Well, it’s official. Recently, President Carter took breath from his other crises and announced that the United States had entered a period of recession. “The Wolf Has Arrived”, Time headlined, but reassured us that it was “better late than never”. This curious judgment is based on the belief that the recession, like a crisis in a long, wasting disease, is a Good Thing. It should have come a year ago, Time argues, but was delayed by a “bad case of inflationary psychology”.

For months, consumers (Yes! It’s their fault again!) have been rushing out to buy in the belief that prices, no matter how high already, could only go higher. “This has ballooned inflation to an annual rate of more than 18 per cent”, Time regrets. It also had the effect — though here the news magazine is silent — of keeping the economy afloat.

It was only in the middle of March that someone “pulled the plug on the economy”. That someone, Time tells us, was Paul A. Volcker, Chairman of the Federal Reserve System. Volcker has long been arguing for a deliberately induced recession as the only way of beating inflation. He wholeheartedly accepts the proposition that the present combination of economic stagnation and rising prices can only be dealt with by defeating inflation first.

Volcker, like most political leaders and economic gurus in the advanced capitalist world, believes the way to do this is to control the money supply. Once the money supply is reined in, the argument goes, inflation will fall and we will have achieved the necessary condition for economic recovery. This doctrine — or at least its recent revival — owes much to Professor Milton Friedman; so much so, that Friedman has become the chief economic influence on such figures as Chile’s General Pinochet, Britain’s Mrs Thatcher, our own Mr Fraser, and even Hollywood’s Mr Reagan.

Thus, it is probably worth looking a little more closely at just what the new monetarists argue and what evidence there is for their position. This task takes on even more importance when we note that it is not just conservative politicians and economists who have fallen under the monetarist spell. In Britain, for example, it was the last Labour government that handed over economic policy making to the monetarists,
or at least this is the argument of three Labour Party economists writing in a recent Fabian Tract on The Politics of Monetarism. "The most significant development in economic policy over the last two or three years has been the conversion of almost everyone concerned with the management of the British economy to the doctrines of monetarism", the three authors say.

"This development has had the full support of the financial establishment and of the Conservative Party, as well as that of most of the leading figures of the last Labour Government." Thatcher's victory has not, therefore, meant any vital change in direction, they argue. The monetarist consensus simply continues to prevail.

The same thing is likely to occur in Australia. Any future Labor government here would no doubt face this same sort of consensus in Treasury and throughout the public service, among academic economists and among those "experts" paid directly to put the views of the owners and controllers of our economy. One purpose of taking issue with the monetarist consensus here and now is to make it harder for the Australian Labor Party to be captured in the same way its British counterpart was.

Since Professor Friedman has been selling this consensus so successfully over the last few years (even converting the five economists of the Nobel Prize Committee of the Swedish Academy of Science, who awarded him the 1976 Nobel Prize in Economics) we may as well start by looking at his version of the theory.

From the Horse’s Mouth

"In its most rigid and unqualified form the quantity theory asserts strict proportionality between the quantity of what is regarded as money and the level of prices," Friedman writes. "Hardly anyone has held the theory in that form, although statements capable of being so interpreted have often been made in the heat of argument or for expository simplicity."

"Virtually every quantity theorist has recognised that changes in the quantity of money that correspond to changes in the volume of trade or of output have no
tendency to produce changes in prices. Nearly as many have recognised also that changes in the willingness of the community to hold money can occur for a variety of reasons and can introduce disparities between changes in the quantity of money per unit of trade or of output and changes in prices."

These two "modifications" to the most "rigid and unqualified" version of the quantity theory of money can be illustrated in the theory's famous equation. If we let \( P \) be the price level and \( Y \) be the total output of the economy measured in "real" terms, then \( PY \) is the money value of the output of the economy. This, in turn, is equal to the money supply, \( M \), multiplied by the number of times, on average, the money supply is "turned over" in a given year to buy or sell this national output. If we call this last number \( V \), the "velocity of circulation" of money, the quantity theory equation becomes:

\[
PY = MV
\]

Thus, if the money supply, \( M \), expands by five per cent, the price level \( P \) must also go up by five per cent, unless the level of real output, \( Y \), increases. Only if the increase in the money supply exactly matches an increase in output will prices be stable — assuming all the time that the "velocity of circulation" of money does not change. We will come back to this last point, but let's first note what Friedman thinks these "modifications" amount to:

"What quantity theorists have held in common is the belief that these qualifications (that is: changes in the quantity of money corresponding to changes in output or changes in the "willingness or the community to hold money") are of secondary importance for substantial changes in either prices or the quantity of money, so that the one will not in fact occur without the other."

The policy implications follow directly. "Acceptance of the quantity theory clearly means that the stock of money is a key variable in policies directed at the control of the level of prices or of money income. Inflation can be prevented if and only if the stock of money per unit of output can be kept from increasing appreciably."

We ignore this simple prescription at our peril: "Monetary authorities have more frequently than not taken conditions in the credit market — rates of interest, availability of loans, and so on — as criteria of policy and have paid little or no attention to the stock of money per se."

"This emphasis on credit as opposed to monetary policy accounts both for the great depression in the United States from 1929 to 1933, when the Federal Reserve System allowed the stock of money to decline by one-third, and for many of the post-Second World War inflations." If only we had watched the money supply, Friedman is saying, both the Great Depression and the current inflationary crisis could have been avoided.

Too Good To Be True

It all seems to good a tool to be true. But unfortunately, in the real world, there is no such simple link between the money supply and inflation, though in this matter, as in so many others, it is much easier to become famous by peddling an easily understood and plausible view that happens to be wrong, than by giving true insight into a complex, contradictory and fundamentally irrational system.

The difficulties start back with the quantity equation:

\[
PY = MV
\]

or at least with two of the four terms. Unfortunately for the monetarists, they find it very hard to say anything certain about the two "monetary" notions in this equation: the "money supply" itself, and the "velocity of circulation" of money. Let's take them in turn, and see what some of the problems are.

First, the more straightforward of the two: the "velocity of circulation" of the existing money supply. Of the four variables in their equation, this is the one the monetarists have least to say about, preferring everyone else to forget that it is there. The reason is clear. For their theory to hold, the "velocity of circulation" of money has to be more or less constant. If the money supply is held down, but that money supply is "turned over" more rapidly, it is still possible for inflation to take place. Alternatively, an increase in the money supply might not translate into higher prices if the velocity of circulation falls at the same time.
In practice, all sorts of combinations are possible. Thus, in Britain, between the first quarter of 1971 and the first quarter of 1974, the velocity fell quarter by quarter from 3.111 times to 2.345 times as the supply of money was increased. When the Labour government came to office and the increase in the money supply slowed down, the velocity of circulation increased quarter by quarter to 3.094 times in the third quarter of 1977.

In other words, the velocity of circulation of the money supply changed in such a way as to make up for changes in the money supply itself. Something else, apart from the factors the monetarists consider, must be at work. This “something else” was recognised as long ago as 1810, in a famous report of a Select Committee of the House of Commons on The High Price of Bullion:

That committee pointed out that “the mere numerical return of the amount of bank notes in circulation cannot be considered as at all deciding the question whether such paper is or is not excessive.... the quantity of currency bears no fixed relation to the quantity of commodities .... and any inferences proceeding on such a supposition would be entirely erroneous.”

The committee concluded that: “the effective currency of a country depends on the quickness of circulation .... as well as the numerical amount” and that “all the circumstances which have a tendency to quicken or retard the rate of circulation render the same amount of currency more or less adequate to the wants of trade.”

If it is the “wants of trade” that really matter, and the velocity of circulation of money merely adapts to this, there is little left of the monetarist position. But this point, recognised so long ago, is not the only one that leads to problems for the quantity theory.

The other term in their equation that the monetarists have difficulty with is M itself: the money supply. Everyone knows there are different “definitions” of money which include or exclude different sorts of financial assets as money, ranging from a narrow definition which includes only cash and bank deposits, to wider ones which include progressively less “liquid” assets. Now the question of which definition to use might seem just a technical one, and has been treated this way by the monetarists. However, it is not the technical difficulties the monetarists face that we want to highlight; rather it is the fact that any attempt to control the money supply under one particular definition, in violation of the “wants of trade”, will make that definition irrelevant.

Nicholas Kaldor, in his critique of Friedman, has made this point well using a parable: “Every schoolboy (and, we would presume, every schoolgirl — T.O’S) knows that cash in the hands of the public regularly shoots up at Christmas, goes down in January and shoots up again around the summer bank holiday.”

Kaldor acknowledges that nobody, not even Friedman, would suggest that the December increase in note circulation is the cause of the Christmas buying spree. “But,” he asks, “there is the question that is more relevant to the Friedman thesis: could the ‘authorities’ prevent the buying spree by refusing to supply additional notes and coins in the Christmas season?”

How could this be done? One way, Kaldor suggests, would be by instructing the banks, for example, not to cash more than £5 at any one time for each customer and to keep down the number of cashiers, so as to maintain reasonably long queues in front of each bank window. “If a man (sic) needed to queue up ten times a day, half an hour at a time, to get £50 in notes, this would impose a pretty effective constraint on the cash supply,” he concludes.

But would it stop Christmas buying? Naturally there would be chaos for a few days, but soon all kinds of money substitutes would spring up: there would be a rush to join the Diners’ Club and everyone who could be “trusted” would get things on “credit”. Those who are not so “trusted” — Kaldor suggests this applies to the mass of the working class — would be paid in chits issued instead of cash by, say, the top five hundred businesses in the country (who would also, for a commission, provide such chits to other employers).

These five hundred firms would soon find it convenient to set up a clearing system of their own, by investing in a giant computer which would at regular intervals cancel out all mutual claims and liabilities. Once this
had happened there would be a complete alternative money system, side by side with "official money".

What, at any time, is regarded as "money" are those forms of financial claims that are commonly used to clear debts. But, Kaldor points out, any shortage of commonly used types is bound to lead to the emergence of new types. (This is how, historically, first bank notes and then cheque accounts emerged.)

Thus the difficulties the monetarists have in "defining" the money supply is not accidental; and, what is more, the more successfully they try to control it, the harder they will find it is to define it.

The Theory in Action

Despite these theoretical difficulties, and despite the fact that they have had no success so far in defeating inflation, monetarists around the world continue to preach their doctrine of putting a clamp on any economy that shows any life.

Americans will feel the cost more and more this year and next, unless Carter, in a fit of pre-election nerves, modifies aspects of his monetarist advisers' economic package. At least for Americans — and this perhaps applies for us in Australia — election timetables might serve to delay the worst aspects of the monetarist freeze. The British, however, have no such luck. They've had their election, and now they're paying.

This was spelt out by Britain's Chancellor of the Exchequer, Sir Godfrey Howe, when he presented the Conservative government's second Budget last month. The 1980-81 Budget is unmistakably deflationary. Output is expected to drop 2.5 per cent this year. Unemployment will increase, as will inflation. Real incomes and demand are forecast to fall. Recovery is not forecast till 1984, which just happens to be when the next election is scheduled.

The Budget called for more cuts in government spending, hitting particularly education, the financing of nationalised industries and social security, but covering virtually every other area. The exceptions are interesting: defence spending is to increase by three per cent in real terms this year, and expenditure on law and order by two per cent. The aim is to reduce the deficit from £9 billion to £3.5 billion, and to continue the process over the next four years so that the money supply will then be growing at only six per cent, instead of the present 11 per cent.

Somehow, sometime, this is all supposed to lead to a fall in the inflation rate and then to an economic recovery, but neither Sir Geoffrey Howe, nor Mr Volcker in the United States, can demonstrate either the "how" or the "when" of this connection. They both, like their Australian counterparts when pressed, fall back on one or other tenet of their monetarist faith.

They might do better, though, if they looked more closely at the history of their faith — or at least they might not do as much harm. For it is a remarkable thing that Friedman, for all his fame, his Nobel Prize, and his access to the great, has discovered nothing. All he has done is revive a very old theory, in fact, one of the first theories developed to explain how capitalism works. Over three hundred years ago the English philosopher David Hume developed a version of monetarism that was, in many ways, more sophisticated than Friedman's. It was certainly more humane in its policy implications.

Hume, writing in 1752, formulated the quantity theory of money this way: "It seems a maxim almost self-evident, that the prices of every thing depend on the proportion betwixt commodities and money, and that any considerable alteration on either of these has the same effect either of heightening or lowering the prices. Encrease the commodities, they become cheaper: encrease the money, they rise in their value. As, on the other hand, a diminution of the former and that of the latter have contrary tendencies."

We might conclude from this, Hume suggests, that an increase in the price level following an increase in the amount of money circulating (he was thinking of the "price revolution" in Europe following the importation of silver and gold from the Americas in the Sixteenth and Seventeenth Centuries) would just leave everything the same. It might have more effect, either good or bad, he says, "than it would make any alteration on a merchant's books, if instead of the Arabian method of notation, which requires few characters, he should make use
of the Roman, which requires a great many. Nay, the greater quantity of money, like the Roman characters, is rather inconvenient and troublesome; and requires greater care to keep and transport it."

But there is another effect of changes in the money supply which Hume was very much aware of, but which the modern monetarists wish to ignore: "But notwithstanding this conclusion," he continues, "which must be allowed just, 'tis certain, that since the discovery of the mines in America, industry has encreas'd in all the nations of Europe, except in the possessors of those mines; and this may justly be ascrib'd, amongst other reasons, to the encrease of gold and silver."

"Accordingly we find, that in every kingdom, into which money begins to flow in greater abundance than formerly, every thing takes a new face; labour and industry gain life; the merchant becomes more enterprizing; the manufacturer more diligent and skillful; and even the farmer follows his plough with greater alacrity and attention."

How can this be, if increasing the money supply simply increases the price level? Hume has an answer: "To account, then, for this phenomenon, we must consider, that tho' the high price of commodities be a necessary consequence of the encrease of gold and silver, yet it follows not immediately upon that encrease; but some time is requir'd before the money circulate thro' the whole state, and makes its effects be felt on all ranks of people."

"When any quantity of money is imported into a nation, it is not at first disperst into many hands, but is confin'd to the coffers of a few persons, who immediately seek to employ it to the best advantage. Here are a set of manufacturers or merchants, we shall suppose, who have receiv'd returns of gold and silver for goods, which they sent to Cadiz. They are thereby enabled to employ more workmen than formerly, who never dream of demanding higher wages, but are glad of employment from such good paymasters."

"If workmen become scarce, the manufacturer gives higher wages, but at first requires an encrease of labour; and this is willingly submitted to by the artizan, who can now eat and drink better to compensate his additional toil and fatigue."

"He carries his money to market, where he finds every thing at the same price as formerly, but returns with greater quantity and of better kinds, for the use of his family. The farmer and gardner, finding, that all their commodities are taken off, apply themselves with alacrity to the raising of more; and at the same time, can afford to take more and better clothes from their tradesmen, whose price is the same as formerly, and their industry only whetted by so much new gain. 'Tis easy to trace the money on its progress thro' the whole commonwealth; where we shall find, that it must first quicken the diligence of every individual, before it encrease the price of labour."

It is this effect, on real income, that Hume wants to highlight. Since real incomes have increased, prices do not go up by as much as the increase in money supply. "The prices of all things have only risen three, or at most four times, since the discovery of the West Indies," Hume notes, but the increase in the amount of gold and silver in Europe has been much greater than this. The reason? "More commodities are produc'd by additional industry, the same commodities come more to market, after men depart from their antient simplicity of manners. And tho' this encrease has not been equal to that of money, it has, however, been considerable, and has preserv'd the proportion betwixt coin and commodities nearer the antient standard."

Hume explains the case of a shortage of money by reversing the argument, and paints a picture that is becoming more familiar: "A nation whose money decreases, is actually much weaker and more miserable than another nation, who possesses no more money, but is on the increasing hand. The workman has not the same employment from the manufacturer and merchant; tho' he pays the same price for every thing in the market. The farmer cannot dispose of his corn and cattle; tho' he must pay the same rent to his landlord. The poverty and beggary and sloth, which must ensue, are easily foreseen."

Easily foreseen, perhaps by David Hume's readers in 1752, but not by Milton Friedman's in 1980.