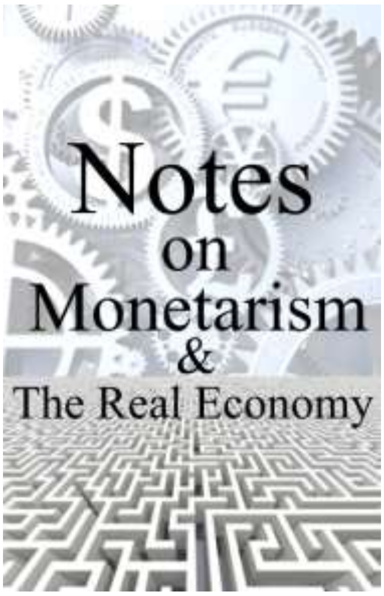

Notes on
Monetarism & The Real Economy
provide an extended explanation
of content in the
British Strategic Review 2022

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Some aspects of inflation

In the BSR there is discussion of the ability of marginal investments and price setting by companies to influence the rates of inflation in output unit prices of supply side production of goods and services.

This discussion arises from the quest to identify the mechanisms whereby inflation rises or falls, so as to determine how to reduce inflation through practical policy propositions.

Policy propositions need to establish a specific policy target/s and identify the most appropriate policy instruments in terms of efficiency, effectiveness and ability to maintain traction.

One of the arguments to justify discouraging labour unions and workforces from demanding rises in wages is that this will cause inflation. However, the reason for demands for higher wages tend to arise as a result of existing inflation rates affecting the cost of living and causing a decline in the purchasing power of the current disposable incomes of wage-earners.

Therefore, the causal factor giving rise to wage demands is an inadequate growth in nominal wages to accompany the past and current rates increasing in the unit prices of goods and services.

Basic cause of inflation of goods and services

Analysis by the British economist Hector McNeill, on the causes of inflation in 1975 to 1976 arose from a desire to understand stagflation (slumpflation) that resulted from the 1973 rise in OPEC petroleum prices. The self-evident cause of inflation was cost-push inflation directly linked to the seven-fold increase in petroleum prices between 1973 and 1983. Irrespective of the conditions of slumpflation, McNeill also established that most inflation arises from cost-push inflation. The theoretical basis as well as the subsequent evidence supports McNeill's view.

It is therefore essential that macroeconomic policy frameworks need to tackle the issue of how to provide incentives for firms and workforces to manage cost-push inflation Most conventional policy instruments based on the supply and demand concepts of the monetarist and Keynesian Aggregate Demand Model, there is an unstated belief that inflation is largely demand-pull. Indeed, all of the policy instruments:

- Interest rates
- Money volume
- Taxation
- Government raising of debt and investment assignment

are all based on the demand-pull assumption. McNeill showed that each of these policy instruments, if applied to control inflation under the conditions of slumpflation would exacerbate the real income status of constituents and were therefore prejudicial. The economic theory and development objective of McNeill's work became to identify theory and policy instruments to control inflation so as to maintain or increase real incomes.

In the subsequent policy actions taken by the Reagan and Thatcher administrations to apply high interest rates "to lower inflation" exacerbated the state of affairs by reducing inflation by depressing the economies leading to rising income disparity.

Supply side economics as a new paradigm

Because inflation has a largely cost-push origin which affects individual firms to different degrees, the solution to the issue is to be found within the mechanisms of the operations of companies and work forces. It is a supply side issue. However, the so-called "Supply Side Economics" (SSE) developed by the Canadian economist Robert Mundell and others, appeared in the late 1970s as a proposition as a potential solution to slumpflation. SSE does not, in reality, have much to do with the supply side but it is an Aggregate Demand Model-based fiscal scheme of marginal tax rate reductions justified on the basis of the additional net-of-tax receipts being invested in higher productivity manufacturing leading to more competitive pricing. In practice, this was at best a partial success because there was no dis incentive to prevent the windfall tax gains from simply filling the pockets of corporate ownership, shareholders and executives. During this period income disparity rose and real wages continued on a downward real disposable income trend as a result of the combination of SSE and high interest rates in the USA and UK which led to widespread home repossessions and tradition farming families losing their farms.

Another paradigm, the Real Incomes Approach

The period 1975 through 1981 saw two quite different supply side paradigms take shape. One was SSE described in the previous paragraph and the other was Real Incomes Policy (RIP) developed by the British economist Hector McNeill. RIP is a genuine supply side paradigm in that it places far more practical emphasis on the learning and technical innovation that occurs within companies and work groups. To manage input inflation in terms of processes and unit output price setting, RIP provides direct incentives to foster an entrepreneurial behaviour in the sense of firms and workforces, in all sectors, becoming more directly involved in seeking ways to make use of resources more effectively and efficiently.

McNeill has managed to recast the focus of policy on productivity and learning. However, he has always acknowledged the majority of the theoretical and evidence supporting RIP is to be found in Nicholas Kaldor's inaugural lecture as Professor of Economics at Cambridge University in 1966 and the work of the American economists Robert Solow and Kenneth Arrow in the 1950s and 1960s, all of which, in combination, point to learning and innovation accounting for over 80% of real economic growth. McNeill has also emphasised that the practical foundations for business rules for companies are to be found in work of the American aeronautical engineer, Theodore Wright's whose work established the existence of the human and work force learning curve in 1938 and the American industrial economist, Elton Mayo's work emphasising the importance of tacit knowledge (human learning and the acquisition of practical competence) in 1949.

One of the most convincing general macroeconomic circular economy models of how RIP operates is to be found in he work of the French economist Jean-Baptiste Say (1767-1832). Say made a direct connection between the levels of wages and consumption in the economy. The advance of an economy depends, according to Say, on entrepreneurs. Entrepreneurs are defined as enterprise managers and workers who work out ways to make a more efficient use of resources so as to drive a constant stream of innovation. This results in an ability to lower unit prices and thereby raise the purchasing power of disposable wages thereby augmenting consumption. The notable distinction here is that demand, in terms of the cash flow, used to pay for consumption, comes principally from wages that grow as a function of productivity rather than the ADM assumption that supply grows as a result of money volumes in the economy.

Both Nicholas Kaldor and Hector McNeill presented clear explanations of why money injections have little effect of real demand. Kaldor argued that credit was taken by firms to fund marginal investments to achieve planned improvements in productivity and therefore monetary growth, in this case, results from a need that is planned for and this does not arise from monetary injections. Therefore such funds were an endogenously-generated demand for money strictly related to technological productivity questions.

McNeill has supported this logic arguing that unit output inflation has nothing to do with money volumes and "demand" but output prices are established, in a competitive economy, by price setting by management who are well aware that raising unit prices will lose business. The better tactic is to improve productivity to enable the setting of more competitive prices to gain market penetration.

It is notable that basic foundation texts of monetarism and Keynesianism seem to assume learning and technological innovation are processes that happen willy-nilly almost as a result of osmosis. This is why these questions remain as empty pages in these tomes.

Inflationary mechanisms

McNeill, in more recent work has explained the mechanisms whereby monetary policy has actually generated inflation in goods and services prices.

OTHER NOTES

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