Money, Credit and Interest

James Cumes

Abstract:

The paper challenges the deeply-embedded belief that hikes in interest rates "fight inflation" and explains how domestic inflation shifted to trade deficits. It distinguishes between asset-price and consumer-price inflation and the interest-rate impact on each as well as on fixed-capital investment. The attempt to control inflation through hikes in interest rates, allied with deregulation, privatisation and globalisation, created a speculative world economy, major shifts in economic power and massive American external debt, for whose reduction only a return to enhanced fixed-capital investment, productivity and real production would seem to be the answer. Shifts in economic strength continue to transform the world political and strategic power landscape. A major point is that inflation may occur not because an economy is "overheated", or because too much money is printed, but rather because of the opposite: because investment, productivity and production are too low.

oooOooo

1. Introduction

During the past thirty-seven years, most national economies and the global economy have been dominated by issues related to inflation, money supply and credit. The period has been marked by unstable currency, stock and real-estate markets, and burgeoning speculative as distinct from real economic enterprise. Within the complex of problems and quests for solutions, the rate of interest has been a central preoccupation for governments, banks, traders, economic and financial gurus and laymen alike. It has established itself overwhelmingly as the principal instrument of economic and financial management. Therefore, an understanding of what it is and what it does is crucial to an understanding of what has happened in the past and what changes might be necessary if we are to achieve more stability and more confidence in our future economic and financial policies. As always, those economic and financial policies will have an array of direct and indirect effects on social, political and strategic situations with which they are inevitably linked.

2. Interest, Inflation, Investment

The interest rate, we might reasonably suggest, is the price for hiring money or obtaining credit. It is the price you will pay for having a certain amount of liquid resources in your hands or under your control, for use in direct or indirect investment, for speculation or gambling, or for some form of consumption, whether essential food, clothing and shelter or entertainment, pleasure, relaxation or conspicuous waste.

It was the hike in interest rates by the Fed in July 1969 that, in alliance with some simultaneous fiscal measures, marked the transition from the stable post-World-War-Two economy to the increasingly free-wheeling and mismanaged instabilities afterwards. The action of the Fed in July 1969 inadvertently precipitated stagflation and the array of problems that followed. Although, simultaneously, the Nixon administration imposed fiscal restraints, it was the interest-rate rise that had the most significant impact and, even more importantly, it was the interest rate that became the most common and most potent instrument of economic and financial management subsequently. The fiscal factor, though not neglected, especially under Presidents Reagan and Bush the younger, tended largely to hover in the background. By contrast, rumoured changes in interest rates, speculation about such changes or declarations of intention or actual decisions by central banks increasingly became headline news. Front-page press headlines such as those of

19 and 21 November 2005 reporting "ECB making a risky bet" or "Trichet signals that ECB will raise rates" have become routine and typical of popular as well as financial news coverage, in the United States, the European Union, Japan and other countries around the world.

Within a year of the hike in interest rates in July 1969, American industrial production declined by some 7% and unemployment jumped by a million. The unexpected feature however was that the cut in production and the leap in unemployment were accompanied by an *increase* in inflation, giving us what was then seen as a new phenomenon, appropriately given a new name: stagflation.

Clearly this was not what had been intended. The intention was quite the opposite: to reduce inflation and/or to ease inflationary pressures then and in future. That was the conventional wisdom of the time: higher interest rates "fight inflation." There was very little expression of any contrary opinion. An interest-rate hike would relieve inflationary pressures. In the other direction, an interest-rate cut would tend to expand demand in relation to supply and quench any tendency towards deflation in the economy. So the orthodox economists and policymakers believed. So indeed, with few exceptions, they still believe.

There was only one published expression of dissent at the time. That was in 1971 in The Indigent Rich: "What is in fact needed to restore equilibrium at the upper, inflationary level of the modern, Keynesian economy is not more unemployment but less unemployment, not less production but more production." [1]

"The Indigent Rich" was followed, in 1974, by "Inflation: A Study in Stability", in which I said, carefully at one point –

Certainly, the rise in the interest rate will have some effect on the economy. Indeed, it will probably have a major effect. The greater the interest-rate rise, the greater – probably – the impact. In certain circumstances – although this needs closer investigation – the movement in interest rates might be the most thrusting element in increasing prices, wages and incomes and the major destabilising element in the modern economy. As the productive economy is largely based on various forms of credit, the rate of interest might be the most potent single force in changes in the balance between production and consumption and thus in changes in prices and, partly by derivation, in wages. [2]

I then spelled this out in more detail –

We need to re-appraise the role of the rate of interest in the modern economy. Its significance has always been a matter of some mystery. It can be – or has seemed to be – a simple agency for equilibrating the demand for and the supply of money. Or it can be, as Keynes saw it, a price for overcoming liquidity preference: 'the rate of interest at any time, being the reward for parting with liquidity, is a measure of the unwillingness of those who possess money to part with their liquid control over it.' The rate of interest can be a means of reversing trends in the trade cycle and of mitigating its effects. It can be a stimulus to the flow of short-term funds internationally and thus a destabilising element in the balance of payments. Through its domestic and international effects it can, ultimately, destroy the stability of a high-employment economy and undermine the international monetary system.

If it doesn't do all of these things, it can perhaps do some of them. But several things can certainly be said about it:

The rate of interest has a significant role in the modern economy.

Its role in the economy now is different from that which it had twenty-five years ago, because the economy in which it operates is different.

A rise in the rate of interest will have a depressing effect on those parts of consumer spending (such as purchase of houses) which, because they involve large outlays, are therefore dependent on credit.

But other consumer spending will remain high and might even be increased inter alia, by the transfer of expenditure from the interest-dependent objects.

On balance, therefore, a rise in the rate of interest is likely to have a relatively small net effect on consumption but it is likely to have a relatively large net effect on production and could cause unemployment or move employment away from production to, for example, consumer marketing.

Through its effect on production and employment, a rise in the rate of interest will therefore tend to intensify inflation and a fall in the rate will tend to reduce it.

More directly, the rate of interest will have an effect on production costs, especially on those industries that are heavily dependent on borrowed funds and this impact on costs will again intensify inflation if the movement in the interest rate is upwards and reduce inflation if the rate moves downwards. [3]

That was written in 1974. Apart from my subsequent writings, attitudes towards the rate of interest and its impact on the economy remained unchallenged until the London Financial Times carried a five-column headline above a letter by Geoffrey Gardiner in 1988. The headline read: "High interest rates are no more a cure for inflation than bloodletting was for fever."

The Gardiner letter outlined some of the history of thinking about the impact of the rate of interest. Then and later, he noted that the early British economists all took the view that high interest rates cause high prices. Around 1621, Sir Thomas Culpeper and his son both campaigned for lower interest rates so that English merchants could compete with the Dutch who rejoiced in lower rates.

The idea that high rates of interest will reduce prices seems to have originated in 1832 when a British Parliamentary committee looked at the monetary and banking system of the day and produced a report known as the "Minutes of the Secrecy Committee", which now resides in the archives of the Bank of England.

It was the Governor of the Bank of England at the time, J. Horsley Palmer, who, in answer to No. 678 of more than 5,300 questions posed by such people as "Mr Rothschild" and "Mr Baring", gave an answer for which he offered little empirical or other supporting evidence. He said that, if one made money more expensive, by which he presumably meant higher interest rates, lending would fall and so would prices. That was in 1832. The Palmer doctrine, if it deserves such a respectful title, has prevailed ever since, right up to the present day.

The hike in interest rates crucial for our era was that made in July 1969. In 1971 and 1972, the new Chairman of the Fed, Burns, did in fact lower interest rates for a time and is credited with having helped Nixon's re-election in 1972 by his "accommodative" handling of monetary policy. The cut in interest rates was said to have been intended to offset Nixon's price and wage controls. Consequently – and ironically - Burns has since been roundly condemned for cutting interest rates and thus igniting the inflation that plagued the American economy during the rest of the seventies and into the eighties. Those who still condemn him have no clearer idea – even now - of the relationship between the interest rate and inflation than Burns did more than thirty years ago. All of

them have lived and still live contentedly with J. Horsley Palmer's fuzzy conviction of 1832.

That isn't quite the whole story; but it is necessary to go back nearly fifty years before the events of the early 1970s to discover any significant discussion of the possibility that an increase in interest rates was, in fact, linked with an increase in consumer prices, that is, with an increase in inflation as popularly understood.

It was in January 1923, in an article in the Bankers Magazine, that A. H. Gibson put forward the notion that a rise in interest rates was to be associated, not with a reduction but with an increase in inflation. Like *The Indigent Rich* of 1971 and *Inflation* of 1974, Gardiner's letter of 1988 in The Financial Times had had no apparent impact on thinking about embedded policies and attitudes towards the rate of interest. In 1993, therefore, he wrote a book, *"Towards True Monetarism*" in which, after twenty-four years of monetary policy based firmly on the conviction that an interest-rate hike reduced inflation, he said -

"The suggestion that, contrary to standard doctrine, there is a historical correlation between rising prices and rising interest rates, the latter being caused by the former, and that lower interest rates lead to lower prices, appears to have been first publicised by A.H. Gibson in an article in the January 1923 issue of the Bankers Magazine. Gibson's revelation is not mentioned in the popular textbooks. In 1930, after five years work, Lord Keynes published his Treatise on Money in two volumes. It is a work with failings, some of which he appears to have later acknowledged, but in the second volume Keynes makes up a little for its faults, not only by publishing Gibson's discovery, but also by expanding the evidence for it. On page 178 of the second volume Keynes makes this fascinating comment on Gibson's theory,

'The Gibson paradox – as we may fairly call it – is one of the most completely established empirical facts within the whole field of quantitative economics though theoretical economists have mostly ignored it.'" [4]

Keynes' statement that empirical facts "completely established" the Gibson paradox was, of course, further validated by what happened after July 1969: inflation increased and did so to a quite unexpected and remarkable extent. Part of this result may fairly be attributed to the welfare programs introduced by President Johnson in the 1960s, as part of his Great Society. In what was clearly something of a softener to those who would suffer most from the restraint policies of his administration and the Fed, Nixon acted to maintain personal incomes. Specifically, he sent a message to Congress on 8 July 1969 in support of legislation to extend unemployment insurance which he described as "an economic stabiliser."

Cold-War defence spending and the hot Vietnam War also intensified inflationary pressures, as did the oil-price shock in 1973. However, although there were these additional factors in the American situation in 1969 and later, they did no more than intensify the effect that the interest-rate rise had on inflation. In other words, stagflation was caused by interest-rate hikes and intensified by such other factors as the welfare stabilisers and defence spending.

In this connection, Gardiner wrote –

"Expanding Gibson's own figures Keynes prints a comparison of the yield on Consols with the wholesale price index for the period 1791 to 1928. The two sets of data march in step. It is more than likely that the data could be extended up to the present day with the same high correlation that Keynes revealed except for the unusual wartime period, 1939 to 1946; but even during five of those seven years, throughout which Bank Rate was two per cent, the rate of price increases was remarkably low by the standard of the

1980s. As the level of interest rates between 1940 and 1946 was influenced by Keynes, he must have kept in mind Gibson's Paradox. He cannot be accused of ignoring it himself."

The United States had a similar experience. On 27 November 1985, Lord Beswick told the British House of Lords that a Congressional Sub-committee reported on 21 September 1961 that "the period from late 1939 to 1951 was as violent and catastrophic as any in the entire history of the United States. At the beginning of this period millions were still unemployed from the great depression. A short time later we were shooting away 250 million dollars every day on the battlefield ... Then came the Korean conflict. Yet during this entire period of economic stress and turmoil the interest rate on long term Government bonds never exceeded 2 and a half per cent. And those bonds never sold below par". Lord Beswick said that the report added the comment "The Fed can restrain higher interest rates when it wants to".

There is one point in Gibson's doctrine that needs clarification. He says that rising prices "cause" rising interest rates, rather than that rising interest rates "cause" inflation. On this point, Gardiner writes that "It is long-term interest rates which the Gibson Paradox correlates with prices. The correlation, which is very high, is not quite so strong for short-term rates of interest, but, according to Keynes, it is still highly significant. One interesting thing about Gibson's data is that it clearly shows that the rise in interest rates follows the rise in prices, not the other way around. This is surprising, as one would expect rising interest rates to push up prices. The much higher interest rates of more recent times certainly pushed up both costs and prices." [4]

There is little doubt that Gibson would have found "the modern theory of the relationship of interest rates and inflation rather curious" – and curiously naïve and unconsidered. "He would have considered that low interest rates on gilts encourage the application of savings to real investment in the hope of a better return. Real investment (plant, machinery, and other productive assets) if effective, should reduce real prices because it should lower production costs. Gibson's reason for the fall in the prices of basic commodities at the time he was writing was the big investment made in food and raw material producing countries in the period 1907-1913.... In the later decades of the twentieth century it has perhaps been more correct to say that the cost of energy, and especially oil, is the ultimate regulator of costs (if indeed there is one)." [4]

Apart from Gardiner's distinguished work, the link between the rate of interest and inflation was described, as far back as 1974, in "Inflation: A Study in Stability", as follows:

"The effects of interest rates are... complex. But certain it is that a rise in the interest rate means a necessary narrowing of that range of enterprise that will be profitable without a further escalation of prices. The deterrence that this provides to maintaining or increasing production will itself cause an increase in prices through pressure of sustained demand on static or reduced supply. If an increase in interest rates is combined with some price-fixing or price-justification arrangements, the effect on production, and ultimately on the price level, will be all the greater.

"Higher interest rates will also cause a diversion of investible funds from direct investment in production (including that through stock exchanges) into mortgage and consumer lending. Why should an investor take the risks of enterprise when he can get ten per cent or more clear on a safe mortgage or about as much on finance-company notes? There will thus be increased pressure from the consumer demand side just at the time that there is a weakening of incentive on the supply side to meet it.

"That brings us to the need to apply policies to restrain, or restrain the growth of, consumer demand at the same time as incentives are provided to increase production..." [5]

The stagflation of the 1970s, which affected many countries apart from the United States and which provided formidable empirical data to support the Gibson Paradox, should have inspired a close examination of the impact of interest rates on inflation but, curiously, it did not. Not only did conventional wisdom remain unmoved but the policies of using hikes in interest rates to fight inflation became more deeply entrenched. At the end of the 1970s and the early 1980s, the practice was to raise interest rates to fight inflation and then, if inflation persisted or moved even higher, to move interest rates even higher too, so that the misconceptions about the interest rate caused the impact on the economy and the society to escalate from damaging to disastrous.

There was a tendency to regard this imposition of suffering on a wide variety of people in the economy, as unavoidable and almost a "moral" requirement – a discipline of sackcloth and ashes that would purge the economy of its sins. Again, this applied to other countries as well as the United States. When a renewed bout of inflation occurred in Australia in the late 1980s, the Australian Government applied its usual policies of hikes in interest rates. That caused a sharp recession. The impact on employment and income, especially of lower-wage people, was even more severe than usual and caused real and widespread distress. The then Treasurer and later Prime Minister Paul Keating tried to assuage the stricken by saying that it was "the recession we had to have." No doubt he believed that his imposition of monetary and credit discipline would mean a stronger economy and better times for its people in the years ahead. However, he showed no understanding that the interest-rate increases that had provoked the recession would stimulate further inflation or, as did indeed happen, shift inflation from domestic price rises to even larger deficits in the balances of trade and payments. There was no sign either that the government glimpsed in any way that their policies were draining the secular strength of their own economy by gutting Australian industry and adding further to the dramatic growth of the highly competitive economies of south-east Asia.

Gardiner sums up the position as he sees it, as follows:

"Price variations which arise from natural variations in costs of production, such as the variation brought about by investment in more efficient machinery, are quite a different thing from what we now know as inflation and deflation. Inflation, which has been the main bugbear of the second half of the twentieth century, is not necessarily a natural phenomenon. It may have little to do with underlying costs. Instead it may have as one of its main causes excess demand arising from the unregulated creation of credit. One can see a dilemma: even if it were true that high interest rates discourage the creation of credit, it would still be true also that they discourage the investment which might reduce real costs of production, and expand the economy. Surely the latter objective is more important than the former? If, however, the monetary economists are wrong, and high interest rates cause both inflationary and real price rises, and they also lower the rate of investment, one threatens the economy with a triple jeopardy whenever one raises interest rates in pursuance of an erroneous theory." [4]

This prompts us to draw what are crucial distinctions between (1) asset-price inflation, (2) consumer-price inflation and (3) fixed-capital investment. Movements in the rate of interest will have a crucially different effect on each of them.

Many of the inflationary crises of the last thirty-five years have had their origins in excessive demand for assets, often with a highly speculative element. Housing prices are moved higher because credit is available at an accommodating mortgage interest rate and, the market having started to move up, more people enter the market because they think that prices will go higher still. Much the same happens with share prices or with currencies or with most assets that are subject to variable market influences. The inflation of asset prices is not a modern phenomenon. It goes back a long way to such events as the tulip boom of the sixteenth and the South Sea Bubble of the seventeenth century, to the New York stock-market boom of the 1920s as well as the housing and stock-market bubbles in Japan around 1990. It applies to the stock-market, housing and associated bubbles in the United States during the past decade, some parts of which are still, as we move through 2006, bubbling away merrily, though observed with growing nervousness on the part of some participants.

There can be no doubt that a sufficient hike in interest rates will kill these asset-price inflations that is, those inflations that have taken prices beyond – for the most part, extravagantly beyond - the level justified by underlying values. “Sufficient” is an important qualification. If the hike or hikes are small, say of only 0.25%, they might still lie sufficiently within the borrowers’ comfort zone. Such “accommodative” interest-rate rises might only encourage further borrowing in time and volume, inflate the bubble still further and so create conditions for an even bigger bust down the road. However, what we want to emphasise here is that asset-price inflations – that is, the existence of asset valuations that, through “irrational exuberance” or other unsustainable influences, contain a lot of “blue sky” above fundamental market value – are particularly sensitive to interest-rate changes. They may be said to live or die according to whether the interest-rate climate remains accommodative or not.

We must distinguish clearly between asset-price and consumer-price inflation. Just as one intriguing link and contrast between the two, housing prices may now be in the midst of a runaway boom, with prices rising 50% or more over a relatively short period. At the same time, rents for those same houses may remain stable or rise only modestly. For example, in the United States, if rents continue to rise at their current (end 2005) annual pace of 2.5%, house prices will have to remain flat for over ten years to bring America's ratio of house prices to rents back to what can reasonably be regarded as its long-term norm. Alternatively, a clear risk is that house prices might fall – or plunge. That sort of contrast between house price and rent levels can indicate that an asset bubble is either on the way or has already formed and that a correction of that bubble, through credit contraction, may be likely and painful.

Consumer-price inflation is the inflation with which we have tended mainly to be preoccupied since 1969. It is consumer-price inflation that central banks are so often mandated to keep below 2% or 3% or whatever. The Fed under Greenspan avoided setting targets – although his successor is known to have favoured them in the past. The ECB has usually aimed at a target of “close to or below 2%”.

Consumer-price inflation can be affected by seasonal or special factors. Prices of fruit and vegetables and food more generally tend to fluctuate seasonally and with drought, flood and other variations in weather. However, underlying or “core” consumer-price inflation will be affected by changes in interest rates, targeted perhaps at asset-price inflation rather than consumer-price inflation. Increases in interest rates will tend to discourage real investment in productive enterprises, thus reducing supply and losing the productivity gains that new investment might have won. The discouragement of investment at home might encourage imports, thus holding down consumer-price inflation but creating deficits – or reduced surpluses – in the balances of trade and payments.

As the above indicates, movements in interest rates will have an impact on fixed-capital investment, the force of that impact depending on how large the movements are. If interest rates are kept low and stable for long periods that is likely to stimulate fixed-capital investment – real capital formation – over a wide range of industry producing goods and services for domestic use or export. Fixed-capital investment, if maintained in this way and allowed to effect the creative destruction that innovation requires, will tend to stabilise and maximise growth and employment and lift productivity to a level as high as state-of-the-art capital equipment and management permit. Fixed-capital investment is the vital initiator of the process of enhanced productivity and production and, through its impact on supply and costs, is the most effective and most rewarding instrument with which to fight consumer-price inflation. To maximise fixed-capital investment, interest rates applying to it should be kept as "accommodative" as possible, that is, rates should be kept as low and as stable as possible for as long as possible. The low rates will encourage real production and the stability of the rates will reduce speculative incentives and tend to operate against the formation of real-estate, stock-market, bond and other asset-price inflations and bubbles.

Those, we believe, are the fundamentals that we need to understand in approaching monetary and credit issues. To what extent have these fundamentals been observed in the formulation and implementation of policies in the last eighty and particularly the last thirty years? Let us take a more detailed look at some of those policies in a variety of countries, but especially in the country that has been most influential in world economic and financial affairs, the United States.

3. Experience from the Interwar Period

The monetary situation both reflects and has a powerful impact on the underlying economic, social and political situation. In the inter-war period of the 1920s and 1930s, the monetary situation reflected instabilities that flowed from the Great War, two of the characterising events being the hyperinflation in Germany and Churchill's attempt to restore the pre-war gold standard in Britain in 1925.

Hyperinflations – inflations in which the monthly rate exceeds, let us say, 50% or thereabouts - are largely a twentieth-century phenomenon. The most widely studied hyperinflation occurred in Germany after World War I. From August 1922 to November 1923, prices increased at an average monthly rate of 322%. On average, prices quadrupled each month during the sixteen months of hyperinflation.

While the German hyperinflation is better known, a much larger hyperinflation occurred in Hungary after World War II. Between August 1945 and July 1946 the general level of prices rose at the rate of over 19,000 percent per month, or 19 percent per day.

Even these very large numbers understate the rates of inflation experienced during the worst days of the hyperinflations. In October 1923, German prices rose at the rate of 41 percent per day; and in July 1946, Hungarian prices more than tripled each day.

What causes hyperinflations? No one-time shock, no matter how severe, can explain sustained - that is, long and continuously rapid - price growth. The world wars themselves did not cause the hyperinflations in Germany and Hungary. The destruction of resources during the wars can explain why prices in Germany and Hungary would be higher after the wars than before; but the wars themselves cannot explain why prices rose continuously at rapid rates during the long periods of the hyperinflations.

The key is that hyperinflations are usually caused by extremely rapid growth in the supply of "paper" money. They occur most characteristically when the monetary and fiscal authorities continue to issue large quantities of paper money, on a regular basis, to pay for an extraordinary and continuing volume of government expenditures. In hyperinflations, prices typically grow more rapidly than the money stock because people attempt to lower the amount of purchasing power they keep in the form of the swiftly devaluing money. Instead, they try to hold more of their wealth in the form of almost any kind of physical commodities, such items as gold and silver if practicable but almost anything else with intrinsic value if precious metals and the like are not available. As they buy these commodities, not only for daily use but as a store of value, prices are forced up ever higher and inflation accelerates.

Hyperinflations tend to be self-perpetuating. Hyperinflations end when governments make a credible commitment to halt the rapid growth in the stock of money. By this token, the German hyperinflation ended in late 1923, with the creation of a new unit of currency. The German Government promised that the new currency could be converted on demand into a bond having a certain value in gold, with the implied promise that the rapid uncontrolled issue of paper money would cease.

An alternative view held by some economists is that not just monetary reform, but also fiscal reform, is needed to end a hyperinflation. According to this view a successful reform entails two credible commitments on the part of government. The first is to halt the rapid proliferation of paper money. The second is to bring the government's budget into balance. This second commitment is necessary for a successful reform because it removes, or at least lessens, the government's incentive to resort to inflationary taxation. Proponents of this second view argue that the German reform of 1923 was successful because it created an independent central bank that could refuse to monetize the government deficit and because it included provisions for higher taxes and lower government expenditures.

Hyperinflations reallocate wealth. They transfer wealth from the general public, which holds money, to the government, which issues money. They also cause borrowers to gain at the expense of lenders in the cases where loan contracts are signed prior to the worst phases of the inflation. Those loans simply vanish, in real terms, in a few hours or days of hyperinflationary impact. Businesses that hold stores of raw materials and commodities gain at the expense of the general public. In Germany, tenants gained at the expense of property owners because rent ceilings did not keep pace with the general level of prices. One view is that, by destroying the wealth of Germany's established classes in Germany, the hyperinflation cleared the way for the Nazis to win political power. Certainly, it created such economic and social turmoil that radical political outcomes of some kind could reasonably have been predicted.

Hyperinflation tends to drive the economy away from monetary transactions toward the clumsiness and inefficiency of barter. People hold money in as small quantities, for as short a time as possible. In a normal modern economy, major and fundamental efficiencies are derived from using money in exchange. However, during hyperinflations, people prefer to be paid in commodities in order to avoid what might be regarded as an inflation tax.

4. Current Inflations: Causes and Consequences

The hyperinflations that took place in Germany in 1923, in Hungary in 1945-46 and in several Latin-American countries – Argentina, Brazil, Peru, Bolivia, Chile and Uruguay – in the last thirty years seem to have provided the models for the monetarist theories of the 1970s and 1980s, some elements of which continue to be applied today. Monetarism postulated that inflation or hyperinflation was caused by excessive issue of paper or fiat money. Consequently, it was the money supply that must be carefully monitored and controlled if inflation were to be cured and avoided. However, excessive issue of paper dollars was not the cause of the inflation and stagflation that occurred in the United States after 1969 and that then spread to other highly industrialised countries. The dollar continued to be regarded as a respected reserve currency and several of the Latin-American countries used “dollarisation” to create a confidence-building “new currency” to manage their hyperinflations.

Although there had been, during the 1960s, huge expenditures on defence, the Vietnam War, space and external aid, as well as social welfare under Johnson's Great

Society concept, United States inflation in July 1969 was modest. On a base of 100 for 1982-84, prices had lifted from around 31 in the earlier 1960s to a level of around 35 to 36 for 1969.

After 1969, the higher inflation – which never remotely approached hyperinflation if we define it as around 50% a month – came not from excessive government spending, large budget deficits or extraordinary printing of fiat money. It came instead from a reduction in production, especially industrial production, while consumer spending stayed high. So the inflation and stagflation of the 1970s and 1980s did not qualify for the remedies applied to correct a hyperinflation of the kind of that in Germany in 1923. What was called for was not a new currency which would have the confidence of users at home and abroad. Rather what was needed was a new stimulus to fixed-capital investment, which would enhance productivity and increase production. That would lift supply to match or exceed the level of aggregate demand originating in the private and public sectors combined. However, instead of doing this, a succession of United States Administrations, plus the Federal Reserve Board, did exactly the opposite. They persisted in fighting inflation by raising interest rates and thus providing additional disincentives to investment and increases in production or "supply" that would have solved inflation by raising supply to the level of aggregate demand. From the early 1980s onwards, they also cut taxes in ways that further exaggerated disequilibria arising from excess consumption and inadequate production.

The solution came eventually when supply became available from outside the United States economy. Inflation then shifted from increases in domestic prices to deficits in trade and payments balances. However, that brought a whole new set of economic, political and strategic problems, including a marked tendency for domestic inflation to persist in those items, such as health and education, for which a shift to the external balances was not practicable.

Here we will just note that the shift in inflation to trade deficits and the accumulation of massive budget deficits over the years have brought us to a situation in 2006 in which a hyperinflation is a real, possibly near-term prospect. Consulting economist and specialist in government economic reporting John Williams, who paints a more realistic picture of the American economy, especially contrasted with the official statistics, wrote in February 2006 that, if and when the value of the dollar falls dramatically under the weight of an avalanche of debt –

"You're going to see a lot of dumping of U.S. securities, particularly Treasuries. To absorb them, you're going to see a sharp spike in rates or the Fed will step in and provide liquidity to the market and buy them. My betting is, especially with Mr. Bernanke, who is a student of what happened in the Great Depression, now in charge, that he has some ideas about what is going to happen here. If you look at what happened in the banking collapse in the early '30s, it's widely believed now that the Fed made a mistake in not pumping liquidity into the system. They let the money supply collapse as the banking system collapsed and that tended to accelerate the deflation and the depression; made the depression deeper than it perhaps had to be. So going forward here, if we have a circumstance where that mistake could be made again, the effort likely will be in the other direction, to provide liquidity to the system. You're not going to see banks fail. You're not going to see large financial institutions fail. The Fed will back the system with every dollar that it can print. But of course all that would go on top of what is already an uncontrolled federal deficit. The end result, when it does all come together, will be something akin to a hyperinflation, but at the same time you'll have also a very depressed economy. So there'll be an inflationary recession, which I think we're already beginning to get into, that possibly could evolve into a hyperinflationary depression, as much as I really hate to use that term. I am an optimist at heart... but if there's any way of getting around this—and I'm looking for ways for it to happen—I just don't see it. I mean, if we can accept for a moment my premise that there's no way of curing the fiscal problem shy of a bankruptcy—and that there's no way the government is going to renege

on its debt—I'm sure it'll do what has been politically expedient in the past: You rev up the printing presses and pay off the debt with the money that you print—even as that money becomes worthless. The thing is, with the dollar, we are dealing with the world's reserve currency. So we are talking about a global crisis of unprecedented proportions, probably one that would lead to the collapse of the current currency system. You'd probably have to have an international conference to reconstitute the global currency system and somehow build confidence in the public that the new system will work and that it's stable, so that we are not put in the same position as the poor people of Germany, after WWI, because that is the type of hyperinflation that could evolve here. So the cures will have to be remarkable. They will have to convince people that things have changed. As crazy as it sounds, I think the only thing they will be able to do is to go back on some kind of gold standard."

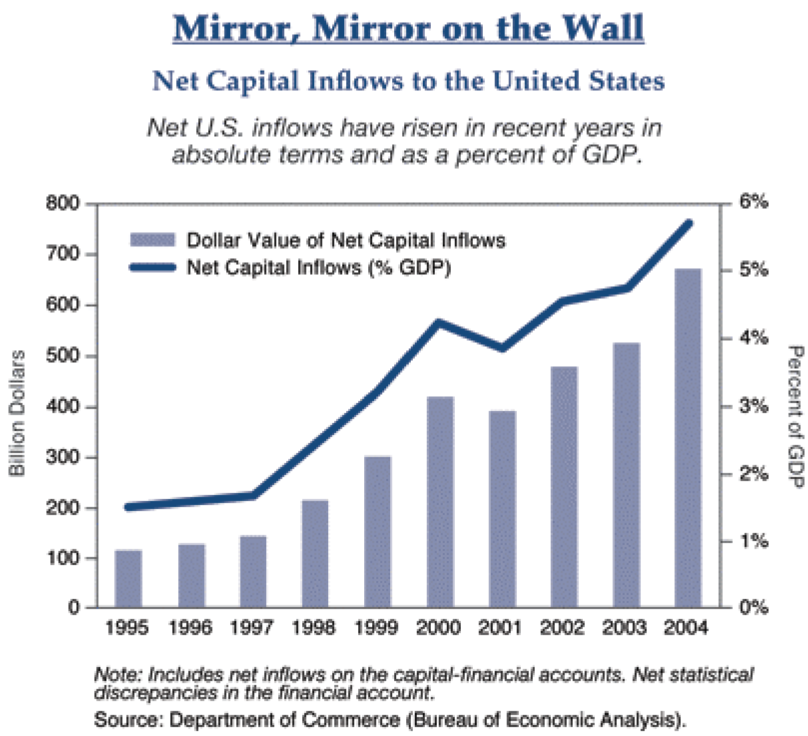


Chart 4

5. The Self-inflicted Wounds of Deficits

Deficits do matter. The attempt by Chancellor of the Exchequer Winston Churchill to return to the gold standard in 1925 illustrates another aspect of monetary policy, especially the impact of political considerations on the efficient performance of the economy in terms of investment, productivity and production. It illustrates the fundamental significance of the exchange rate and its effect on trade, economic growth and employment.

In Chapter 13 of his book, "Money: Whence it came, where it went," [6] John Kenneth Galbraith described the "Self-Inflicted Wounds" of the attempt by Britain to return to the gold standard in 1925 at the old parity as "perhaps the most decisively

damaging action involving money in modern times." That it was damaging was for sure; and it powerfully confirms the proclivity of great men and distinguished leaders to commit acts that are ill-advised and often absurd. The attempt by President Nixon and the Fed Chairman to control inflation in 1969 was, at least with hindsight, equally ill-advised and had more widespread damaging effects even than Churchill's error in 1925. Even more ill-advised is history likely to show Fed Chairman Greenspan's efforts to have been to control - and create! – a series of bubbles in the early years of the 21st century.

Although others had doubts, the case against Churchill was led by Keynes. It was a simple one. [6] By returning to gold at the old parity, Britain accepted the need for a painful depression of prices and wages with accompanying stagnation and unemployment, all of which would be a rich source of social stress. Keynes was anxious to discover why Churchill, a man of considerable reputation, was impelled to do "such a silly thing". Keynes explained that Churchill had "no instinctive judgement to prevent him from making mistakes;" and "lacking this instinctive judgement, he was deafened by the clamorous voices of conventional finance; and, most of all, he was misled by his experts". [6]

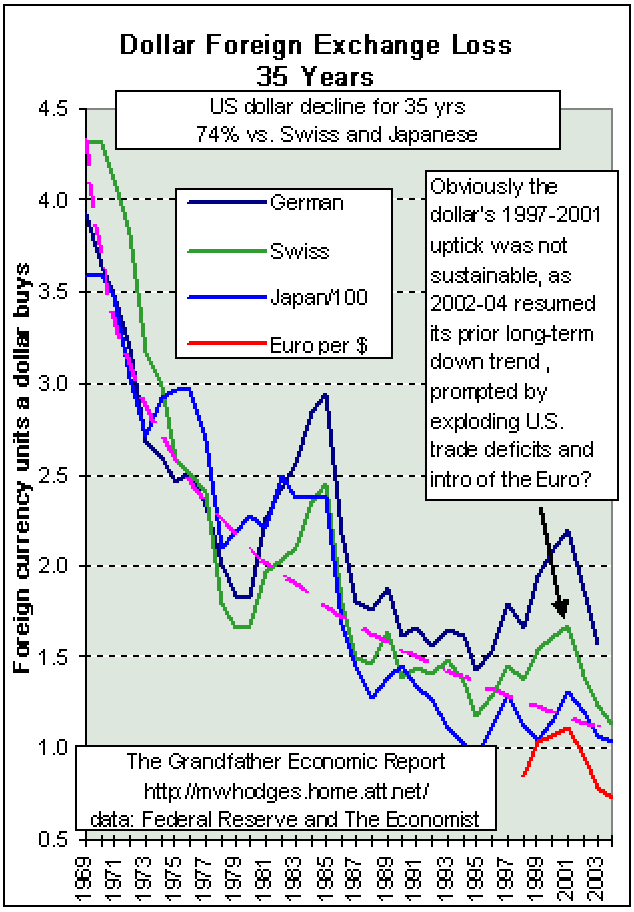
Keynes was not forgiven for his criticism, and later events made him even less eligible for absolution, for men of reputation naturally see the person who has been right as a threat to their own eminence. In the next four years, prices in Britain remained under pressure and unemployment remained high - from 7 to more than 9 per cent of the labour force. Joblessness became a British trademark.

Eighty years on, it is not easy to imagine a time when organized workers could be advised forthrightly of a wage reduction and react temperately and with understanding. It was not an easy thing to do in 1926. When the miners were advised that their wages would be reduced as the monetary policy required, they, not surprisingly, prepared to strike. The owners anticipated the action with a lockout. To support the miners, a general strike was called. The general strike did not last very long and, in the manner of many British misfortunes, was enjoyed by much of the population. Churchill was among those who were allegedly taking a gallant stand for law, order and constitutional government against the tyranny of the mob. The miner's strike lasted through 1926 before it was finally defeated. Throughout the twenties exports remained sluggish, the gold position of the Bank of England remained perilous, and further support had to be solicited from the United States.

Already under a cloud for his defection – as it was seen - on the Versailles Treaty, Keynes was now made to pay for his foresight by contenting himself with heading an insurance company, writing, cultivating the arts, some casual teaching and speculating on his own behalf and that of King's College, Cambridge, of which he became the bursar. Not until the Second World War did matters become so serious that he was readmitted to the Establishment. Churchill fared better, his financial misjudgement not being regarded as so critical that it should affect his political career adversely.

By early 1930, unemployment was falling, output increasing, though both still quite modestly. The gold position of the Bank of England was still thin. Then, from across the Atlantic, came the repercussions of the American stock-market crash of October 1929 and the Great Depression followed. The miserable economic consequences of the 1925 financial decision had been the reason, at least in part, for the election of a Labour government which now proved to be no more immune than its predecessors to the dictates of orthodox finance. On 23 August 1931, Ramsay MacDonald was advised that a hoped-for loan from an American bank consortium would most likely be possible, on condition that proposed budget cuts, including a cut in the dole, received Cabinet and public support. A Cabinet minority proved recalcitrant. So MacDonald resigned and formed a coalition with Liberals and Tories. In September, the obligation to pay gold under the Gold Standard Act was suspended. To defend the gold position in the United States, Fed Chairman Eugene Meyer raised interest rates. The Depression – now without

doubt richly deserving to be called Great - plunged into its darkest and most terrible depths.



In a sense, Churchill triumphed. The left was destroyed for another fifteen years; but events had provided some proof that, indeed, "the 1925 return to the gold standard was perhaps the most decisively damaging action involving money in modern times." [6]

6. Relevance to the Present

We should draw a distinction between the way in which Britain's return to gold at the old parity caused deficits in the British trade and payments in the 1920s and the way in which massive trade deficits were created by United States policies from 1979 onwards. The United States Government was prepared for the value of the dollar to fall after the link with gold was cut in 1971. The dollar continued to lose value in most of the 1970s and 1980s – heavily against gold until the early 1980s but also against most other major currencies - but this did not prevent the trade position from deteriorating and deficits effectively becoming chronic from 1979 onwards. The size of the deficits declined during the boom of the late 1990s, not however because the dollar continued to fall in value. In fact, the dollar recovered much of its external value during that period.

Rather we must look to the extent of fixed-capital investment and its impact on productivity and production over the whole of the thirty-six year period from 1969 to 2005. The decline in fixed-capital investment in the 1970s and 1980s was accompanied by a decline in the value of the dollar. Despite that, the trade balance deteriorated still further during the whole of the period from the early 1970s to the middle of the 1990s. In the later 1990s, the external value of the dollar rose sharply but the trade deficit improved significantly. This seems to have been the direct result of sharply higher fixed-capital investment deriving from creative and innovative enterprise in the real as distinct from the speculative economy, as well as the appeal of the American economy to foreign investors. This suggests that we would be unwise to look simply to a decline in the value of the dollar to correct the massive deficits in United States trade and payments now and in coming years. Rather the solution manifestly lies in adopting policies to encourage real investment, productivity and production. Lack or insufficiency of those policies caused the imbalances in the first place and led to their persistence over the three decades and more since.

As we have already noted, the United States has not so far suffered from what might be called hyperinflation – the degree of inflation, for example, in Germany in 1923. However, we should not entirely rule out such a possibility – or, at least, such a rate of inflation as would dwarf anything experienced in the last thirty-seven years.

The value of the dollar is estimated to have lost about 75% of its value against major world currencies since 1969. Gold was worth $35 an ounce in 1969. It is worth

more than $600 in May 2006. There is every reason to believe that the value of the dollar – its value in terms of other major currencies, gold or other commodities – will decline further and, if economic and financial policies are not soon fundamentally modified, could fall precipitously in the years ahead.

This likelihood is reinforced by the enormous indebtedness of the United States and the consequent huge quantity of dollars in notes or highly-liquid financial paper, held domestically and overseas. It is estimated that almost half of the public debt of the United States is held by foreign interests. The trade-balance statistics suggest that these holdings increase by some hundreds of billions of dollars each year.

William Greider described the descent into indebtedness in 2002:

"The threatening implications are seldom discussed with any clarity or candour, but the numbers are not secret. The US economy's net foreign indebtedness--the accumulation of two decades of running larger and larger trade deficits--will reach nearly 25 percent of US GDP this year, or roughly $2.5 trillion. Fifteen years ago, it was zero. Before America's net balance of foreign assets turned negative, in 1988, the United States was a creditor nation itself, investing and lending vast capital to others, always more than it borrowed. Now the trend line looks most alarming. If the deficits persist around the current level of $400 billion a year or grow larger, the total US indebtedness should reach $3.5 trillion in three years or so. Within a decade, it would total 50 percent of GDP. Instead of facing this darkening prospect, Bush and team regularly dismiss the worldviews of these creditor nations and lecture them condescendingly on our superior qualities. Any profligate debtor who insults his banker is unwise, to put it mildly." [7]

That was four years ago. The annual deficits are now, at almost $800 billion, about double the figure quoted by Greider. The question is how these debts can ever be paid and a process of repayment can ever begin, since what is required is a substantial reduction in the trade deficit – and its eventual conversion into a trade surplus – before that can happen.

Will the United States debt be paid off in the way the German Government tried to meet its financial obligations in 1923 – by printing money? There have been references by the new Fed Chairman – not entirely in jest - to the device of a helicopter drop to spread purchasing power to the masses, if that might become necessary to avoid a debilitating depression and deflation. Whether through the helicopter or otherwise, the option of printing ever more money to relieve the debt burden and keep the economy running at anything like acceptable levels, must have its attractions.

However, any such approach must bear in mind what happened during and after the German hyperinflation of 1923. Effectively, the economy collapsed into barter, much of the established society was destroyed and a new currency had to be installed. The collapse of the economy and the ruin of the society were seen by some to be factors in the rise to power of the extremist Nazi regime. While we cannot forecast this for the United States and while, further, we cannot paint a precise picture of the details that the process would entail, an attempt to extract the United States from its indebtedness through the unrestrained printing of money would certainly bring dramatic changes to the political, social, economic and strategic situation of the United States. The pattern of world power that might emerge is difficult to forecast in any detail or with any confidence. At the very least, it might hasten the advent of a period of acute instability as the United States loses its status as a superpower and a period of transition to some sort of new world leadership ensues.

Greider draws an interesting parallel between the decline of British power and the present threat to American hegemony. He says that the reluctance of such creditors as Japan and China to deal a body blow to their debtor, the United States –

"... resembles the American attitude early in the last century, when it was the ascendant economic power but did not wish to become a 'Great Power' itself, with responsibility for maintaining world order. Instead, the United States propped up Britain for many years as the failing empire sank into unsustainable debt. British power was fundamentally eclipsed in 1914, but the United States provided the financial nurture to keep it upright, as a kind of dummy leader in world affairs, until after World War II. Washington decisively pulled the plug in 1956, when Britain (along with France and Israel) invaded Egypt to capture the nationalized Suez Canal. It was the last gasp of British colonialism, and Washington disapproved. By withholding an IMF loan to London, the United States crashed the pound, forced Britain to withdraw from war and its prime minister to resign in disgrace. The Brits were finally relieved of their delusions." [7]

Any such relief for the United States from its "delusions" would be such a radical change in the pattern of world power that its features and consequences can be glimpsed only in general terms. In all likelihood, the changeover would not have anything like the relatively favourable consequences that followed what Greider describes as American accession to world power in 1956. One of the most intriguing questions must be to what extent the United States would be prepared to yield power to anyone – especially given the American performance under the influence of the neo-cons and President Bush. In "Stuff Happens", British playwright David Hare has one character saying, "Power doesn't make deals, Prime Minister. Power doesn't need to do deals. Power does what it wants." If, unlike the British fifty years ago, the Americans persist in their delusions beyond the point at which they can reasonably be entertained, the outcome is likely to be much less comfortable – for most, if not all of us - than in 1956.

1 "The Indigent Rich", J.W.C. Cumes, Pergamon Press, 1971, p. 128.

2 "Inflation: A Study in Stability," J.W.C. Cumes, Pergamon Press, Sydney, 1974, p. 161.

3 Ibid., pp. 166-167.

4 "Towards True Monetarism," Geoffrey Gardiner, Dulwich Press, London, 1993, pp. 42-44.

5 Op. cit., "Inflation: A Study in Stability", p. 190.

6 pp. 174-176.

7 "The End of Empire", William Greider, The Nation, 23 September 2002.