952 to investigate the possibility of tying interest rates for deposits and business loans to the cost of living index. If the index rose above a specified level as at a specified date, the banks would apply a surcharge to the ordinary interest rate charged to borrowers. At the same time, they would grant their depositors appropriate compensation in the form of a higher rate of interest on deposits. The scheme was first introduced in 1955 by the provincial savings banks and co-operative credit societies. The commercial banks also agreed to

21 The assets that have been most widely suggested as suitable for correction are Government securities, debentures, savings in life insurance or building societies, and bank loans and deposits. In fact, the United Kingdom Government announced two forms of index-linked savings schemes on August 6, 1974. But there are many unresolved questions surrounding indexation, not least of which is the measure of inflation that should be chosen — index of retail prices or of wholesale prices, or the gross domestic product deflator, all of which have tended to rise at different rates, with accelerations and decelerations that have not been synchronised. See TIM CONGDON in *The Times* 8 August 1974.

22 Some steps have now been taken in this direction in the November 1974 Budget to allow for increases in the value of stocks on which tax is payable. This will now be limited to 10 per cent of the trading profit. (See *Financial Times* 13 November 1974).

offer these facilities as from January 1, 1957 and at one time (mid-1958) index-tied deposits rose to one-quarter of the total. Then, as greater monetary stability was achieved, the index-tied deposit began to lose its appeal, since if prices ceased to rise the return was 1 per cent *below* the rate paid on ordinary accounts, which were now again preferred. Hence resort to indexation need not mean acceptance of inflation as a permanent phenomenon, though one would feel less confident about the indexation of wages, which is likely to result in an inbuilt inflationary pressure of the cost-push variety. This reservation would apply, for example, to the threshold payments[23] that have been triggered off by rises in the cost of living and which were added to the wages paid after April 1974 under Phase III of the Government's incomes policy.

Even so, a prices and incomes policy can only work (whether statutory or not) if the need for it is widely accepted throughout the economy. And all of the experience to date suggests that there is not likely to be such a general acceptance. Perhaps, if it was seen to be fair and had a positive ingredient by linking increases in wages to achieved increases in productivity, a more widely based acceptance might be possible, but so long as a prices and incomes policy is only another name for wages restraint, no amount of propaganda will persuade the public that it can ever be otherwise. And there is a case for propaganda, since, even if policy is made more positive, people must be persuaded to accept it. As already indicated, what is required is a social revolution; attitudes can only be changed if there is a persistent flow of propaganda having that end in view.

If, nevertheless, the Government of the day fails in persuading large sectors of the economy to accept a prices and incomes policy linked to achieved increases in productivity, what are the alternative weapons in the fight against inflation? Very simply, if we are not to face total economic collapse as a result of slipping into a state of hyper-inflation, these must consist of monetary and fiscal discipline. It may be true that much of our inflation has been imported. Basically, one might argue that the inflationary upsurge was due to the conjuncture of poor to average seasons and bad to moderate

23 The formula devised in October-November 1973 required the payment of an additional 40p per week to all those coming under the "threshold agreements" for every percentage point by which the increase in the cost of living since October 1973 exceeded 6 per cent.

harvests (in the United States, Russia, China and Australia, especially in 1972-73),[24] which greatly reduced the supplies of foods and feed-stuffs that were available to meet the demand. In addition, there was much speculative buying, which forced prices still higher. There were also increases in the demand for non-food raw materials as a result of the worldwide increase in levels of output. There can be little doubt that commodity shortages triggered off the sharp rise in prices that hit all world economies in the early 1970s, but the situation was certainly exacerbated by monetary and fiscal indiscipline. Moreover, even an active monetary policy can achieve little, unless it is permitted to operate within an appropriate fiscal framework. The two must go together.

What do we mean by monetary and fiscal discipline? If we have a sudden cut-back in the supply of money to the economy, necessarily there would be a sharp fall in economic activity and heavy unemployment. Hence, there is much to be said in an inflationary situation for a gradual reduction — say, over a period of three to five years — in the supply of money, with the object of also reducing the rate of inflation to something in the region of 3 to 5 per cent. Obviously, a sharp deflationary cut-back in the money supply will result in a sharp rise in bankruptcies and unemployment, because no economy can adjust overnight to a significant loss of liquidity. However, even if the reduction in the money supply is gradual — giving time for adjustments to be made by industrial managers — it would seem inevitable that as flows of money are reduced throughout the economy there will have to be some cut-backs in economic activity and in employment, with the percentage of unemployment also rising gradually, though hopefully it will be possible to keep it within manageable limits.[25] Ultimately, a degree of "equilibrium" might be achieved.

If we assume that a 1 per cent increase in the price level will generally lead to a 1 per cent increase in the demand for money balances, which experience suggests is a relatively accurate basis for forecasting and, if further one assumes an economy again growing at something like its productive potential — say 3 to 3½ per cent per annum — some degree of "equilibrium" might well be main-

24 The 1973-74 harvests were better, though poor in China, and 1974-75 good, except for maize (corn) and soya in the United States.

25 Cf. PARKIN's view, *loc. cit.*, p. 43 "A five-year cure could probably be achieved from inflation rates around 10 per cent with a very small margin of unemployment".

tained with a money supply permitted to increase by (say) 6 to 8 per cent per annum. Again, this would imply not only action by the monetary authorities to contain the rate of growth in the money supply, but also maintenance of fiscal discipline.

And by fiscal discipline is meant not merely a balanced budget, but one in which there is also some significant reduction in the levels of public expenditure, in order to alleviate the pressure of demand on scarce resources and thereby the real basis of inflationary pressure, which monetary factors only serve to exacerbate. At the same time, it must be remembered that all modern "mixed" economies are geared to certain levels of Government expenditure. If, therefore, there are cut-backs, private industry will have to adjust to a new situation and this may again mean unemployment. Moreover, this will be true whether or not we are on the downward sweep of a Kondratieff "long wave". Hence, the need in this case also to reduce public expenditure gradually, thereby releasing resources that in due course may well be absorbed by new private investment geared to an expansion of production in the private sector. Indeed, over the longer run and especially if accompanied by tax cuts, lower rates of interest, and industrial retraining programmes, this may be the means of restoring confidence to the private sector, inducing an increasing quantum of new investment and thereby an increase in productivity. If at the same time industrial relations can be improved, the economy as a whole will be able to benefit from the fruits of the new investment.

Moreover, one would expect interest rates to fall to lower levels — partly for monetary reasons, but also because of the reduced pressure on resources deriving from the lower levels of public expenditure. It is unlikely that money rates of interest will ever decline again to (say) the levels of the early 1960s (when the clearing banks' "blue chip" rate varied between 4½ and 7½ per cent), but one might reasonably anticipate that they would be lower than 13 to 13½ per cent (1974). Perhaps, they might be expected to move within a band above and below 10 per cent (perhaps from 8 to 12 per cent).

In summary, if the public is not prepared to accept a prices and incomes policy (of which the social contract is merely an extension) — and all the experience to date suggests there is not likely to be such a general acceptance — then the only alternative to total economic collapse as a result of slipping into a state of hyper-inflation will be the imposition of monetary and fiscal discipline. This means,

on the one hand, a gradual decrease in the rate of increase in the supply of money, until it approximates (say) 6 to 8 per cent per annum (allowing for economic growth at — say — 3 to 3½ per cent per annum) and, on the other, not merely a balanced budget but also some significant reduction in the levels of public expenditure, in order to alleviate the pressure of demand on scarce resources and thereby the real basis of inflationary pressure, which monetary factors only serve to exacerbate. In these ways, the rate of inflation (percentage rise in prices per annum) might be reduced to something like 2 to 3 per cent or even less. Moreover, if this objective could be achieved in general terms in most of the leading industrial countries, there would be little need to worry about imported inflation.

On both counts, one would expect a consequent reduction in economic activity. It would seem inevitable, even if the reduction in the supply of money is gradual, that there will be cut-backs in economic activity and employment, with the percentage of unemployment also rising gradually (say, to approaching 1 million, or about 4 per cent of the working population), though hopefully the level of unemployment will be kept within manageable limits, ultimately reducing to something like an "equilibrium" level of 2½ to 3 per cent. So far as the maintenance of fiscal discipline is concerned, it must be accepted that all modern "mixed" economies are geared to certain levels of Government expenditure. If, therefore, there are cut-backs in public expenditure, private industry will have to adjust to a new situation and — in the short-run — this again means unemployment. Hence, the need in this case also to reduce public expenditure gradually, thereby releasing resources that in due course can be absorbed elsewhere in the economy. As already indicated, this could be greatly assisted by lower interest rates, tax cuts, and retraining programmes. Also, to the extent that a social contract can be made to work and the whole emphasis does not have to be placed on monetary and fiscal discipline one would expect the levels of unemployment to be lower and the pressure on resources to be alleviated by restricting the growth in real incomes to achieved levels of productivity. It is in this sense that a prices and incomes policy has such a strategic role to play in the fight against inflation.

Hull

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