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Why the purchasing power of wages fall

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The Series: Economic Briefs

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Why the purchasing power of wages fall

The logic of monetary theory is represented by an identity known as the Quantity Theory of Money (QTM). In the first Economic Brief, “Why monetarism does not work” the ineffectiveness of the Quantity Theory of Money was explained. And yet, this identity is used to justify monetary policy decisions.

Before the publication of John Maynard Keynes, “The General Theory of Employment, Interest and Money” most regarded the economy as an equilibrium between supply side production of goods, services and capital goods and this process affording wages that, in sum, constituted consumption or demand. This model was explained by Jean Baptiste Say (1767-1832), the French economist. Say also made clear the importance of people who organized production and were able to increase efficiency and productivity. In the Say economy, entrepreneurs saved from current production to invest in better production techniques leading to moderated or even lower unit prices leading to a rise in the purchasing power of wages.

Running up to the 1929 New York Stock Exchange Crash, excessive amounts of money was being injected into the economy. These funds were not going to supply side investment, but rather, were used to speculate on the stock market. By having so much money flowing into such a non-productive activity much was lost when the crash came. Many lost their houses, a long period of inadequate investment meant purchasing power of wages had stagnated. With the failure of stock investments there was a decline in demand which cascaded into loss of employment and the Great Depression.

The Say Model had been undermined to excessive monetary injections into the economy. The document “Why monetarism does not work” described how money injections distort sector activities and create differentials in performance and employment. In summary, if monetary flows are not managed effectively, the equilibrium demand, represented by wages and the productivity of the supply side that pays those wages, will cause disequilibrium and failure. To be plain, it was the lack of control of monetary injections that cause the Great Depression and not the inability of the Say model to avoid the Great Depression. The responsibility for avoiding the Great Depression lay with those controlling and monitoring the money supply.

Keynes’ General Theory, did not appear to spend any time reviewing the Say Model to see how better investment and productivity, as a future solution to sustaining wages to maintain consumption and demand. He placed more emphasis on money injections based on government debt and the use of this money in public expenditure. He replaced the central tenet of the Say Model, producing adequate wage levels, with consumption and demand being dependent on monetary injections.

This “new” way of looking at things took hold as a result of this being heralded as a solution on how to avoid the dreadful state of affairs experienced in the Great Depression. In parallel, economists began to blame the Great Depression on “flaws” In the Say Model without admitting that the disequilibrium created was the result of a lack of any effective oversight and management of money volumes. Part of the problem has been that banks had used depositor funds to advance loans used to speculate rather than use in productive investment.

Subsequent financial regulatory legislation separated the functions of retail banking from investment banking. As a result, between 1945 and 1965 the UK economy returned to a close-to-Say Model when demand rose as a function of wages in a period of unprecedented real growth and reduction in income disparity. This so-called “Golden” period has been associated with Keynesian policies. However, no Keynesian policies were applied during his period as the analysis completed by Robin Matthews[1] confirmed when the current account of the country remained positive, unemployment was really low and policy, if anything was highly deflationary.

The false logic arising from Keynes’ work and the QTM is that money volume can be equated with demand and as demand rises unit prices also rise in the form of inflation. Inflation means a decline in

[1] Matthews, R.C.O. (1968). “*Why has Britain had Full Employment since the War*?”. Economic Journal, 78(311): 555–569.

purchasing power because with a fixed nominal wage, price rises mean that less real products and services can be purchased.

In 1975 a significant rise in petroleum prices which set a trend for the following 20 years, caused significant cost rises in many petroleum importing countries. As a result, unit output prices rose in response to this cost-push inflation. Since under these circumstances wage rates froze and demand fell, the result was a cascade of rising inflation combined with rising unemployment, or slumpflation.

In 1975 development work was initiated to review economic theory and practice in order to devise a solution to this predicament. This resulted in the emergence of the "Real incomes Approach to economics". At the same time, another approach entitled "Supply Side Economics" was developed. Paradoxically, the Real Income Approach to economics is directed at supply side decision making to augment productivity and real incomes while Supply Side Economics has no supply side foundation at all but is a fiscal variant that lowers the marginal tax rates of the higher income earners on the assumption that their decisions will create a "trickle down" impact.

On the other hand, the Real Incomes Approach established that inflation was generally caused by cost push inflation, not only in the slumpflation period but also in periods of so-called price stability. The more recent evidence generated by 12 years of quantitative easing (QE) has proven the Real Incomes Approach to be correct. No matter how much money QE has injected, inflation has only become mainly evident in cost-push inflation resulting from rises in land and real estate prices, as explained in the document, "Why monetarism does not work".

The Keynesian policy instrument of centralised interest rate fixing, money injections and use of fiscal mechanisms such as variations in taxation were unable in theoretical and practical terms to bring slumpflation under control. It is paradoxical that many governments accepted that monetarism, as a theory and policy could help control slumpflation. However, the monetary policy instruments are, in reality, the same as Keynesian policy instruments, i.e. centralised interest rate fixing, money injections and use of fiscal mechanisms such as variations in taxation

Because Keynesians and monetarists apply the same flawed Quantity Theory of Money that equates inflation with excessive money, attempts were made to tame the inflationary component of slumpflation with very high interest rates. This, of course shrunk demand even further leading to a near collapse of the economy and nearly a million people losing their homes and wages were depressed even further.

In the background monetarists and the financial intermediation service sector became concerned that the value of their assets could decline and they lobbied heavily to remove the financial legislative controls over banking. The argument was that, "getting rid of red tape" could generate demand through more money injection. Starting in 1991 major changes were introduced to remove financial regulations leading to the phenomenon of "financialization". In reality, this has begun in 1971 when Nixon came off the gold standard[2] and through the 1970s there was a rapid development financial instruments, options and derivatives trading that created markets whose value exceeded that of the national economy in a "grey" encapsulated market.

In the period 1945-1965 in a close to Say Model, income disparity fell and the purchasing power of wages grew and with this the general standard of living of the majority rose. Since 1975 through to 2007 income disparity increased as the purchasing power of wages declined. On the other hand, asset values increased on an increasingly speculative basis until in 2007 many financial instruments held by banks which they had been sold under fraudulent schemes, by other banks, turned out to be worthless. Confidence fell and the system collapsed, in a parallel sequence of events to the 1929 Crash which occurred when confidence in the share values collapsed.

Gordon brown had made the mistake of making the Bank of England independent and the financial services industry had, as a result, become the main source of influence over monetary policy. The government was in no position to handle the threats made by the bankers of "sinking " the economy if they did not receive a bail out from the government and administered by the Bank of England. The

[2] The demise of the Bretton Woods agreement and the gold standard is the subject of another brief in this series.

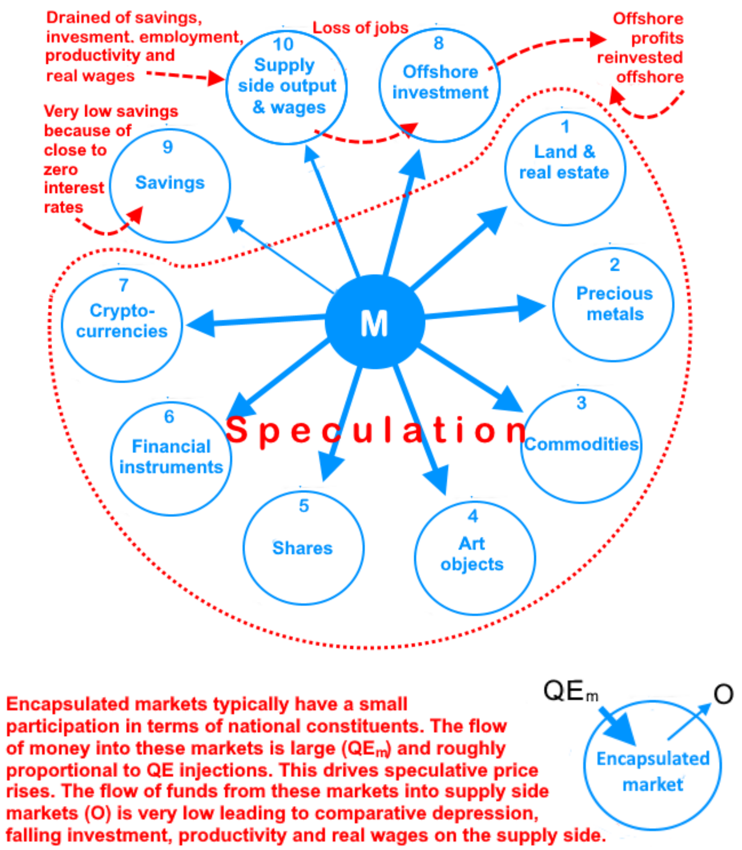
result was QE and for the last 12 years, as explained in the document, "Why monetarism does not work" major flows on money have been directed into several speculative asset markets and the supply side, the generator of employment and payer of wages, has been unable to access such funds because of high interest rates. As a result, inflationary leakage from the asset markets of land and real estate has created a rising cost-push inflation over the last decade leading to a constant decline in the purchasing power of wages.

Conclusion

No matter what is declared as being the beneficial intent of monetary policy in ensuring prosperity, the track record of 30 years of which 12 have been under QE demonstrates that:

- The purchasing power of wages of the majority has constantly declined
- The wealth of asset holders as a tiny minority, has constantly risen
- The wealth and income disparity in the United Kingdom have constantly risen while between 1945-1965 it had declined
- Leakages into offshore investment has reduced onshore employment and therefore demand for domestic products; reinvestment of offshore profits in offshore expansion has resulted in less productive investment onshore
- Monetary policy has displaced the working population as the source of demand and replacing this with exogenous money, in line with Keynesian and monetarist theory and practice
- In terms of democratic principles, the tenets of Keynesianism and monetarism followed by an independent Bank of England, undermine representation of the needs of the majority
- Parliament and political parties have no effective oversight or decision-making power over this disastrous trend because the Bank of England is "independent"

A summary of impacts of quantitative easing[3]



[3] McNeill, H. W., "*"Strategic Review - A summary of impacts of quantitative easing*", DAI 2020-2030, RIO, SEEL-Systems Engineering Economics Lab, January, 2021.