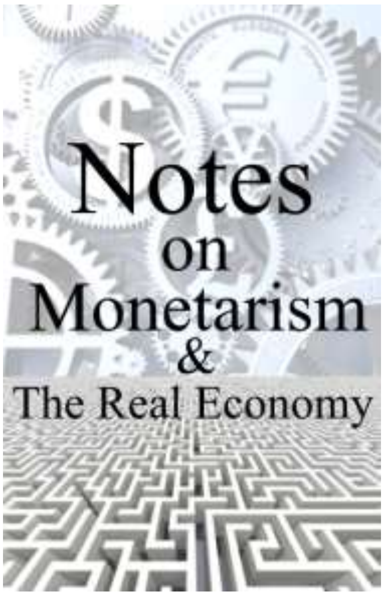
Note 6



Notes on
Monetarism & The Cost of Living
provide an extended explanation
of content in the
British Strategic Review
Special Edition 2022

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Notes are prepared in response to reader queries by the Strategic Decision Analysis Group, SEEL-Systems Engineering Economics Lab, Hampshire, UK.

16th July, 2022

The constitutional crisis created by monetary policy

Summary

Introduction[1]

Following the 2008 financial crisis, the close to bankrupt condition of several banks led to the adoption of quantitative easing (QE), the combination of significant injections of money at close-to-zero base interest rates, to help improve bank balance sheets.

The result of some 12 years of QE were revealing.

Enough evidence was generated to disprove the validity of the Quantity Theory of Money (QTM) and to expose more clearly an underlying bias of monetary policy towards the interests of asset holders and traders.

The disproof of the QTM is covered in another Note Number 3 entitled "Why the Bank of England cannot solve the Cost of Living Crisis".

This note explains the reason monetarism and monetary policy has contributed to an increasing constitutional problem as a result of a tendency to promote the wellbeing of asset holders and traders at the expense of wage-earners.

[1] This Note has been completely revised and updated because of some misleading content 21/07/2022

Background

Note 3 in this series, "*Why the Bank of England cannot solve the Cost of Living Crisis*" provides an elaboration of the QTM identity to indicate the destinations of most QE funds. The standard theory encapsulated in the QTM, is that money volumes M have a direct relationship to the average prices of goods and services, P. As show in the identity below:

$$P.Y = M.V \quad \ldots \quad \text{(i)}$$

Where V is the velocity of circulatio of money and Y is income.

The Cambridge equation[2] is a variant of the QTM that includes savings as a non-circulating money class of asset. Because savings are not circulating they have the effect of reducing M and therefore, this will lower P. However, the initial impact of QE's very low interest rates discouraged saving but P still remained low for a notable time, contrary to the "logic" of the QTM.

Hector McNeill[3] extended the Cambridge equation by adding all of the other assets into which QE funds had flowed. This new identity, the Real Money Theory (RMT), is shown below:

$$P \times Y = (M - (r + p + m + a + h + f + c + o + s)) \times V \quad \ldots \quad \text{(ii)}$$

Where:

- Land and real estate - r
- Precious metals - p
- Commodities - m
- Art objects - a
- Shares - h
- Financial instruments - f
- Crypto-currencies – c
- Offshore investment – o
- Savings - s

Pre-1929, post-1973, and post-2008 financializations

The current problems facing the economy have been associated with different degrees of financialization, with QE having been the most intensive. The general impact the flow of funds into assets was a marginalization of the supply side production, declining investment and productivity and declining real incomes, especially on the part of wage-earners.

The 1929 New York Stoc Exchange Crash was caused by an imbalance between financial transactions and supply side production. Following the Second World War, Britain had unprecedented growth between 1945 and 1965 when investment grew, real incomes rose and income disparity fell. Many consider this to be the golden years of Keynesianism. However, the economist Robin Matthews[4] analysed the data for that period and showed that over the very successful period, no Keynesian policies

[2] This QTM variant was variously shaped by John Maynard Keynes, Alfred Marshall an Arthur Cecil Pigou
[3] McNeill, H. W., "*A Real Money Theory*", Charter House Essays in Political Economy, 2021.
[4] Matthews, R. C. O., 'Why Has Britain Had Full Employment since the War?', Economic Journal, 78 (London, 1968)

were applied. Indeed, Matthews pointed out that policy was in fact very deflationary. At the same time the fundamental justification for Keynesian policies, to reduce unemployment, was not an issue since unemployment was very low and this is why Keynesian policies were not applied.

At the same time there was no sign of financialization.

During the periods 1945 through 1965, there was no financialization approaching anything that has been witnessed since 1975 (see below) so the role of monetarism during this period of growth was marginal.

The beginnings of financialization

In 1971 the world economy came off the Gold standard and reverted to a fiat currency system. In 1973 OPEC Arab members applied sanctions on petroleum importers and worldwide there was a growth in stagflation (rising inflation and unemployment). Keynesianism and monetarism, the main policy alternatives, could not resolve this issue without imposing prejudice of constituents. The development of petrodollar recycling led to a massive influx of money into petroleum importing countries through financial intermediaries and banks recycling the funds. Financial regulations designed to stabilize financial dealings and introduced following the 1929 crash, such as the separation of investment and retail banking operations, were removed and the world returned to an increasing level of financialization.

Offshore investments

The rise in offshore investment took off leading to a marginalization of supply side production industries in the United Kingdom, falling employment in the industrial and manufacturing sectors, falling investment, productivity and real wages.

The rapid growth in the "Grey market"

As a result of a massive growth in and reliance upon financial instruments, such as derivatives, which took off in the mid-1970s following Black & Scholes[5] hedging model that was used to automate hedging trades in derivatives, this market "*The grey market*" expanded well beyond the size of national output on the goods side. Fraudulent dealing and an inappropriate rise in interest rates in late 2007 led to a collapse of derivative values associated with sub-prime mortgages whose income streams dried up. This led to the 2008 financial crisis.

Rather than review the track record of the British economy and identify how the UK had achieved real growth and low unemployment, such as the period 1945 through 1965, governments in a relative panic took the precipitous decision to increase financialization to its most intense by introducing quantitative easing (QE).

The constitutional impact of financialization

Besides intensifying the decline in supply side production, investment and productivity, QE also sustained the decline in real wages. In assessing the impacts of QE, it became evident that this policy greatly benefited one section of the UK constituency made up of asset holders and traders while it prejudiced those working in supply side goods and service provisions in exchange for wages. Not only

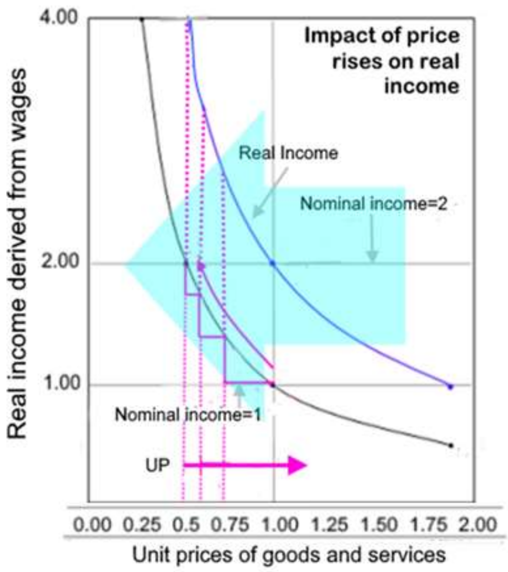
[5] Scholes, M., and Black, F., "*The Pricing of Options and Corporate Liabilities*", The Journal of Political Economy, Vol. 81, No. 3 (May - Jun., 1973), pp. 637-65.

did QE greatly increase income disparity between these two groups the main reasons for this disparity became more evident.

The unit prices of goods and services are an important determinant of the real income or purchasing power of the incomes of all constituents. The purchasing power of the currency is determined by its innate exchange value for goods and services and this is determined by the relative levels and movements in prices. Thus, if prices of goods and services are in general falling the value of the currency rises because more real products and services can be purchased for a given disposable income. If prices of goods and services, in general rise, then the value of the currency falls because fewer real products and services can be purchases for the same disposable income. Therefore, inflation lowers the value of the currency and real incomes and deflation raises the value of the currency and real incomes. Unit prices of goods and services determine "real income".

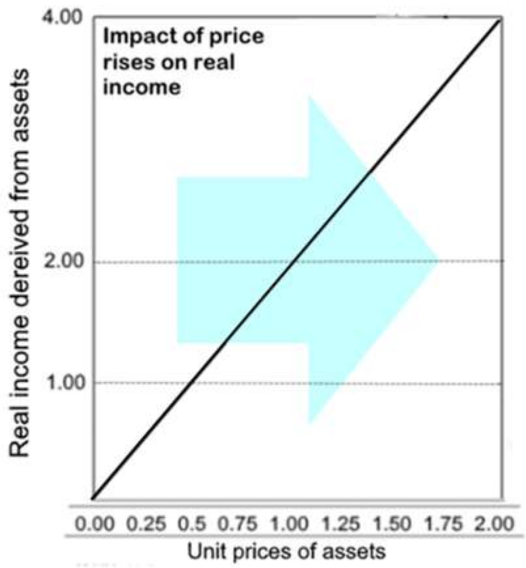
In Figure 1, the case of wage-earners is show where price rises (moving from left to right) cause real incomes to decline. Wage- earners make up around 95% of the working population and voters.

Figure 1: Desirable policy impacts for wage-earners



Desirable movements in factors		
Lower	Unit prices	Higher ●
Higher	Productivity	Lower
Lower	Inflation	Higher ●
Higher	Deflation	Lower ●
Higher	Currency value	Lower
Lower	Price Performance Ratio	Higher ●

Figure 2: Desirable policy impacts for asset holders & traders



Desirable movements in factors		
Lower	Unit prices	Higher ●
n.r.	Productivity	n.r.
Lower	Inflation	Higher ●
Higher	Deflation	Lower ●
Lower	Currency value	Higher
Lower	Price Performance Ratio	Higher ●

Input to supply side production of goods and services

As in the case of wage-earners the relationship of the interests of supply side production sectors is the same in that preference is given to lower input prices which affect production costs. Therefore, the relationship of companies to the prices of their resource inputs and capital equipment and all variable inputs is the same as consumers.

Asset holder and asset transaction constituent sources of income

On the other hand, the situation for asset holders and traders is shown in Figure 2. Asset markets are referred to as encapsulated markets in terms of their separation from the volumes of transactions occurring in the production and supply side goods and service markets. These markets also tend to be managed by a smaller proportion of the constituency involving less than 5% of the working population. With large injections of funds, such as experience under QE, these markets were characterised by rising speculative prices. As a result, the participants in these markets could make significant margins on transactions in markets or by simply holding on to the assets for a period of time so that their sales price rose.

As can be readily appreciated the participants in these markets, gain no advantage from falling prices in assets, simply because what they buy is the same as what they sell and the tine factor, as opposed to effort, raises the sales price. Therefore, contrary to the state of affairs in goods and services markets the purchasing power of the monetary value of the asset holding is determined by an inverse relationship between assets and its innate exchange value. Thus, if prices of assets are in general falling so does the income and wealth of asset holders. If asset price rise so does the wealth and income of asset holders.

Inputs to asset trading

In the case of the inputs to asset trading, these are assets to be eventually sold. Based on the early experience in the New York Mercantile Exchange (Nymex) starting in the 1970s, this was unlike supply side productive sectors, because input prices of assets have no particular impact on profitability because of the assumption of money injections maintaining a rise in values. Therefore, assets trading as well as asset-based income follow the same straight-line positive relationship with prices.

Why are these income lines different?

There is an important difference between wage-earners and asset-holders income responses to variations in the prices of goods and services or assets. In the case of income derived from assets the nominal and real incomes rise as a direct proportion to asset prices, therefore the relationship is a straight line. Quite often income paid in the form of bonuses are proportional to the success of individuals making trades which raise the value of assets held and/or sold. As a result, there is no limiting factor on income levels, they are directly proportional to asset prices.

In the case of wage-earners, wages tend to be fixed over time so rises in the prices of goods and services take up a curved line relationship because although the nominal income (number of currency units earned) is fixed it also becomes a limiting factor when prices rise. This is why the "cost of living" is a common factor in the political discourse of wage-earners.

The real income effects of income sources

Therefore, inflation raises the value of assets-based wealth and deflation lowers the value of assets-based wealth. Therefore, the relative benefits of price movements to constituents earning their incomes from asset transactions on the one hand, and the constituents who earn wages for contributing to the production of goods and services, on the other, have an inverse relationship.

This also represents very different sets of interests on the part of these constituents on the objectives of macroeconomic policy and the potential impacts on their relative interests, according to the policy instruments applied. There is, therefore, the fact that the real incomes of the majority of the population are safeguarded by policy securing stable or falling price in goods and services. On the other hand, there is a minority of constituents who deal in assets, whose real incomes are safeguarded by policies that facilitate the rising prices of assets.

Policy impacts on nominal and real income disparity

The British Strategic Review 2022, described how monetarism has had the tendency to drive up asset prices to the benefit of a minority of constituents. On the other hand, monetary policy has no policy instruments to influence wages even although monetarism and financialization has imposed a prolonged period of deficient investment in plant, equipment and training, and wages have tended to be frozen or adjusted infrequently. The leakage of asset prices through into supply side production inputs represent an increasing income from sales and rents to asset-handling constituents while these same transactions cause cost-push inflation resulting in rising unit prices of goods and services. This results in a decline in the real incomes of wage-earners. As a result, the average levels of assets-based income constituents rise at a faster rate than wage-earners whose real incomes often fall.

Income disparity grow as a direct function of monetary policy.

Constitutional implications of income sources

The constitutional implications of the differential impact of different income sources of income on the wellbeing of the constituents are that, as things stand, the results of monetarism over the last 50 years has been one of bias or discrimination against wage-earners. Policy has diminished the relative wellbeing of the majority, while enhancing the wellbeing of a minority. Naturally these circumstances signify that policy has augmented the extent of the differences in the needs of constituents and their demands in relation to economic policies. This impact is clearly at odds with what would normally be considered to be the constitutional objectives of permitting all constituents to pursue their objectives while preventing the pursuit of objectives by any constituent from preventing others pursue theirs. In this case, each group of constituents pursue their objectives but wage-earners face specific constraints imposed, not by asset holders and traders, but as a direct result of policies that place an emphasis on the injection of money into the economy.

In the context of universal suffrage, where all people over a specific age have the vote and, in theory, at least, voting leads to a public choice on policies, including economic, the majority of voters should be able to decide on policy matters in their mutual interest to be able to advance the wellbeing of the all.

Employment, electoral significance & the nature of economic value in the UK

The employment, number of votes, value and nature of the value of asset and wage-earning occupations are shown in Table 1.

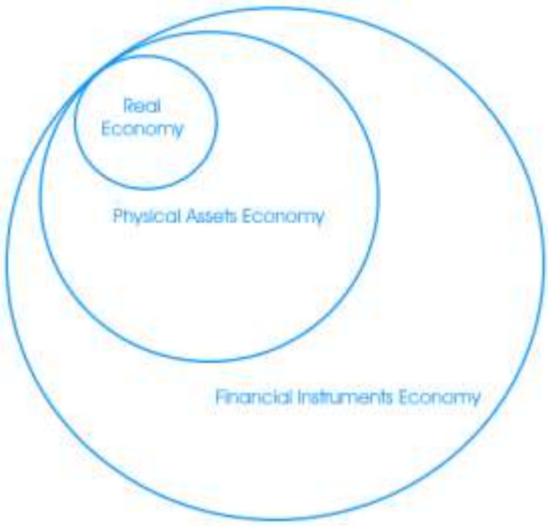
Table 1. Some general facts concerning wage-earning and asset-based constituents

Factor	Real economy	Physical assets	Financial assets
Constituency participation in terms of employment	85%	around 10%	<5%
Estimated maximum number of votes	40 million	4.8 million	2.4 million
Value measure in nominal pounds sterling	Significant	Significant	Very high
Nature of the value	Cash flow	Asset value	Asset value

Law and governance

Recent statements by government point to a desire to distance the conduct of government from judicial oversight and judgement.

In a recent BBC Hard Talk interview with Stephen Sackur, Baroness Helena Kennedy provided some clear positions on where law enters into a situation where there is prejudice arising from decision and actions that lead to prejudice.



She observed that, "*It's only in authoritarian states and totalitarian states that they try to punish our thoughts.*" This part of the interview was related to misogyny and she qualified this general statement which paraphrasing had the sense that, " *thoughts become a legal issue when actions, resulting from a particular mindset, prejudices others - in this case women.*"

This legal argument has a far broader significance including the differentiations caused by monetarism in sustaining a form of social discrimination based on a policy that favours the interests of one type of constituent while prejudicing others.

This prejudice has broadly included the obliteration of the UK's industry and manufacturing sectors, loss of compensatory employment and a falling balance of payments. The British Strategic Review 2022, explained why monetary theory is flawed and cannot be used to predict policy outcomes. Indeed, most of the monetary logic and decisions based on the QTM, including quantitative easing end up as policies without any theory; decisions affecting the constituents of the United Kingdom are, in reality, quite arbitrary.

Economic policies need to switch to a constitutional economics approach to ensure that policy decisions are subject to a stricter due diligence in terms of an appropriate level of detail applied to impact analyses on different types of constituent.

The observation that "*Thoughts become a legal issue when actions, resulting from a particular mindset, prejudices others*", applies to the undeniable evidence of prejudice affecting increasing numbers of wage-earners conveniently generated by QE. It becomes apparent that insufficient due diligence was brought to bear in the decision analysis presented to justify the policy of QE or, indeed in the formulation of any decision based on the QTM identity.

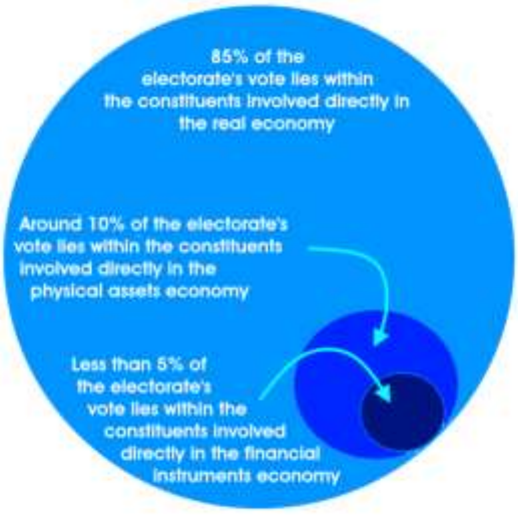
It is not as if assets such as land, real estate and precious metals are a new form of asset. These assets have been traded for centuries and yet were never included decisions based on the QTM.

If it can be established that the mindset that applies a flawed logic, albeit a political ideology, is at odds with clear evidence, then surely decisions on policy, based on this mindset, constitute actions which are prejudicing others and therefore should be subjected to legal oversight for approval.

A central tenet of constitutional economics is public choice. This depends on the full facts relating to any intended legislation being available to the voters as part of due diligence procedures that need to meet minimum standards of evidence. It seems to be the case that, as in law and the topic of standards of evidence, the role of constituents in the public choice necessary with respect to monetary decisions is effectively zero. To a degree the so-called "independence" of the Bank of England helps to distance both parliamentary oversight and the constituents from this domain of legislation and regulations. However, it would seem that there is some urgency in changing the current state of affairs by changing procedures to place all such evidence before constituents as part of a process of participatory policy development. In the end this needs to be subject to a vote, to help improve transparency to prevent governments distancing their conduct from judicial and public oversight and judgement.

The free market argument

It is not unusual for economists and politicians to explain away increasing income diversity and poverty to the operation of the free market and the notion that all citizens need to look after their own affairs. However, the markets concerned are shaped by the channelling of money that is raised through monetary injections by government through banks in a tendentious way to largely asset dealers and markets. Thus, the policy levers the market making in favour of asset holders and traders and as a result the reduction in money flowing through the supply side production of goods and services affects real wages which, for many years have been on a downward trajectory.



Concluding

As it stands, monetarism and monetary policy, based on the evidence largely generated under QE and through analysis of the QTM, does not possess sufficient constitutional mechanisms to pass a more transparent and logical judgement on assertions as to the impact of policy on prices. Without such a procedural oversight it is likely that monetarism will continue to discriminate against wage-earners by sustaining a decline in real wages while at the same time helping drive money into asset markets so as to enhance the wealth of asset holders and traders.

Therefore, this discriminatory nature needs to be examined from the constitutional legal basis because given that data and analysis demonstrates prejudice, it therefore becomes a dereliction of the duty of care of governments of all constituents in the design, planning, implementation and conduct of economic policies, legislation and regulations.

OTHER NOTES

No.1 - 19th February, 2022 Some aspects of inflation

No.2 - 08th April, 2022, From earned income to pauperism and back

No.3 - 15th April, 2022 Why the Bank of England cannot solve the cost of living crisis

No.4 – 17th April, 2022 Technology, technique and real incomes

No.5 – 11 July,2022 Sustaining growth in real wages by investing in results