Public Talks

Friedman plus Keynes – a New Equation

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In August 1930 the number registered as wholly unemployed just tipped the two million mark. Twenty-five years later in 1955, after the Keynesian revolution had been accomplished, there were issued the lowest ever unemployment figures for the month of August – 181,000. Then came the counter-revolution in monetary theory, and this August, a further twenty-five years on, the number registered as wholly unemployed tipped the two million mark once again. An historically accurate – though loaded – view of events.

Those of you who read the appropriate columns in the newspapers and journals and tune in to the supposedly more serious radio and television programmes will have been informed by the economic journalists and commentators that during the past ten years there has opened up a great divide amongst academic economists.

On the one side, you will have gathered, are the Keynesians. Their champions are Ricardo, Marx, and Keynes, none of whom can now speak for themselves. The contemporary Keynesians, it would appear, are managed from Cambridge,[1] with public relations organised from London by the National Institute of Economic and Social Research. You will have been informed that Keynesians believe that money does not matter.

On the other side of the divide are the monetarists. They have no need for separate management or public relations, as their champion is alive, well, and living in the United States – Professor Milton Friedman, now a Nobel Laureate. From constant repetition you will know that monetarists believe that money does matter.

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1 A reference to the Cambridge Economic Policy Group of the late 1970s.

Admittedly there is a divide, but the mass media view I have just outlined is not only loaded, but also pays scant regard to historical accuracy.

Throughout his life John Maynard Keynes was very much concerned with money matters. Before the First World War he was appointed to the Royal Commission on Indian Finance and Currency – then a most important issue for the government at Westminster. During the final years of his life, at the end of the Second World War, he was concerned with the Bretton Woods Agreement and with negotiating the U.S. loan. The former was a monetary agreement of world-wide importance, whilst the U.S. loan saved this country from financial collapse.

During the inter-war years Keynes published his *Treatise on Money*, which, some argue, is a more important work than his later *General Theory*. David Ricardo too dealt with money and banking issues at great length, and it was in recognition of his expertise in the sphere of monetary economics that he was appointed a member of the Bullion Committee.

From about 1581, when it is recorded that a crude form of the quantity theory of money[2] reached Cambridge from France, all the established economic theorists, right through to the present day, have accepted that over a period of years there is a positive and significant association between changes in the money supply and changes in the general price level.

When the rate of increase in the money supply is persistently in excess of the rate of growth of real output then, inevitably, prices will rise. A stable general price level requires the maintenance of a balance between changes in the money supply and changes in real output. There is no argument about this. Over the centuries the

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2 The quantity theory of money is typically represented by the relationship M V = P T, where M is the quantity of money, V its velocity of circulation, P is the general level of prices, and T the volume of trade, or transactions. The value of V is sometimes derived from observations of the other parameters. In the monetarist view of the theory, emphasis is placed on the demand for money as an alternative to the holding of other types of financial assets.

available evidence from all countries has made the proposition incontrovertible.

The academic divide between contemporary Keynesians and contemporary monetarists did not arise from the rejection by one side, and the acceptance by the other, of the quantity theory of money. The divide arises from a fundamental difference as to the nature, and the causes, of unemployment.

Fundamental to the contemporary Keynesian view is the theory that the volume of output and employment is a dependent variable, determined by factors largely within the control of government fiscal and monetary policies.

That the volume of output and employment is a dependent variable is indeed central to the *General Theory of Employment* as formulated by Keynes in the thirties. He argued that the volume of output and employment is determined by the point of intersection between the aggregate demand function and the aggregate supply function.

Fundamental to the contemporary monetarist view is the theory that the volume of output and employment is an independent variable, in the sense that it is determined by factors that are not susceptible to control by government fiscal and monetary policies.

The policy proposals of the two factions then follow directly from their fundamental theoretical differences. Keynesian policy proposals are directed towards the discharging by government of their responsibilities for sustaining a high level of employment. In the U.K. the government first accepted this responsibility with the publication of its 1944 White Paper on employment.[3] Monetarist proposals are directed towards eradicating inflation.

Presumably both sides would agree, however, that inflation and unemployment together are worse than inflation or unemployment. Moreover, the proposition that one evil is an improvement on two evils commends itself to common sense.

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3 The UK government issued a White Paper on Post-War Employment Policy in May 1944, with a view to full employment under post-war conditions.

The differences in policy proposals are, as I have said, the result of a fundamental difference not so much in monetary theory as in employment theory. In any sphere, if a difference is to be resolved, then first it must be seen what that difference is. In this particular case, once the difference between contemporary Keynesians and contemporary monetarists is seen to be in the employment theory and not in whether money matters, or does not matter, or does not matter overmuch – once this is seen, the divide can be bridged.

Indeed, the academic dispute that creates the divide appears to be unnecessary, for it can be shown that the economics of Keynes and the more recent developments in monetary theory are not incompatible, but in combination they point the way to achieving a stable general price level whilst at the same time sustaining a high level of economic activity.

Contemporary monetarism was born out of a clash between what was then known as the Chicago School and a long-running academic dispute about the Phillips curve hypothesis. In 1956 the University of Chicago published a volume entitled *Studies in the Quantity Theory of Money*, a product of that university's workshop in money and banking. The volume was edited by Professor Milton Friedman and he personally contributed the leading essay: *The Quantity Theory of Money – a Restatement*.

According to the late Harry Johnson and others the restatement was essentially a sophisticated version of Keynes's theory of liquidity preference. Professor Harry Johnson was an important figure in the early development and dissemination of the restated quantity theory. As a corporal in the Canadian army he had been a post-war undergraduate at Cambridge, and thus well acquainted with the pre-Keynesian Cambridge quantity equations and with the economics of Keynes. Later, he was a colleague of Professor Friedman at Chicago, and also a Professor at the London School of Economics.

However, regardless of the primary sources of Professor Friedman's statement, it did open the way for fruitful and scientific

controversy which led to an important development in monetary theory. The pre-Keynesian quantity theory of money assumed an automatic tendency towards full employment, and as during the thirties this was manifestly in conflict with the facts of experience, the theory fell into disrepute. The restated quantity theory met these criticisms with a counter-contention. According to Professor Friedman, the restated quantity theory is – and I quote – "in the first instance a theory of the *demand* for money" – and he puts the word 'demand' into italics for emphasis. He then goes on: "It is not a theory of output, or of money income, or of the price level."

In other words, the restated quantity theory is not a theory of aggregate response to monetary change. The question of whether an economy responds to monetary impulses by price level, or by output level, is outside of its scope.

By setting itself free in this way the Chicago School suffered a serious shortcoming. Its policy implications were not attractive to governments charged with the responsibility of maintaining a high level of employment. For example, when Professor Friedman visited this country in 1970 as leader of the Chicago School, the label of monetarism was just beginning to gain ground, and in a lecture delivered at the Senate House of the University of London, he formulated what he called 'The eleven key propositions of monetarism'. I quote the fourth proposition in full:

"The changed rate of growth of nominal income shows up first in output and hardly at all in prices. If the rate of monetary growth is reduced then, about six to nine months later, the rate of growth of nominal income and also of physical output will decline. However, the rate of price rise will be affected very little. There will be a downward pressure on prices only as a gap emerges between actual and potential output."

As I understand this proposition, Professor Friedman, ten years ago, was being quite explicit. A restrictive monetary policy will precipitate a slump; providing that slump is sufficiently intensive then, in due course, the rate of price rise will slow down. Not a

statement likely to arouse passionate dissension among academic theorists, or businessmen – or, indeed, anybody else. Equally, not a statement likely to appeal to many politicians, even though the established Keynesian orthodoxy was incapable of proposing a solution to the persistent inflation that appeared to be inevitably associated with their demand management techniques.

Or, perhaps more accurately in the light of later events, the Keynesian orthodoxy was unable to propose a solution to inflation acceptable to free trade unions and to a free electorate, as George Brown, Barbara Castle, Edward Heath and Jim Callaghan will testify. But no doubt these defeated politicians will testify also that they would have had no chance of remaining in power on the promise of precipitating a permanent slump in order to eradicate inflation.

The restated quantity theory of money which Professor Milton Friedman was expounding in 1970 is, however, only one of the elements in contemporary monetarism.

Another element, the element that does make contemporary monetarism attractive to politicians, evolved from a long-running academic dispute that followed hard upon the publication of an empirical study by Professor A. W. Phillips. It was entitled: *The Relation between Unemployment and the Rate of Change of Money Wage Rates in the United Kingdom: 1861–1957*.

This study was first published in a London journal in 1958, just two years after the publication in Chicago of Professor Friedman's restated quantity theory of money. Professor Phillips hypothesised that there was a negative functional relationship between the unemployment rate and the rate of change in money wages.

As unemployment reduced, the faster money wages increased; as unemployment rose, the rate of increase in money wages slowed until, at a certain level of unemployment, the rise in money wages was halted. With stable money wages was created the possibility of a stable general price level. This relationship became known as the Phillips curve hypothesis.

To beleaguered governments, attempting to maintain a high level of employment by demand management and, at the same time, to keep inflation within bounds, the hypothesis offered the possibility of a trade-off between more or less unemployment, and less or more inflation. Not only were the policy implications of the Phillips curve hypothesis attractive to politicians, but also the hypothesis seemed to provide a theoretical confirmation of the common view that fear of unemployment is a necessary discipline for employees.

This view was not, and is not, exclusive to employers in the so-called right-wing establishment. Mr. Ernie Bevin,[4] as Minister of Labour in the wartime coalition, referred to it as “the most unfortunate discipline of all, the economic whip.” Professor Joan Robinson, a founder member of the Cambridge group, who by no stretch of the imagination can be considered a member of any right-wing orthodoxy, wrote in 1942 when the peacetime objective of full employment first came up for discussion: “The first function of unemployment (which has always existed in open or disguised forms) is that it maintains authority of master over man.”[5]

She went on: “Unemployment in a private enterprise economy has not only the function of preserving discipline in industry, but also indirectly the function of preserving the value of money. If free wage bargaining, as we have known it hitherto, is continued in conditions of full employment there would be a constant upward pressure on money wage rates... In peacetime the vicious spiral of wages and prices might become chronic. This would only bring a variety of evils in its train... It would make hay of the Social Security programme.”

By the mid-sixties, given the impetus of Professor Phillips’s study, Professor Paish, to take one of many possible examples, was

4 Mr. Ernest Bevin (1881–1951), Minister of Labour from 1940 to 1945, had previously co-founded the Transport and General Workers’ Union in 1922.

5 Quoted from two well-known articles, published anonymously in The Times on 22nd and 23rd January 1943 under the title of Planning Full Employment.

arguing that in the U.K. a 2¼ percent rate of unemployment was sufficient to halt inflation. This could be reduced to a 2 percent rate if trade unions were also restrained.[6] Although the original Phillips curve hypothesis was soon found to offer no general explanation of post-war experience, it spawned a vast literature seeking to explain inflation in non-monetary terms, and in this it was in direct opposition to the assertion of the Chicago School that "inflation is always and everywhere a monetary phenomenon".[7]

Eventually Professor Friedman was moved to attack, and on theoretical grounds he described the Phillips curve hypothesis as being 'utterly fallacious'. He argued that whilst in the short run unanticipated inflation would reduce real wages, and a reduction in real wages might be expected to be related to some expansion of employment, in the longer run the inflation would be anticipated with money wages and prices moving together in step. When this happened both real wages and unemployment would return to their pre-inflation levels. "You cannot fool all the people all the time", echoed Professor Friedman. "The true long-run Phillips curve is vertical", he concluded.

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6 Professor Frank Paish of the London School of Economics, an adviser to the previous Callaghan government, had asserted in an IEA paper in April 1967: "Britain's balance of payments deficits are solely caused by inflation, and inflation in turn is a consequence of an inadequate margin of unemployment. The amount of unemployment needed to eliminate inflation altogether can be confidently put at around 21 percent. From then on, the economy can be allowed to grow steadily in line with the rate of growth of productive capacity – perhaps 3 percent or thereabouts a year – without any fear of a payments crisis. If it were found that wages were still rising too fast with unemployment above 21 percent, restriction of demand (i.e. higher unemployment) would have to be continued to a higher level." The figure of 21 percent was evidently a typographical error, presumably corrected to 2¼ percent at some time after publication of the original paper.

7 Quoted from *The Counter-Revolution in Monetary Theory*, a lecture given by Professor Friedman at the University of London in 1970, and published by the IEA: "Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output."

This conclusion of Professor Friedman's effectively disposed of the Phillips curve hypothesis as a non-monetary explanation of persistent inflation. At first people might be fooled by inflation, and as long as they were fooled, the Phillips curve might provide an explanation of events, but very quickly people would cease to be fooled – they would come to expect inflation. When people cease to be fooled by inflation the Phillips curve ceases to work.

Professor Friedman's method of disposal, concluding the long-run Phillips curve to be vertical, meant that there must be for any economy a certain level of unemployment towards which that economy automatically tended irrespective of the continuing rate of change in money wages and prices. This certain level of unemployment Friedman called the 'natural unemployment rate'.

From this concept there was soon formulated the 'natural unemployment rate hypothesis', now more usually called the 'expectations augmented Phillips curve hypothesis'. Thus, from Friedman's successful theoretical attack on the non-monetary explanation of inflation offered by the Phillips curve, there was added to the restated quantity theory of money, a theory of output and employment, and with this new combination, contemporary monetarism was born.

The amalgam of the restated quantity theory of money and the expectations augmented Phillips curve has a great attraction for any government not seeking to establish a fully controlled or bureaucratic state socialist economy, but nonetheless wishing to eradicate inflation without causing prolonged mass unemployment.

By the siren sounds of contemporary monetarism, politicians were encouraged to believe that the economics of Keynes and the derived Keynesian employment policies of necessity would create inflation, in the absence of extensive government control.

In the short run this inflation might be successful in reducing unemployment to below the natural rate, but in the longer run the inflation would be anticipated, and then unemployment would return to the natural rate, regardless of the continuing actual rate of

inflation.

On the other hand politicians were enticed to believe that although monetary policies might cause a temporary hump in the rate of unemployment, in the longer run they would achieve a natural unemployment rate without inflation. Why suffer inflation to no advantage? Sooner or later the economy will return to its natural rate of unemployment regardless of whether monetarist policies are being pursued. All that Keynesian policies offer is the additional disadvantage of persistent inflation.

It is the attractiveness of this argument that has led the present administration to attempt its experiment in monetarism. We may note that the possibility of this experiment succeeding in eradicating inflation at this time, without causing prolonged mass unemployment, rests upon whether the 'expectations augmented Phillips curve hypothesis' does in fact work in practice.

I suggest that this hypothesis is little better than a confidence trick worked on politicians and the majority of the electorate by plausible academic theorists. I do not impugn the motives of these academics, for it would seem that in the heat of theoretical dispute, and through the weakness of the opposition, their analytical powers were lulled by the sweetness of their own siren sounds.

Contemporary monetarists argue that an economy automatically tends towards a natural rate of unemployment, and that this natural rate, therefore, is independent of government monetary and fiscal policies. This argument implies a fundamental difference from the theory of Keynes, for the theory of Keynes argues that the rate of unemployment is to a large extent determined by a government's fiscal and monetary policies. However, I would hold that this apparent fundamental difference applies more in the form of words than in real substance.

Full employment, as the term was used by Keynes in his *General Theory of Employment*, does not mean an absence of unemployment. It was, for the purposes of Keynes's *General Theory*, a theoretical benchmark. In given conditions the volume

of output and employment cannot be expanded *ad infinitum* – that there must be a limit to the expansion is self-evident. This limit Keynes called 'full employment'. One may fault Keynes for using misleading terminology, but in his writings he made his definitions clear. The term 'full employment' may be misleading, but there is no excuse for academics to be misled by Keynes.

The *General Theory* concept of full employment coincided with what Keynes called 'the point of true inflation'. This was a precise and accurate description. At anything less than full employment, any increase in monetary demands would go in part to raising prices, and in part to expanding output and employment, but when full employment was reached, any further increase in monetary demand could not, by definition, expand output and employment; it must therefore go wholly in raising prices.

For Keynes, full employment and true inflation were two ways of looking at the same condition. In Chapter 20 of the *General Theory*, Keynes wrote of this particular condition: "We have reached the situation in which the crude quantity theory of money is fully satisfied. For output does not alter, and prices rise in exact proportion to MV."[8]

Remember, in the *General Theory of Employment*, as it was formulated by Keynes, full employment does not mean an absence of unemployment; it refers to a rate of unemployment that cannot be reduced further by government fiscal and monetary policies aimed at increasing aggregate monetary demand.

The precise rate of unemployment that Keynes considered to be consistent with full employment is now a matter for conjecture. A pointer, perhaps, is that in 1937 when the numbers registered as wholly unemployed had fallen to less than one and a half million – equivalent to a rate of between 9 percent and 10 percent on the basis then used for the calculation – Keynes was arguing in the

8 If the volume of output is fixed, then the relationship MV = PT implies that the level of prices is directly proportional to MV, the product of the quantity of money and its velocity of circulation.

columns of The Times against any additional central government expansion of monetary demand at that time, as a means of achieving further reductions in unemployment.

The pre-Keynesian quantity theory of money assumed an automatic tendency towards full employment by virtue of Say's law.[9] During the inter-war years of depression this assumption was manifestly in conflict with the facts of experience, and the theory came to be considered as "too silly to be worth considering".

Friedman's 1956 essay freed the restated quantity theory of the Chicago School from the charge of being "too silly", and opened the way towards important new developments in monetary theory.

Admittedly the abnegation of responsibility for explaining the difference of the effects of money changes between price and quantity movements was to prove a serious shortcoming for the Chicago School, but by incorporating the expectations augmented Phillips curve into monetary theory the contemporary monetarists have turned full circle.

If the pre-Keynesian quantity theory of money is too silly to be worth considering, then so too is contemporary monetarism.

To argue that an economy automatically tends towards a natural rate of unemployment is not substantially different from arguing that an economy automatically tends towards full employment. Certainly this is so as that term was used by Keynes.

We know that to argue that an economy automatically tends towards full employment is a nonsense; it conflicts with the facts of experience. What then are we to do? Do we reject monetarism? Do we reject also the recent developments in monetary theory? The danger in outright rejection is that the baby tends to go with the bath water.

In developing the theory of Keynes, post-war Keynesians have

9 Say's law suggests that, in a market economy, an increase in the production of outputs for sale is due to a desire to exchange the additional output for an increase of income, which will be then be spent on other products; thus, it is evidence of effective demand. The theory was set out in Say's *A Treatise on Political Economy*, published in 1803; the term was introduced by Keynes.

tended to reject monetary theory, with dire results to the economy when their conclusions were put into practice. Contemporary monetarists tend to reject the analysis of Keynes, and I predict their conclusions will have dire results to the economy if long pursued as practical policies. Yet inflation today is a malignant disease. We cannot afford to reject the lessons of monetary theory, but equally we cannot afford to reject the theory of Keynes. Unemployment is an insidious disease.

Bearing in mind the weaknesses and strengths of the kind of economy in which we live and have to earn our living, it would seem that the right approach is to develop Keynes's *General Theory of Employment* in such a way that it can incorporate the recent developments in monetary theory.

This approach, from where we are now in September 1980, includes the possibility, without any loss of freedom, of proceeding immediately and directly towards the eradication of inflation whilst at the same time sustaining the highest possible volume of output and employment. This approach accords with the objective of political economy throughout the ages.

Amongst those individual economists who have held the liberty of the subject and the free development of human nature in high regard there are many differences of emphasis, and there are many differences in their policy proposals, but these differences do no more than reflect changing conditions; a different starting point, not a different objective. To reach the equator from the Arctic one travels south, but from the Antarctic one travels north.

When Keynes was charged by the academic establishment with changing his views in 1931, he wrote in the New Statesman and Nation: "I seem to see the older parrots sitting around and saying 'You can rely on us. Every day for thirty years regardless of the weather we have said, what a lovely morning! But this is a bad bird. He says one thing one day and something else the next.'" Changing conditions require changes in public economic policies, and these policy changes require the continuous development of

economic theory. Academic disputes and divides serve to bring honest differences into the light so that the invalid may be rejected and the valid incorporated into the new. Disputes do not serve this purpose when they descend to strengthening entrenched positions wherein the differences are more apparent than real.

Worse than this, as in the case of the present divide between the contemporary Keynesians and the contemporary monetarists, the strengthening of entrenched positions tends to obscure the real nature of otherwise honest differences and, as a result, prevents new developments. As I have argued this evening, the present differences between contemporary Keynesians and monetarists are not so much a matter of monetary theory as a matter of employment theory. Once this is seen new developments in macro-economic theory become possible.

In the Economic Study Association we have been working for some fifteen years on developing the economics of Keynes so that it can incorporate the recent developments in monetary theory. We have had some moderate success, and this autumn we are detailing our developments in a seminar series. In one Saturday evening lecture you will appreciate that it is not possible for me to go through the results of fifteen years' work. I trust, however, that what I have said tonight will be sufficient to enable us to draw some broad conclusions. In the words of Professor Pigou, "It is for its fruit-bearing qualities, not for its light-bearing qualities, that economic knowledge is worth pursuing."[10]

We may start with a point of general agreement. If inflation is to be eradicated then the rate of increase in the money supply must be brought into line with the rate of growth of real output potential. From this there is no escape outside of a fully controlled economy.

For the past 25 years the rate of growth of real output potential for the United Kingdom, on a full employment basis, has been

10 Arthur Pigou succeeded Alfred Marshall as Professor of Political Economy at Cambridge University from 1908 to 1943. The quotation is from the first chapter of his book *The Economics of Welfare*, published in 1920.

fractionally over 3 percent per year. This, then, must be the final objective of any succession of monetary supply targets.

There are no insuperable difficulties about the government controlling the monetary supply. We live in a monetary economy with a managed currency; government is, as it were, the monopoly supplier of money and therefore has absolute control.[11]

To eradicate inflation government must keep the money supply under control, but in order to do so must give up attempting to exercise other controls. For example, they must give up trying to control interest rates. As any monopolist knows, or is soon taught by experience, he cannot control both price and quantity. In addition, government must also accept certain other disciplines, such as keeping their spending within the bounds of their income. We all have to accept this discipline, so why not governments?

Recent developments in monetary theory are important since they leave no room for reasonable doubt that if the government are to bring the money supply eventually into line with the growth of real output potential, without precipitating a slump, the demand for money also must be reduced. If, through the exercise of their control over the money supply, government create the conditions of a persistent excessive demand for money then they will cause a prolonged slump with mass unemployment.

Now, as I have argued, government can control the money supply, but in a society such as ours they cannot control the demand for money; by developing the analysis of Keynes we find that government can and do exert a significant influence over the demand for money through their fiscal policies.

Thus it follows that in addition to accepting the monetary disciplines necessary to keep control over the monetary supply, government must also accept certain fiscal disciplines so as not to inflate the demand for money.

The theory developed by the E.S.A. predicts that the demand

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11 For example, by regulating the capital reserve ratio of the banking system in terms of the amounts of cash and other assets that banks are required to hold.

for money will be persistently inflated by the tax shifting process when government taxing and spending exceeds a certain amount.

This theoretical prediction is consistent with the conclusion Colin Clark deduced from an empirical study published in the Economic Journal of 1945.[12] From this empirical study, based on pre-war evidence, Colin Clark concluded that when the general government tax revenue plus borrowing requirement exceeded a certain proportion of the Net National Income then forces were set in motion which caused a persistent rise in costs and prices.

Clark's empirical study was instigated by the then Labour government of Queensland, to whom he acted as advisor. Keynes, who was editor of the Economic Journal when the manuscript was received, agreed with Clark's conclusion, and expressed the view that it would prove to be the United Kingdom experience in the post-war years.

The preliminary results from E.S.A. statistical researches, based upon more recent data, indicate that for the U.K. what Clark called the upper limit to taxation is today around 32% of the net domestic product at market prices. Throughout the post-war years British governments have persisted in exceeding this limit, and there is a significant and positive relationship between the extent of their excesses and the rate of inflation.

Thus theory predicts and empirical studies confirm that when government taxing and spending exceeds a certain limit then the forces of the tax shifting process will persistently raise the general price level and in this way increase the demand for money. If this tax inflated demand for money is not met by an inflationary supply of money then a slump is inevitable.

Further, if within this overall limit to government taxing and spending the economy is to sustain the maximum volume of output

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12 In *Public Finance and the Value of Money*, by Colin Clark, published in the Economic Journal, Volume 55, No. 220 (December 1945), pages 371–389. In proposing an upper limit of 25%, Clark said: "The limit is approximate, and should be written 24–26%, if not 23–27%. Beyond 27%, there is a high probability that inflation will materialise."

and employment consistent with a stable general price level, then government must accept the additional fiscal discipline of raising their tax revenue in a way that does not inflate the costs to firms of producing any particular volume of output. That is, using the terms of Keynes, government must eschew all taxes which directly inflate the aggregate supply price.

These broad general policy conclusions are derived from incorporating the recent developments in monetary theory into a development of the economics of Keynes.

Perhaps as a final point I can be more specific: What about this country in September 1980? I have argued that monetary policy is not enough. This, however, was Sir Keith Joseph's contention before the election, and now it is rumoured that the Chancellor[13] is producing a Cabinet paper on what assistance he can give to industry. But what can he do immediately?

I suggest the question is better posed as: What can he stop doing immediately? To regain control over the money supply he must reduce the tax-inflated demand for money. To reduce the tax-inflated demand for money he must bring government taxing and spending within the economic limit. This economic limit is a ratio, therefore the Chancellor can move towards getting within the limit by contractionary measures or by expansionary measures.

It is self-evident that the greatest benefits will accrue to all concerned if, so far as possible, expansionary measures are used, and I distinguish between expansionary and inflationary measures. I am not talking of 'Going for growth'; I am talking of deflating the demand for money.

With over two million unemployed and the number still rising,[14] the Chancellor continues to impose employment taxes – P.A.Y.E., Social Security Contributions, the National Insurance surcharge, etc. – that are equivalent to a Value Added Tax (VAT) rate of 40%.

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13 Sir Geoffrey Howe (1926–2015) served as Chancellor of the Exchequer from 1979 to 1983. He was succeeded by Nigel Lawson, and resigned from the Thatcher government on 13th November 1990 over its European policy.

14 Unemployment in the UK rose to over 3 million from 1982 until 1986.

Of these taxes a significant proportion are taxes which directly inflate the aggregate supply price, namely employers' social security contributions and the National Insurance surcharge. By abolishing these taxes the Chancellor would, within six weeks, reduce the aggregate supply price, reduce the tax-inflated demand for money and, by reducing the cost of labour to firms, he would improve the competitiveness of British producers and thus create the conditions for an expansion of output – not, you may note, by increasing monetary demand, but by reducing the demand for money by cutting tax-inflated costs.

If this government is to eradicate inflation without causing prolonged mass unemployment the Chancellor needs to look not to what more he must do, but to what he is doing, and can stop doing immediately.

So far during his term of office he has persistently inflated the demand for money and, as a consequence, failed dismally to control the money supply. His fiscal and monetary policies have been, and continue to be, directly opposed to each other. One way or another these opposing policies must be stopped if the economy of this country is to survive what is now a worldwide depression.

"Milton thou shouldst be living at this hour, England has need of thee." The former Poet Laureate's cry has been answered by a Nobel Laureate,[15] an answer Wordsworth never dreamed of.

We needed a re-emphasis of the importance of monetary discipline, but not at the expense of wholly rejecting that great Cambridge economist who, more than any other, by his theoretical and practical work laid the foundations for twenty-five years of post-war prosperity and growth.

This is a new day and calls for a new equation.

15 Friedman received the Nobel Memorial Prize in Economic Sciences in 1976.