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New labour, new monetarism

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New Labour's economic policies share much in common with old-fashioned monetarism, particularly in their narrow focus on interest rates as an instrument of policy.

The notion that economic policy follows a coherent strategy drawn from a clear economic analysis of capitalist economies would be laughable. But it is often possible to discern some general tendencies and to see the influence of economic ideas on economic policy. We would not go as far as Keynes when he wrote that:

> the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economists. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back.[1]

Indeed, we would acknowledge that a politician's adoption of ideas from economists can arise from those ideas leading to policy conclusions which the politician wanted to follow for other reasons. The early years of the Thatcher government illustrate the influence of economic ideas, usually described as monetarism, and how the interpretation of those ideas could be used to promote

1. See J.M. Keynes, *The General Theory of Employment, Interest and Money,* Macmillan, London 1936, p383.

policies which the government wished to pursue anyway. At the danger of giving the current government's economic policies more coherence than they deserve, we argue that there is a set of ideas that lie at the heart of the economic policies of New Labour. Since these ideas have a clear resonance with those associated with monetarism, we designate them as the 'new monetarism', and we refer to those which influenced the Thatcher government as 'old monetarism'.

We begin by describing the monetarism of the 1980s, which we label as 'old monetarism', and note the failures of simple monetarism through problems with control of the stock of money. But, we argue, 'old monetarism' also involved privileging the financial sector over the productive sector, and viewed economic difficulties as arising from government intervention in the labour market. We proceed by describing a 'new monetarism' which we see as central to the economic policies of New Labour. This 'new monetarism' also privileges finance and seeks to change the labour market; the implicit assumption appears to be that the levels of investment and of aggregate demand take care of themselves.

Old monetarism

Monetarism was often summarised in the phrase 'money matters', in supposed contrast to Keynesianism, which was accused of neglecting the role of money. This was not only an inaccurate interpretation of Keynesianism but overstates monetarism. It could be more accurately characterised by saying that money matters for the control of inflation but does not matter a jot for unemployment. The main architect of monetarism, Milton Friedman, advocated the adoption of a policy rule that the stock of money should increase by a predetermined amount: he argued that a growth in the money stock of say 5 per cent per annum in the context of real growth of 3 per cent per annum would generate inflation of 2 per cent per annum.[2] It was also argued that if people know that the money stock will grow at 5 per cent with the implication of 2 per cent inflation, they will act accordingly: for example, wages will be set with the expectation of 2 per cent inflation. In an open economy, the exchange rate will reflect differences between inflation in the countries concerned.

2. Milton Friedman's evidence to the Treasury and Civil Service Committee provides a very good summary of his ideas. See Friedman, *Memoranda on Monetary Policy,* Treasury and Civil Service Committee, HC 720-11, July 1980.

The policy then adopted in both the United Kingdom and the United States involved the setting of targets for the growth of the money stock (associated with the advent of the Thatcher and Reagan governments respectively, but with precedents in the previous Callaghan and Carter administrations). In both cases, the attempts at tight money drove up interest rates, after a decade of low real interest rates, for although nominal interest rates had been high during the 1970s those rates were often below the rate of inflation, with negative real rates of interest. This set the stage for an era of much higher interest rates than had previously been experienced: real rates of interest have typically been around 5 per cent per annum since 1980, compared with historic averages of 2 to 3 per cent per annum. The recessions of the early 1980s in the UK and in the USA did much to undermine the monetarist approach since that theory did not indicate that monetary deflation would involve major reductions in output and employment.

Simple monetarism, by which we mean control of the money supply to set the rate of inflation, soon collapsed. At this level, the causes of the collapse are straightforward. There were evident difficulties in controlling the money supply, and the targets for monetary growth were persistently missed. In Table 1 we cite targets and outcomes for the UK money stock (the sterling M3 definition) and for the Public Sector Borrowing Requirement (PSBR) as set in the period 1980-1985, under the Medium Term Financial Strategy. The assumption which was made by monetarists was that some part of the PSBR would be financed by the government printing money (technically MO, that is cash and reserves with the Bank *of* England) and this would then lead to an expansion in the broader definitions of money such as sterling M3 (broadly deposits with banks). It is clear from this table that over the period in question, money supply targets were always missed.[3] The PSBR targets were also missed with the exception of two cases, but then only after the relevant targets were raised subsequently. That was in 1981/82 and 1982/83, but witness the persistent raising of the target in the latter period.

Fixing PSBR to hit a certain target for the money supply is an extremely

3. In October 1985 the 1985/86 target for sterling M3 was suspended and finally abandoned in the budget of 1987. The suspended 1985/86 target was set at 5-9 per cent with an out-turn of 14.4 per cent. In the 1986 Budget the target for 1986/87 was set at 11-15 per cent which was significantly overshot yet again.

difficult, if not impossible, task. And so it proved to be. Whilst Milton Friedman could blame traitors in the Bank of England (as in Friedman 1980), that experience only served to confirm that in a sophisticated financial system where

Table 1: Monetary targets and the outturns

	Year target imposed and outturn	1980/81	1981/82	1982/83	1983/84	1984/85
Growth of Money Supply (% change)	March 1980	7 - 11	6 - 10	5 - 9	4 - 8	
	March 1981		6 - 10	5 - 9	4 - 8	
	March 1982			8 - 12	7 - 11	6 - 10
	March 1983				7 - 11	6 - 10
	March 1984					6 - 10
	Outturn	18.9	14.8	12.3	11.2	12.0
Public Sector Borrowing Requirement as % of GDP at market prices	March 1980	3.75	3	2.25	1.5	
	March 1981		4.25	3.25	2.0	
	March 1982			3.5	2.75	
	March 1983				2.75	
	March 1984					2.25
	Outturn	5.75	3.49	3.37	3.25	3.25

Source: *Economic Trends,* June 1985

money is created through the credit process by banks, it is well nigh impossible to control the stock of money. There has always been a paradox at the heart of monetarism, namely that monetarists argued that markets should not be controlled in any way, but the money stock created in the financial markets could and should be controlled. During the 1970s, monetarists had made much of a link between changes in the stock of money and the rate of inflation, operating with roughly a two year lag: hence control the stock of money now, so to be able to influence inflation two years hence. But the growth of the money stock indicated in Table 1 was much greater than that of the rate of inflation.

Other countries shared the British experience. In the case of Germany, the Bundesbank has failed to meet the monetary target on 10 occasions in the 21 years from 1975 to 1995 (inclusive).[4] Where does the reputation of the Bundesbank come from? In the case of the USA, monetary targets were missed there too (with the exception of the years 1981 and 1984) and in 1986 they were suspended, never to appear again.[3]

Another and more enduring aspect of monetarism is the view that unemployment would move to its 'natural level' (the 'natural rate of unemployment'). This is obviously a significant use of words with clear overtones of inevitability about unemployment. But the 'natural' rate of unemployment would (in theory) constitute full employment with a balance between the demand for and supply of labour if the labour market were akin to the perfectly competitive model. In lay person's terms, this would be a labour market in which wages and employment could change quickly as the composition of demand varied: what some would call a flexible labour market, and what others would see as an insecure spot market for labour. This 'flexible' competitive labour market could be achieved if'imperfections' were removed. These 'imperfections' were associated with features such as trade union power, minimum wages imposed by Wage Councils, unemployment benefits, etc. It was precisely legislation to remove these 'imperfections' which formed a major part of the Thatcher agenda.

4. Information taken from the Annual Report of the Bundesbank, 1995, p77.
5. For more details of the USA experience see, Arestis. P and M. Marshall, 'The New Right and the US economy in the 1980s: An assessment of the economic record of the Reagan administration', *International Review of Applied Economics,* Vol 4, No 1, 1990, pp52-54.

Thus monetarism encapsulated the view that unemployment arose essentially from constraints on the flexible functioning of the labour market, constraints which could be repaired through legislation which reduced the power of trade unions and the influence of the state. This represented a major shift from previous perceptions. No longer was unemployment attributed to inadequate aggregate demand which could be addressed through fiscal and monetary expansion. The Conservative government declared in 1985 that the one thing clearly not responsible for unemployment is a lack of demand and that the biggest single cause of our high unemployment is the failure of our jobs market, the weak link in our economy.[0] Nor was unemployment and sluggish growth to be placed at the door of industry because of a failure to invest and to achieve international competitiveness. Monetarism represented the triumph of the market over the state, in the sense that it viewed failures of the labour market (to generate full employment) as due to external government interventions such as unemployment benefits, minimum wage legislation etc, and that it accepted that the product market and private industry operated in an efficient manner.

Related to this aspect, there is the notion of the 'flexibility' of labour markets which is often used to explain the lower recorded unemployment rate in the UK (around 7 per cent) as compared with the higher rates (22 per cent in the case of Spain) in much of the rest of the European Union. The point is highlighted in Table 2 where standardised unemployment rates are given for recent years. Whilst it is true that the UK unemployment rate has been decreasing especially since 1993 (which can be explained by the forced devaluation of the pound in 1992), other countries in the EU (Austria, Denmark, Luxembourg, The Netherlands and Portugal) have been doing much better than the UK. But even for the other EU countries which have been experiencing significantly higher unemployment rates than the UK, this can be explained by their efforts to meet the stringent Maastricht criteria (Belgium, Finland, France, Germany, Greece, Italy, Ireland, Spain and Sweden). If we take into account countries outside the EU, the picture is pretty much the same. Norway and Australia, where allegedly

6. See, Department *of* Employment, Employment: *The Challenge for the Nation,* Cmnd. 9774, HMSO, London 1985. This document went on to argue that since 1979 Britain has begun a revolution in education and training and that the Government can help to improve the labour market by encouraging better training, more flexibility and fewer barriers of regulation and cost, ppl5-23.

Table 2 Standardised unemployment rates

EU Countries	1992	1993	1994	1995	1996	1997
Austria	3.6	4.2	3.8	3.9	4.4	6.6
Belgium	7.3	8.9	10.0	9.9	9.8	9.7
Denmark	9.2	10.1	8.2	7.2	6.9	6.4
Finland	13.0	17.7	17.4	16.2	15.3	15.3
France	10.4	11.7	12.3	11.7	12.4	12.6
Germany	6.6	7.9	8.4	8.2	8.9	9.5
Greece	7.9	8.6	8.9	9.7	9.8	10.0
Ireland	15.1	15.6	14.3	12.3	11.8	10.8
Italy	9.0	10.3	11.4	11.9	12.0	12.2
Luxembourg	2.1	2.7	3.2	2.9	3.3	3.7
Netherlands	5.6	6.6	7.1	6.9	6.3	5.6
Portugal	4.2	5.7	7.0	7.3	7.3	6.2
Spain	18.5	22.8	24.1	22.9	22.1	20.9
Sweden	5.6	9.5	9.8	9.2	10.0	10.7
UK	10.1	10.4	9.6	8.8	8.2	7.4
Average for EU countries	8.6	10.2	10.4	9.9	9.9	10.0
Non EU countries						
Australia	10.7	11.0	9.8	8.6	8.6	8.7
Canada	11.3	11.2	10.4	9.5	9.7	9.5
Japan	2.2	2.5	2.9	3.1	3.4	3.4
Norway	5.9	6.1	5.5	5.0	4.9	4.2
USA	7.5	6.9	6.1	5.6	5.4	5.2
Average for non-EU countries	7.5	7.5	6.9	6.4	6.4	6.2

Source: *OECD Economic Outlook;* Labour Market Trends and Ministry of National Economy

Table 3 Standardised employn figures: percentage changes from previous period

	1992	1993	1994	1995	1996*	1997*
EU COUNTRIES						
Austria	1.5	-0.3	0.2	-0.4	-0.7	-0.2
Belgium	-0.4	-1.1	-0.7	0.4	-0.1	0.5
Denmark	-0.6	-1.0	-0.6	1.6	1.0	1.0
Finland	-7.1	-6.1	-0.8	2.2	1.1	1.5
France	-0.6	-1.2	0.1	0.9	0.0	0.3
Germany	-1.8	-1.7	-0.7	-0.3	-0.9	0.2
Greece	1.5	0.9	1.9	0.9	0.8	0.9
Ireland	0.4	1.8	3.5	4.0	3.2	2.0
Italy	-0.9	-2.5	-1.7	-0.6	0.4	0.1
Luxembourg	2.5	1.8	2,3	2.5	2.3	2.6
Netherlands	1.6	0.7	-0.1	2.4	1.9	1.8
Portugal	-6.4	-2.0	-0.1	-0.6	0.4	0.4
Spain	-1.9	-4.3	-0.9	1.7	1.3	1.6
Sweden	-4.3	-5.8	-0.9	1.6	-0.5	0.5
UK	-2.4	-0.8	0.7	0.6	0.2	0.8
Average for EU Countries	-1.3	-0.7	0.0	1.0	0.7	0.9
NON-EU COUNTRIES						
Australia	- 0.7	0.4	3.1	4.1	1.3	1.9
Canada	- 0.6	1.4	2.1	1.6	1.4	1.9
Japan	1.1	0.2	0.1	0.1	0.6	1.1
Norway	- 0.3	0.0	1.5	2.0	2.4	1.3
USA	0.7	1.5	2.3	1.6	1.4	1.2
Average for Non-EUCountries	- 0.04	0.7	1.8	1.9	1.4	1.5

Source: *OECD Economic Outlook*, 1997

* These are estimates and projections.

inflexible labour markets exist, have been doing much better than the UK. At the same time Canada, with an economy comparable to that of the UK, has been doing worse than the UK. Japan and the USA have had mixed experiences, where the USA has been doing rather better recently, but Japan's unemployment rates have been consistently lower than the USA's.

The picture is too mixed to arrive at any generalised conclusions. Furthermore, if employment rates were used, the picture is not as markedly different amongst the EU countries, as shown in Table 3. With the exceptions of Luxembourg and The Netherlands, the rest of the EU tends to have more or less the same pattern. The comparison with the non-EU countries is still roughly similar to the unemployment case. Countries outside the EU have been doing a great deal better than the countries within it, and consistently so throughout the period since 1992.

Tobin distinguishes between Monetarism Mark 1 (broadly associated with Milton Friedman) and Monetarism Mark 2 (associated with another Nobel Prize winner, Robert Lucas).[7] The particular 'contribution' of Lucas which is relevant to this discussion is the stress on 'rational expectations': the idea that when people form a view about the future, they do so using all the information at their disposal and the 'true model' of how the economy works (which is well known and understood by economic agents), and this view of the future is broadly accurate and does not contain any systematic errors. It is difficult to understate the impact of this idea on economic thinking, and indirectly on economic policy. When those working in the market are assumed as knowledgeable as they were by 'rational expectations', it carries a strong presumption that the 'market knows best'. Since the markets which respond most quickly and where prices change on a minute to minute basis are the financial markets, the assumption of'rational expectations' points to the wisdom of the financial markets. This same idea also led to the notion that financial markets were 'efficient', and that share prices, exchange rates, etc., reflected an accurate assessment of the prospects for a company (in the case of share prices) and for an economy (in the case of exchange rates).[8] Furthermore, an economic

7. J.Tobin, 'The Monetarist counter-revolution today - an appraisal', *Economic Journal,* Vol 91, 1981,pp29-42.
8. It is difficult to write this with a straight face as it is being drafted after a week which saw the Hong Kong stock market drop by 15 per cent one day, then rise by 15 per cent the next!

policy could only be implemented if the financial markets deemed it to be credible: if the policy was not credible, then financial markets would indicate as much (e.g. by the exchange rate falling). What matters then is not so much whether a policy is credible, but whether the financial markets believe it to be so. It also provides a great get-out clause for policy-makers: a policy of increased public expenditure cannot be undertaken because the financial markets would deem it incredible and unsustainable. In addition, monetarism also represented the acceptance of the power and wisdom of the financial markets, especially as monetarism developed and incorporated 'rational expectations'. The financial markets had to be convinced that the government wished to reduce inflation, and this could be brought about through announcement of money supply targets.

New monetarism

Under the monetarism of the 1980s (which we will now refer to as 'old monetarism'), the monetary policy was to control the growth of the stock of money through monetary targets (and the use of interest rates to help reach those targets) with the intention that the growth of money stock would determine the rate of inflation. 'New monetarism' is rather similar: the inflation rate target is set (currently at 2.5 per cent), and the operationally independent Bank of England is given the responsibility to manipulate interest rates to achieve that inflationary target. The mechanism by which that is to happen is never made clear.[9] However (at least) three possible routes can be identified. The first route is that the interest rate rise is expected to lower aggregate demand, leading to lower (than otherwise) output, and the lower demand places downward pressure on inflation. An interest rate hike would be predicted to have some adverse effect on investment, though it may be questioned whether a small percentage change has any marked effect. In so far as this sub route is operable, future productive capacity is lower and the ability of the economy to support employment reduced. The effects of interest rates on savings is usually seen to be ambiguous. But dissavings by households (that is the financing of expenditure through debt) is likely to be affected, and consumer expenditure reduced accordingly. A more significant sub route may be the 'income effect', that is

9. The Treasury Select Committee requested in November 1997 that the Bank of England makes its views of the monetary transmission mechanism known.

higher interest rates raise mortgage payments (on variable interest rates), reducing disposable income and then consumer expenditure. This is offset by the increased income of the interest recipients (wealth holders), but it is usually presumed that the net effect on consumer expenditure is negative. A problem with this channel is that if it is assumed that a higher interest rate lowers nominal expenditure, then the question arises of how the nominal expenditure fall splits between prices and real output.

The second route is a monetary one. A higher base rate leads to generally higher interest rates including those on loans; this would lower the demand for loans with fewer loans being granted and less money created. As a consequence, the money stock is lower than it would have been. A monetarist story can then be added to this: the lower money stock leads to a lower (than otherwise) price level, and this lower price level means a lower rate of inflation. But this would presume that the lower money stock somehow generates a lower demand for money. The monetarist view is that the lower stock (supply) forces a lower demand: but the post-Keynesian view would be rather different, namely that the stock would adjust to the demand. Indeed, if the inflation rate is not a monetary phenomenon - say it is determined by a process of adding a mark-up on costs - then this process would be highly deflationary with considerable decreases in output and thus increases in unemployment.

The third route could be labelled the New Zealand disease, namely that the pursuit of an inflation target through interest rate policy leads to higher interest rates which drive up the exchange rate. This higher exchange rate tends to reduce inflation as the price (in the domestic currency) of imports fall. The fall in import prices may not fully reflect the rise in the exchange rate: that would depend on the strategy of the importers. But the exchange rate rise causes difficulties for exporters: how much difficulty depends on their market power and how far they can raise prices in the foreign currency and preserve prices in the domestic currency. The prices of non-traded goods and services are not directly influenced by this rise in the exchange rate, and domestic factors largely govern the rate of increase of prices of non-traded goods and services. The rate of inflation is essentially a weighted average of the inflation rate on traded goods (held down by the exchange rate rise) and the rate on non-traded goods. There is a strong possibility that the price of traded goods falls relative to the price of non-traded goods. This route has been labelled the New Zealand disease because the independence of the New Zealand Central Bank appears to have precisely these effects. In the past few years in New Zealand, the overall rate of inflation has been around 2 per cent per annum, whilst the rate for tradable goods has been less than 1 per cent, and that for non-tradable around 4 per cent. From 1992 onwards, the real exchange rate (as well as the nominal exchange rate) has been on an upward trajectory and has appreciated by around 30 per cent. This third route can only work if the exchange rate rises: the other side of that coin is that the exchange rates of other countries fall. If other countries then join in, raising interest rates to stem the fall in their exchange rate (and perhaps in the pursuit of inflation targets), the outcome is competitive revaluation of the exchange rate and competitive interest rate hikes.

The Labour Party in opposition decried what they termed the 'one club' approach, in which interest rates were the only policy instrument being used to guide the economy. And yet this seems to be what is now happening again. Interest rates are being used to guide the economy, responding to perceptions of an overheating economy. Fiscal policy is now heavily constrained, and has been virtually ruled out for purposes of guiding the economy, throwing the weight for that guidance on to interest rates. The scope available for fiscal policy is limited through adherence to the Maastricht criteria (limiting the budget deficit to 3 per cent of GDP) and through pronouncements in favour of balanced budgets, the so-called 'golden rule' of public finance (that government should only borrow to meet capital expenditure) and concerns over the size of debt and of interest payments (which are exacerbated by the high interest rate policy).[10] Further, public expenditure plans are locked into those decreed by the previous government, and tax rises are ruled out politically. Thus the use of fiscal policy to regulate aggregate demand in the economy is given up completely. Furthermore, under 'old monetarism', the government was to act under monetary targets

The use of fiscal policy to regulate aggregate demand has been given up completely'

10. Under this rule, borrowing to finance the purchase of military equipment is permissible as it counts as capital expenditure; borrowing to finance the employment of teachers, health service workers or to pay disability benefits (and many other measures) is not.

to inform the financial markets of their intentions on inflation. Under 'new monetarism', the government gives the Bank of England operational independence over the setting of interest rates with the sole objective of meeting a target rate of inflation to assure the financial markets. 'New monetarism' also involves an acceptance of the power and wisdom of the financial markets. In short, fiscal policy is completely subordinated to monetary policy, and this can at most only regulate the inflation rate. Inflation is prioritised over improving the industrial base, promotion of competitiveness, and employment. No regard is paid to ensuring that there is adequate demand in the economy, and fiscal policy is effectively renounced.

It is notable that, in their manifesto for the 1997 election, the Labour Party made no proposals for the control of inflation other than to set a target of 2.5 per cent or less. This was followed by the reform of the Bank of England with operational independence being granted in the very early stages of the Labour government; the clear implication being that granting independence to the Bank was a signal that inflation can be controlled through manipulation of the interest rate. It is a rather strange feature of current political debate that inflation is seen as 'evil' and yet no attention is given to how inflation can be contained." Two interpretations come to mind. The first is the acceptance that unemployment, engineered through higher interest rates, can be used to contain inflation. We have doubts on both the morality and the effectiveness of such an approach. But in the infamous words of Norman Lamont, high unemployment is seen as 'a price worth paying' for low inflation. The second is to argue that inflation within the industrialised world remains low. A combination of globalisation, weakened trade unions, and lowered inflationary expectations after nearly twenty years of anti-inflationary policies, would ensure that inflation does not re-emerge as a serious problem, which some have described as the 'death of inflation'. If that is the case, then there is little need to pay any regard to inflation as a problem, and it would be time to turn to the many other problems which beset the economy.

'Old monetarism' invoked the 'natural rate of unemployment'. 'New monetarism' draws on a similar concept in the form of the Non-Accelerating Inflation Rate of Unemployment, affectionately known as the NAIRU. The

11. Tony Blair, The Mais *Lecture,* text of lecture delivered 22 May 1995.

NAIRU is somewhat mislabelled since it involves a non-rising rather than non-accelerating rate of inflation. The idea is simply that a level of unemployment below the NAIRU would involve rising inflation: wages would tend to rise faster than prices, which in turn would respond by rising even faster. Unemployment above the NAIRU would lead to falling inflation. For the believers in the NAIRU, it can be calculated from the estimation of equations describing wage and price formation, with some recent estimates putting it in the range 5 to 7 per cent. Grieve Smith summarises the position accurately when he writes that 'at present the objective implicit in the inflation target is to prevent unemployment falling below a certain minimum level', where that minimum level is well above the level of unemployment which would correspond to full employment.[12] A particularly pernicious aspect of the NAIRU is that a belief in its existence means that unemployment falling below that level is taken as a signal that inflation will start rising and that interest rates should be raised.

Various factors are said to determine the level of the NAIRU. These can include factors such as the power of trade unions and of business but also the skills and 'employability' of the work force (the latter is lowered by a history of unemployment). The policy instruments overlap (e.g. reduce trade union power, but in the era of 'new monetarism', trade union power is no longer considered a problem), and initially seemed to involve a focus on education, skills, improving employability. This leads to declarations such as 'New Labour believes in a flexible labour market that serves employers and employees alike'.[13] This again involves what may be thought of as 'market imperfections'. For 'old monetarism', those imperfections were associated with the level of unemployment benefits, trade unions, minimum wage legislation etc. For 'new monetarism', the market failure is a lack of training and skills. It is well known that firms will tend to under-invest in training and skills. Training is costly for the firm and there is no guarantee that the person trained will stay with the firm for it to reap the benefits of that training. In the economics jargon, provision of training and skill formation are likely to suffer from market failure. However, whilst the 'new monetarism' at first seemed to be rather more humane

12. Estimate made by the Treasury's Chief Economic Adviser to House of Commons Treasury Committee, December 1996, as reported in J.Grieve Smith, 'Grasping the nettle: the problem of pay', *Renewal,* Vol 5, No 2, 1997, p38.
13. See, The Labour Party, *New Labour Deserves Better,* Labour Party 1997, p15.

than the 'old monetarism' (for example, emphasising skill formation rather than the reduction of benefits), this would be to overlook the implications of the 'welfare to work' programme with the reductions of benefits for lone parents and the threatened reductions in benefits for the disabled. This continues the tradition noted by Galbraith: to get the poor to work, reduce their income, to get the rich to work, raise their income. We should also be wary of appeals to flexible labour markets: this is a euphemism for short-term contracts, for temporary work and fluctuating wages. The aim should be for flexible organisations which can respond to change, but which provide stable employment and have reasons to provide training. The aim should also be for flexible workers who have a range of skills and undertake a range of jobs.

The approach of'new monetarism' to economic policy has two fundamental weaknesses. First, the Bank of England, seeking to establish a reputation as an inflation hawk, will push up interest rates at (or before) the first signs of rising inflation. Unemployment below the NAIRU is taken as evidence that inflation will begin to rise, and the Bank of England steps in to deflate the economy. Since the election of 1997, the Bank of England's Monetary Policy Committee (MPC) has raised the rate of interest no less than five times, precisely on the grounds of the economy being overheated (this is at the time of writing, mid-December 1997). These implications of the operational independence of the Bank of England, a pre-requisite of the UK's membership of the European Monetary Union, will be replicated by the European Central Bank once the single currency is introduced in the EU. There is, thus, considerable deflationary bias introduced into the system. The prospect of inflation from a decline in unemployment leads to interest rates rising, slowing down the economy. But further, the slowing down and the high interest rates impact on investment, and that makes subsequent upswings more difficult to sustain as the expansion hits capacity constraints well before full employment is reached.

Second, while it is a worthy objective of economic policy to have people who are more 'employable', the question remains as to whether there will be sufficient capacity on which they can work and sufficient demand to buy the goods and services which they are capable of producing. Policies to ensure high levels of investment in plant and machinery as well as in people and to create productive capacity in the particularly deprived areas of many inner cities are required. It is also necessary to encourage a high level of demand, through government expenditure, exports and investment. If there is a budget deficit as a result of the higher government expenditure, so be it: it is a price well worth paying. In the longer run it may not even be a price. Higher economic activity would generate more government revenue and lower unemployment benefits, which should imply smaller deficit than otherwise. However, the conditions for membership of the single currency (the Maastricht criteria, including limits on budget deficits) would not allow such an expansion to take place. In any case, the likely over-valuation of sterling, emanating from the operation of the Bank of England, would adversely effect the generation of high levels of demand.

Blair has argued that, 'Unemployment is not just a social problem, but an economic problem as well. The Tories' indifference to the climb in long term unemployment in the 1980s and 1990s is indefensible. We must make a clear commitment to get long term unemployment down'.[14] This focus on the reduction of long term unemployment is indicative of 'new monetarism', as it sees long term unemployment as eroding skills and the work ethic, loosening ties with the labour market, but also not having any impact on inflation. Thus long-term unemployment can be reduced without risking inflation, but not short-term unemployment. Strategies to reduce long-term unemployment include the usual gamut of supply-side measures. But what is not included is any sense of where the jobs for the long-term unemployed are coming from, especially without reducing the jobs that would have been available for the short-term unemployed. The concentration of the long-term unemployed in particular areas requires that jobs be created in those areas: it is as much a problem of job creation as of employability.

'New monetarism' would be central to the operation of the European single currency. Monetary policy would be in the hands of an 'independent' European Central Bank ('independent' being a euphemism for undemocratic) which will have the objective of low (or zero) inflation, to be achieved through the manipulation of interest rates. Fiscal policy will remain in the hands of national governments, though constrained by the 3 per cent of GDP deficit rule (think what that would have meant in 1991 when in the face of recession the deficit in the UK rose to 8 per cent of GDP). Fiscal and monetary policies will be

14. Tony Blair, 1995, op.cit., plO.

uncoordinated: 'The third problem which undermined the effectiveness of monetary policy during the 1980s was the failure to use monetary and fiscal policy in a co-ordinated fashion'.[15] So what does the government do? It gives operational independence to the Bank of England, thus reducing the possibilities for the policy co-ordination! Whilst there are many other issues concerning the single currency (such as the lack of convergence between economies over a wide range of economic variables and institutional arrangements from levels of productivity and employment through to the arrangements for wage and price determination and the structures of the financial system, plus the lack of labour mobility between European economies in comparison with the United States), the centrality of the 'new monetarism' to the project should be seen as a major obstacle.

Financial markets have always posed problems for governments, especially Labour governments, and placed constraints, sometimes severe ones, on economic policy. The globalisation of financial markets and the very much greater flows across the exchanges have served to increase those constraints. But what is different about 'new monetarism' is the appearance of welcoming those constraints, or at least regarding them as benign. If the markets are all-knowing, then they serve the very useful purpose of keeping governments on the straight and narrow. This was expressed by Blair in the following: 'Errors in macroeconomic policy will be punished rapidly and without mercy' - financial markets are right, governments can be wrong.[16] Better to have the financial markets tell you that a policy is not credible than to implement the policy and find that it fails. We would all have to accept that financial markets are powerful and can make or break economies. A number of examples where financial markets imposed their will include Mexico in late 1994, South Korea, Thailand, and other Far Eastern economies in late 1997. These are cases where the economy concerned was pursuing neoliberal policies, especially financial liberalisation policies, but were nevertheless undermined by financial markets. Furthermore, sterling's membership of the ERM in the early 1990s is an example of financial markets welcoming sterling's entry into the mechanism, and then being largely responsible for its exit. Rather than seeking ways of reducing the

15. *Ibid*, p7.
16. Tony Blair, speech to the British American Chamber of Commerce, 11 April 1996.

power of financial markets, 'new monetarism' appears to welcome the guidance of financial markets.

Previous Labour governments have recognised the problem of low levels of investment. In the Labour Party manifesto there were passing references to the need to build up investment, though usually with reference to training and education. There is, however, little by way of clear proposals for increasing investment and creating the necessary capacity so that full employment can be restored. The little there is clearly suggests a policy of making the UK attractive to inward investment. 'With Labour, British and inward investors will find this country an attractive and profitable place to do business'.[17] If this has any meaning, it must be the first time that a Labour government has proclaimed that it seeks to shift income from wages to profits. Whatever the merits of inward investment, government policy should be directed towards ensuring that the gains of that investment accrue to the British people and not to the multinational enterprises. Further, there is little reason to think that inward investment will create jobs in areas of high unemployment, and does little to encourage local entrepreneurial activity: it is more like the promotion of a dependency culture.

The policies so far pursued by the new Labour government can be seen as the final triumph of monetarism and the defeat of Keynesian economic policies. The central concern of government policy is with inflation and with the appeasement of the financial markets, whose judgement on economic policies is accepted. The thrust of policy forgets two essential requirements for full employment: sufficient aggregate demand and adequate productive capacity. Only when those requirements are addressed will there be any prospect for the achievement of full employment.

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17. Labour Party 1997, *op.cit.,* p15.