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ECONOMICS FOR THE EXASPERATED

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GORDON RATTRAY TAYLOR

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Diagram 8, *Trend of Prices—Britain*, is reproduced by kind permission from *An Introduction to the Study of Prices* by Geoffrey Crowther and Walter Layton. Diagram 21, *Decline of British Foreign Trade*, is based on figures given in an article by Professor Henry Clay which appeared in the *Economic Journal*.

'You couldn't have it if you *did* want it,' the Queen said. 'The rule is, jam to-morrow and jam yesterday—but never jam to-day.'

Through the Looking-Glass

'If capitalist society rejects a more equal distribution of income, and the forces of banking and finance succeed in maintaining the rate of interest somewhere near the figure which ruled on the average during the nineteenth century, then a chronic tendency towards the underemployment of resources must in the end sap and destroy that form of society.'

LORD KEYNES (1937) *Galton Lecture*

Introduction

'I should like to have it explained,'
said the Mock Turtle.

IT WAS only a few weeks after the end of the second World War that we again read of fishermen dumping their catches back into the sea. Then we were sure that peace had really come at last. Soon, we knew, we should hear of coffee being burned, wheat being destroyed and cotton ploughed back into the ground. Then it would only need a rising unemployment rate for everything on the economic front to look normal again.

As I write we are in the midst of a severe labour shortage, and to many it will seem academic to talk of unemployment. 'With all this rebuilding and replacement to be done', people protest, 'how can there be any danger of unemployment?' Memories are short. There was plenty of building to do in 1931, plenty of people who needed feeding and clothing, but that did not prevent about three million people being out of work. The existence of unsatisfied human needs is not enough to create work; there are disharmonies in the economic machine which engender unemployment irresistibly. It would not be a very serious gamble to bet that, by 1950, at least ten million people in Britain and the United States will be unemployed.

This is not to say that the world will exactly repeat the mistakes it made in the inter-war years: it will make the old mistakes in a new way. For the world has moved on since 1930. The industrial west (we must face it) has abandoned the old, haphazard economics of Adam Smith and is groping its way towards something new. Only the United States, dizzy with the insubstantial prosperity of war-time, is set on retracing its steps towards laissez-faire, but as soon as it has suffered the shock of a new and more terrible depression, it will hurry after the rest.

For, despite this floundering attempt to avoid depression, the western world will not escape the slump. The causes of its malady lie rooted more deeply in its system than it is ready to believe. It is in an attempt to lay bare these causes that this book has been written.

Unemployment is not, as most people suppose, a specific disease curable by specific remedies. It is merely the index to underlying maladies, just as a high temperature is the symptom of many a bodily disease. To cure it, you must readjust the whole economic system and bring it into harmony. A book about unemployment is a book about every aspect of monetary economics, at any rate as far as it concerns itself with quantities rather than qualities. If unemployment is our theme, therefore, it is only as a thread on which to string many contrasting beads.

The world is searching for something. It is dissatisfied with things as they are. That much is obvious from the books that are being written and the experiments that are being tried: socialism, communism, fascism; from the demands for national independence and from the endless conferences which are being held. What are the economic factors in its discontent and how do they influence the solutions which are attempted? Clearly the right of every man to a fair share in the world's potential output of goods and services is an indispensable condition of contentment. It is not only a question of unemployment. Anything which holds down the standard of living below the limit set by technical resources is equally a cause of unrest and resentment.

To-day the subject of unemployment threatens us with an added danger. In the past, when the economic system was out of joint, it meant that some people lost their jobs or could not sell their goods. But to-day we have entered a phase in which people are trying to control the economic system by various means with the result that we in danger of losing some of our liberty.

JOBS OR FREEDOM?

Books have been written and societies founded to propagate the argument that it is better to put up with unemployment for some than to sacrifice the liberty of all. With the evidence of Germany and Russia before their eyes, many people are prepared to believe that unemployment can only be conquered at the cost of a degree of control so oppressive, so destructive of individual

freedom that the remedy is worse than the disease. Nevertheless, the experience of Germany suggests that, when it comes to a choice, many people are liable to set a higher value on security than on freedom. But must it come to a choice? Cannot we sail between the Scylla of slumps and the Charybdis of serfdom?

Broadly, the answer is that our economic system is inherently unstable. Left to itself, it will always produce unemployment. Hence we have the alternative of making drastic changes in our method of doing business, so as to make the system self-stabilizing, or (if we shy at this prospect) of introducing a degree of control sufficiently firm to pull the system into balance. We shall see in the course of the book just what are the variables which require control and can form our own opinion as to how that control might best be applied and whether it is likely to prove irksome or not.

The danger that liberty may be sacrificed, the danger that unemployment may be left to flourish are at least straightforward and readily recognizable. Unfortunately there is also a more insidious possibility. There is a way of achieving full employment at the cost of holding down the standard of living. The disruptive social effects of unemployment are avoided without endangering profits. And there is a still more serious disadvantage, for when full employment is achieved by a country in this way it is generally at the cost of inflicting greater unemployment on the countries with which it trades. Naturally the victims turn to desperate remedies. Thus this policy plays a critical part in fomenting the outbreak of wars.

It is becoming increasingly clear that powerful interests in Britain and the United States have committed themselves to avoiding mass unemployment by this unsavoury means.

POST-WAR PROSPECTS

The achievement of full employment is, of all post-war problems, the most urgent. It is vain to aim at building a better society until we can be sure that monetary mistakes will not prevent the men from getting to work on the designs. If we are

to carry out the schemes of rebuilding and social improvement we have in mind we shall need all the manpower available.

At the same time as it creates a demand, the need to rebuild the world, literally and metaphorically, after the destruction of a world war, provides us with an unequalled opportunity for tackling economic reforms. Prejudices have been broken up. People are prepared to try new ideas. The collapse of old methods, old conventions, has created a vacuum. Into this vacuum something must be put. Such an opportunity may not recur for many years, perhaps for centuries.

Let us start, then, with a preliminary reconnaissance of the unemployment problem; let us block in the main outlines of the subject.

I

Nature of Unemployment

Of course the first thing to do was to make a grand survey of the country she was going to travel through. 'It's something very like learning geography,' thought Alice, as she stood on tiptoe in hopes of being able to see a little further. 'Principal rivers—there are *none' !*

APPROACH TO the subject of unemployment is complicated by the fact that many people firmly believe that they know quite well what causes it, when in reality they are wrong. The commonest of these misconceptions is the belief that the main cause of unemployment is the introduction of labour-saving machinery.

Undeniably, it is true that if the introduction of machinery enables you to make (let us say) all the soap needed by the community with half the labour formerly required, then a number of soap-makers will be thrown out of work. But in a sane economic system they would soon be found work making something else that people needed—something which, for lack of manpower, they had previously had to do without: refrigerators, maybe, or lawn-mowers. Surely in a world which contains so many people who are short of the barest necessities of life (even in peace-time) anything which enables a man to produce more goods is a blessing and not a disaster. True, if your monetary arrangements are such that the community cannot afford to buy all the additional output, men will be thrown out of work. Instead of using the machinery to produce more goods from the labour of the same number of men, you are using it to produce the same amount of goods as before with the labour of fewer. But don't blame the machinery for such idiocy, blame the monetary arrangements.

While a remarkable number of people still blame machinery for unemployment, there is to-day a considerable band of those who have gone to the other extreme. They have realized that if

people had more money—or, more accurately, *purchasing power*[1]—they could afford to buy those extra goods which machinery can produce but which now remain unsold. In the excitement of this discovery they make the mistake of concluding that shortage of purchasing power is the only cause of unemployment. It is highly important and also the most baffling: for that reason much of this book will be concerned with it: but it is by no means the only cause. Unemployment is, as has been mentioned, the index of a variety of economic maladjustments—just as loss of performance in a car may spring from several faults all present simultaneously.

Orthodox economic textbooks will tell you that there are four main types of unemployment. It would be more accurate to say four main causes of unemployment, for, of course, there is really only one type of unemployment, and that is not having a job. The classification is, of course, purely a matter of analytical convenience: the various causes interact and overlap to such an extent that it is rarely possible to point to a particular group of unemployed men and identify the cause of their unemployment as Type A or Type B. Nevertheless, the distinction will serve as a starting-point, so we will begin by indicating these four groups in order to get a bird's-eye view of the problem.

1. *Structural Unemployment.* At any given moment the industry of a country consists of so many factories producing this type of goods, so many factories producing that, together with various power-stations, coal-mines, steel-plants, shops, railways, roads and other facilities. At a later date, even though the total volume of output may possibly be the same, the relative quantities of each particular class of goods being produced will have changed. Thus there may be fewer gasworks, more electric power-stations, fewer textile factories, more film-studios, and so on. This is referred to as a change in the *structure* of industry.

When demand changes, the structure of industry must change accordingly. When women discarded tight-lacing and shortened

[1] You might double a man's wages, but if prices happened to rise to double about the same time, his *purchasing power* would remain unchanged. Correspondingly, when prices are falling people's purchasing power is rising even though wage-levels are steady. It is, therefore, simpler to talk about purchasing power and avoid having to specify anything about prices.

their skirts concerns making crinolines and whalebone corsets became superfluous. At the same time more factories making sweaters, elastic belts, etc., were needed. A change of this sort produces unemployment for a time. The process of firing hands in the whaling industry and taking them on in rubber-growing cannot be carried out overnight. New factories have to be built. People have to be retrained. It is easy to see that individual members of whaling crews may never find another job. They may be too old, too unenterprising, too obstinate, or they may be anchored by their families to a district where jobs are hard to get.

There are three direct causes of structural change in industry —apart from the painfully familiar one of adapting it to the needs of war. Changes in social habits, like the one we have just mentioned, are certainly the most numerous. Equally drastic are changes due to technical progress. The perfection of the motor-car meant unemployment for ostlers and grooms and harness-makers. It meant, ultimately, an enormous volume of employment in the automobile industry. But once again such a change-over cannot be made smoothly. Many grooms were too old, too set in their ways, to find work in new industries. This type of unemployment is sometimes given a special name: it is called *technological* unemployment.

Thirdly, structural changes are caused by the activities of other countries. As backward countries become industrialized, they begin to make at home many things which they had previously bought from long-industrialized countries such as Britain and the U.S.A. Moreover, their people are often accustomed to low wages, so that their goods can be sold at a low price; as a result they not only make what they need themselves, but proceed to sell it to their former supplier. In this way, Japan began to sell cotton goods to Britain. In consequence, unemployment developed in the British cotton industry.

There is a fourth type of structural unemployment which is rather different in nature from those just mentioned. From time to time certain sections of industry are expanded to an unjustifiably large size through errors of judgment on the part of the business men who run them. The commonest instance is when a large number of firms hasten into production to fill some

newly-created demand—let us say, for the sake of argument, radio sets—then after a few years the stage is reached when everyone who wants (and can afford) a set has got one, and demand falls to a fraction of its original level.[1] At this stage the industry casts hastily about for some 'improvement' which will persuade people to scrap their existing sets; or it seeks (as in the car industry) to start new fashions which will make people dissatisfied with what they have got. If it does not succeed in this wasteful process, it is forced to contract and content itself with the replacement of genuinely worn-out goods. This is a particularly dangerous factor after a great war. There is a big temporary 'replacement demand' for many goods which have been in short supply, but it soon subsides to normal levels.

Here the logical thing to do would be to limit the number of firms entering the new field, even though this would mean that some people would have to wait longer for their goods. And once saturation had been reached, it would be sensible to set about transferring the surplus labour-power to meeting some genuine need elsewhere, instead of stimulating demand artificially by the introduction of new fashions.

Of course, the error of judgment (as we have called it) is not always due to lack of foresight on the part of the business man; in many cases he realizes what is happening, but either banks on being able to sell his business to someone of less foresight before the decline comes, or is prepared to write it off as a loss. In so doing, he does not have to consider the effect on the workers thus suddenly deprived of their jobs.

In other cases, maladjustments of the relative size of different parts of the industrial machine occurs through lack of central planning and co-ordination. For example, a man may go into the manufacture of small steel goods, not knowing that the steel manufacturers have just decided to restrict output of raw steel and raise its price. When they do so, he finds he cannot work at a profit and the factory he has caused to be erected is useless. Or a man might start a factory for supplying road-making machinery,

[1] In economic jargon *demand* or *effective demand* means not merely the desire for something but desire plus the purchasing power required to make it effective.

without knowing that the government had decided to reduce its road-building programme. The name *horizontal maladjustment* is given to these disproportions in the relative size of different parts of industry. The current coal shortage is a vivid instance.

I must not omit to mention a further important cause of structural unemployment which is too frequently left out of consideration by statesmen and planners—changes in the distribution of income. If you impose a tax which falls most heavily on the rich in order to raise the incomes of the poor—let us say, to increase pensions—you reduce the demand for cigars, wine and Rolls-Royces and increase the demand for trams, beer and cigarettes. To a less drastic extent, all redistributions of income and even changes of price tend to alter the way people spend their money, and so create structural changes.

But changes in the income structure are not only caused by government action; they also spring from our curious division of incomes into wages and profits. In good times profits rise sharply, while wages remain constant; as a result, demand for luxuries increases. After a while the trades unions obtain wage adjustments; result, the structure of demand reverts to something nearer its old shape. Similarly in bad times, profits fall, and demand for luxuries—especially for durable goods like cars and houses—falls off. Nor is this all: for in bad times labour is discharged, and so the total wage-bill declines even if the level of wages per head is maintained. In short, changes in the volume of employment due to changes in prosperity bring about structural unemployment as well.

Finally, structural unemployment may also be caused by a change in the foreign exchange-rate, making it cheaper, or dearer, to buy goods from abroad, thus changing the terms on which they compete with home-produced goods.

2. *Transitional Unemployment.* This term is used to describe short spells of unemployment between one job and another caused by inevitable slight frictions in the working of the system. Even in an industry working at full capacity, as in war-time, slight variations in the demand for labour cannot be eliminated: a batch of components may be late in arriving from the sub-contractor, for example.

Transitional unemployment becomes serious in an industry like shipbuilding. When one liner is finished, another cannot immediately be put on the stocks—except in war-time. And even if it could, certain jobs, *e.g.* painting the hull, would always tend to be spasmodic. Only careful long-term planning of the building programme, by which different yards would have ships in different stages of construction at the same moment, can minimize this type of unemployment.

Often included with transitional unemployment, though it really deserves a separate category, is the big labour turnover due to personal causes. A woman leaves a job because she wants work nearer her home. A man doesn't like the foreman and leaves—or picks a quarrel and gets fired. This type of unemployment is low in bad times, but very high in good times. As unemployment is reduced, and labour shortages develop, this changing of jobs becomes more and more serious. In Russia, it was found such a nuisance that (in 1930) all unemployment insurance was banished, and later a complete ban on changing jobs was imposed on certain types of worker. Obviously it is a cause of inefficiency, because time is wasted training people who leave as soon as they become fully useful. If unemployment is to be conquered in Britain it is difficult to know how this problem can be tackled—people would almost prefer unemployment to a ban on changing their jobs at will.

3. *Seasonal Unemployment.* This term probably explains itself. Where unemployment is truly seasonal, there is little one can do to alleviate it, except to try and dovetail complementary types, just as ice-cream vendors become roast-chestnut men in winter. In the case of low-grade labour, alternative employment can sometimes be provided on long-term public works, such as building and road construction.

But much of our seasonal unemployment has nothing to do with the seasons, in the climatic sense. There are, for example, marked seasonal fluctuations of employment in the automobile industry. These fluctuations could be reduced by intelligent planning of the production programme to this end. But if people demand goods more strongly at a particular time of year the manufacturer will have to build up a stock against the seasonal

demand (which costs money) or else there will be delays in delivery. So the first line of attack must be to persuade the public to spread their demand more evenly over the year. (The Ministry of Fuel tried to do this with coal during the war.)

PROBLEMS OF STRUCTURAL UNEMPLOYMENT

Structural unemployment is always with us. It was known in earliest times, but to-day it assumes an unprecedented magnitude, since the main causes of structural change are more active than ever before. All over the world backward countries are busy industrializing themselves, learning to make at home goods they formerly brought from abroad; first Australia and Canada; then Russia and mid-European and South American countries; now, India and China. The rate of technical progress gets faster rather than slower. Social changes proceed apace.

Obviously we cannot put a complete ban on change. The structure of industry must be allowed to change or there can be no progress. Nor can we ever entirely eliminate seasonal and transitional unemployment. Consequently there is always bound to be a certain amount of structural unemployment. Some authorities put the minimum it can be reduced to at 4 per cent of the working population, which in Britain means about half a million men. Personally I think the figure too high—but whatever it is, clearly we cannot ever 'banish unemployment' completely. Any politician who promises there will be 'no unemployment' reveals that he doesn't know the first thing about the subject. What we *can* hope for is that there shall be, at any given moment, a considerable number of unfilled jobs, so that anyone who becomes unemployed can count on getting a new job without much delay. The term 'full employment' is usually defined in this way. However, it is not enough to provide an adequate *number* of jobs, they must also be the right kind of jobs: it is little use offering manual labour to elderly bank-clerks, shorthand-typing to out-of work coal-miners or jobs in Scotland to people with homes in Penzance.

But while we cannot eliminate structural unemployment, we could certainly do a great deal more than we do to eliminate

unnecessary changes and reduce the friction of the necessary ones. At present we do nothing. We make no attempt to discriminate between desirable and undesirable changes. For instance, we permit motor-car manufacturers to change the design each year just in order to make last year's model look out of date, regardless of unemployment while they retool their factories. We accept the right of producers to start a 'craze' for some novelty if they can, or to over-expand an industry in response to some short-lived demand. The government is just as guilty. It passes legislation (such as that introducing paid holidays) with hardly a moment's consideration of the structural changes which will result.

Nor do we do much to smooth the path for necessary changes. We do not try and discourage people from entering declining or over-staffed trades; we do little to retrain those who have been left high and dry for a new job in some other field.

As a matter of fact we pay very little attention to structural unemployment altogether. It seems to be the 1931 depression which is responsible for the tendency to neglect these structural problems. The thought which dominated the minds of so many people during the post-slump period, and produced such mistaken conceptions as Social Credit, was: if only we could get more money into people's pockets, they could go out and buy the things they need and, so doing, give work to the unemployed. No one would attempt to deny the existence of this problem of deficient purchasing power, or to underrate its importance, but it would be a great error to suppose that the provision of purchasing power alone would banish unemployment. As a matter of fact, the immediate result of creating new purchasing power would be to add to unemployment by creating new structural dislocations.

The trouble is, labour is not a homogeneous entity, like water or money. You cannot put any man in any job. As you increase purchasing power you will find many industries short of labour—that is, of the particular types of skill that they need—while massive unemployment still exists in other fields. If you then increase purchasing power still further you will not succeed, to any great extent, in drawing labour from the unemployed groups into the industries which are short-staffed, either because the skill or the will is lacking or because workers are tied to certain

areas by personal considerations. All you will succeed in doing is in forcing up prices of the goods which are most in demand, which will enlarge manufacturers' profits, create further changes in the structure of demand (and hence more structural unemployment), and, as we shall later see, probably bring on a slump.

The reduction of structural unemployment presents a practical problem of great complexity. Broadly, it must be attacked on two fronts. (1) Unnecessary structural changes must be eliminated, and necessary ones reduced to the minimum compatible with the community's real interests: (2) Labour must be made more adaptable. Many structural changes proceed with unnecessary violence: the pendulum swings too far and a new change in the reverse direction sets in: we have already mentioned the case of manufacturers who rush in to fill a suddenly-created want of brief duration. Such movements must be controlled. Again, unemployment can be reduced by matching opposing changes: the expansion of one industry can be used to offset the contraction of another, if the location of new enterprises can be controlled. At present an expanding industry is likely to start in an area where other industries are expanding, thus adding to the labour shortage there, while if it had been located in the same town as a dying industry, the dislocation would have been reduced to a minimum. On the other hand, labour can be made more adaptable. Training could be provided to re-fit men *before* they had been discharged from a declining industry. Assistance could be given in transferring households to areas where labour was in demand.

The question of whether to move the people to the work or the work to the people is easy to decide if we are chiefly interested in maximizing human happiness, for people are attached to districts they have long lived in by homes, families, friendships and many other ties of a sort which economics ignores. But for some strange reason we have made up our minds that it is 'control' ('despotism' it was called the other day) to direct a manufacturer to locate a new factory in a depressed area, while it is 'liberty' to give hundreds of employees the choice between leaving their homes for a distant place or starving. So, without opening the whole subject of control at this point, we can at least see that it is not as simple as it is made to sound.

It is a comic sidelight on this situation that manufacturers carry on loud propaganda against what they rather vaguely call 'controls' and, in order to gain popular support, point with horror to the possibility that the individual worker might be 'controlled' *i.e.* compelled to come to their factories. These are definitely crocodile tears, because the more the worker is controlled, the less the manufacturer need be. Control of the worker is in the manufacturer's interest, but because he realizes that control of the worker but not of the manufacturer is too much to hope for, he prefers no control at all.

PURCHASING POWER

The types of unemployment so far considered are straightforward in conception and easily grasped. Their cure may be tricky in practice, but the general objective is clear enough. We must now turn to something quite different in character: unemployment which is caused by maladjustments in the monetary and financial machinery which accompanies the physical processes of production.

4. *Cyclical Unemployment.* At this point I should like to be able to tell you that there are so-and-so many classes of monetary maladjustment; but the currently popular analysis makes no attempt to explore the field thoroughly—it does not even draw a clear line between monetary and non-monetary causes. It simply busies itself with what it calls *cyclical unemployment.* This refers to the rather well-known fact that industrial activity, and with it employment, rises slowly to a peak (the boom) and then falls back abruptly (the slump) about every eight years. It has continued to do this in every country in which records are available ever since the records started—in the case of Britain more than 100 years ago. This pulsation is commonly called the *trade-cycle.* Naturally, during the slump there is less employment than at the peak, and this is referred to as cyclical unemployment.

The causes of the trade-cycle are highly complex. Monetary factors play a big part; structural maladjustments develop too. Which is cause and which effect has been the subject of much fruitless debate. In the view of the present writer attempts to explain the trade-cycle in isolation from other problems will

always fail, for it is the by-product of a more fundamental type of unemployment which the theorists largely ignore.

5. *Basic Unemployment.* The recent tendency to concentrate attention on the trade-cycle has caused most economists to neglect a most significant fact; to wit, that there is an important amount of *non*-cyclical unemployment created by the same monetary maladjustments which cause the trade-cycle. This I shall refer to as *basic unemployment.*

Colin Clark, one of the few economists who have devoted themselves to getting down to the ascertainable facts instead of spinning airy theories, showed tentatively in his great work *National Income and Outlay* (1937) and in detail in his *Conditions of Economic Progress* (1941) that since about 1890 in America the total output of goods per head of occupiable population has remained roughly constant. In Britain, Germany, Canada, Norway and probably France, progress has not ceased, but has been very slow. Each new invention has enabled us, not to produce more than before, but to produce roughly the same amount with fewer men. Practically the whole of rising technical efficiency has been negatived by rising unemployment, or shorter hours. This little-known fact is of crucial importance. It means that a ghostly roof has been placed on economic progress. The old fear of the machine-wreckers has become true. When the Luddites destroyed the spinning-jenny because they thought it would mean unemployment, they were wrong; in the long run it brought more employment than before. But to-day it *is* true. Hence technological unemployment ceases to be merely a transitional thing, undesirable but inevitable, and becomes something far more serious.

The causes of these two types of unemployment, cyclical and basic, differ from those considered earlier in being far from obvious. Indeed they are difficult and obscure. It will take several chapters to explain them. Broadly speaking, it may be said that they are due to the monetary process getting out of step with reality.

MONEY AND REALITY

Throughout one's dealings with economics it is essential to remember that one is dealing with two parallel but quite distinct

systems. First, a system of real things—factories, goods, people—and second, a system of monetary payments. The golden rule is, always work out what is happening in terms of goods, and when you are clear about that, try and find out what monetary changes must have occurred to bring these real changes about. This principle is still more important when it comes to deducing policies for future action. First work out the changes you desire in the real world, then infer the monetary changes necessary to bring these real changes into being.

Put like this, it sounds absurdly obvious. But it is extraordinary what a grip money exerts over the mind. Every day we hear people put forward arguments in terms of money and conclude that certain changes in the real structure of production must be made in order to make the payments come right in the ledger. For instance, we hear people argue about the foreign trade balance, and conclude that the structure of production must be adapted to enable us to settle our debts. Really, of course, what we must do is to adapt the production structure in precisely the opposite direction so as to prevent these debts arising.

Basic and cyclical unemployment are due to the fact that the payments which provide factories and places in which to work, and the payments which provide incomes with which to buy the output of the said work-places, get out of step with the country's real needs in the way of factories, and people's real needs in the way of goods. Let us see how this comes about.

Summary

Unemployment may be caused by many different kinds of economic maladjustments. First, there is *structural* unemployment (the wrong quantities of workers and factories in particular trades) caused by changes in demand due to fashion, technical progress, the behaviour of foreign countries and other causes.

Rather similar in nature are *transitional* and *seasonal* unemployment.

There are also two classes of unemployment which spring from complex monetary maladjustments: *cyclical* unemployment which rises and falls every few years, and *basic* which converts each increase in productivity into added unemployment.

2

Basic Unemployment

'Well, in our *country,' said Alice, still panting a little, 'you'd generally get to somewhere else—if you ran very fast for a long time, as we've been doing.' 'A slow sort of country!' said the Queen. 'Now,* here, *you see, it takes all the running* you *can do, to keep in the same place. If you want to get somewhere else, you must run at least twice as fast as that!'*

THE STATEMENT, made in the last chapter, that the standard of living has remained virtually constant in America since the turn of the century and has shown a greatly-reduced rate of progress in Britain, Germany, and Canada and certain other countries, may seem so startling that figures should be produced to support it.

When I say 'standard of living' I mean the figure obtained by taking the *national income*—that is the sum total of all individual incomes—and dividing it by the working population, including the unemployed. This eliminates the effect of any increase in output due solely to a rise in the population or a rise in the proportion of the population accustomed to work. If we divided by the number of people actually in work, we should get a measure of how the output per person is increasing; what we want to find out is how far unemployment is negativing this rise in productivity, so we must include the unemployed in the divisor. Adjustments must also be made for short time and for the decline in the length of the working week. Professor Clark has made the necessary laborious calculations.

Properly speaking, this is not a true measure of the standard of living, for to assess it correctly we must also take into consideration what proportion of these goods are articles directly contributing to the enjoyment of the ordinary consumer, and what proportion are machinery, industrial buildings, raw materials,

etc. And in practice the way the total is distributed is also relevant. A more even distribution of incomes raises the standard of living of large sections of the population without necessarily bringing about a corresponding fall in the standard of living of the rich, who may prefer to reduce their rate of saving instead. Nevertheless, the phrase will serve as a handy abbreviation for the clumsy phrase 'average output of goods per head of occupiable population, including unemployed.'

Using this definition, we find that in the United States the standard of living had reached roughly $1400 for each occupied person by the year 1900. In 1937 the figure was the same. True, in prosperous years such as 1916 and 1929, it had climbed above $1600, but in slump years such as 1921 and 1932 it had sunk far below—in the latter year as low as $926. Had there been no unemployment in the United States, the standard of living might by 1937 have reached nearly $1900 per occupied person—nearly one-third more than was actually the case.

In the case of Britain the picture is only slightly less dramatic. Starting from a figure of about £116 in the 1860's a graph of income per head of occupied population shows a rapid rate of increase up to 1890, gradually tailing off until 1914 by when it was £196. Then progress ceased. For the next twenty years the line fluctuates about this figure, climbing to £207 in the 1929 boom, only to fall to £181 in the subsequent slump. Not till 1934 did it reach the 1914 figure again. Thereafter the line rises rapidly, but it cannot be assumed that it has burst permanently through the 'roof'—more probably it is the result of Britain's re-armament programme which did much to sustain employment.[1]

How then is it possible, in the face of these facts, for people (including the authors of the government White Paper on full employment) to go on talking about 'ironing out the peaks and troughs of the trade-cycle'—a process which would result in stabilizing unemployment at about 2,500,000 as far as Great Britain

[1] In all the above figures, due allowance has been made for price-changes during the period. The British figures have been adjusted to what they would have been if 1930 prices had ruled throughout the period; in the case of America, the average of 1925–35 has been taken as the base.

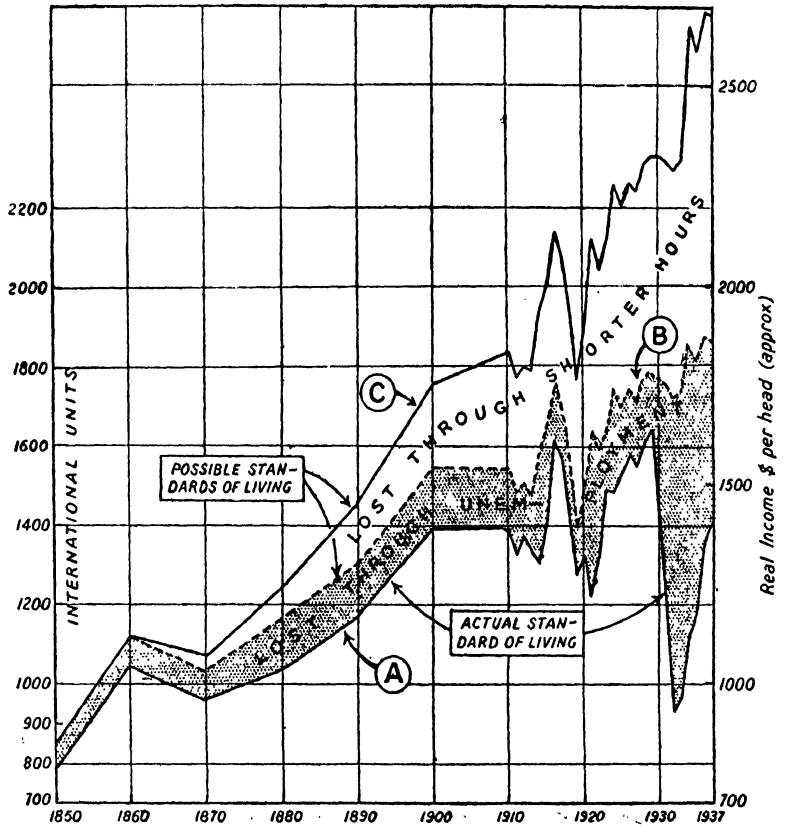


FIG. 1.—REAL COST OF UNEMPLOYMENT: (1) U.S.A.

This diagram shows, for the United States, how much material wealth is sacrificed by shortening the working day, how much by unemployment. Note how the standard of living has remained unchanged (when we smooth out the trade-cycle) since 1900, although productivity, as shown by the C-curve, has been rising steadily. Note also how each slump is becoming worse than the last.

A. Average income per working man (including unemployed).
B. Average income per working man, if there were no unemployment.
C. Average income per working man, if there were no unemployment and everyone worked a 65-hour week.

NOTE.—Figures prior to 1910 are only available ten-yearly and therefore do not show effect of trade-cycle.

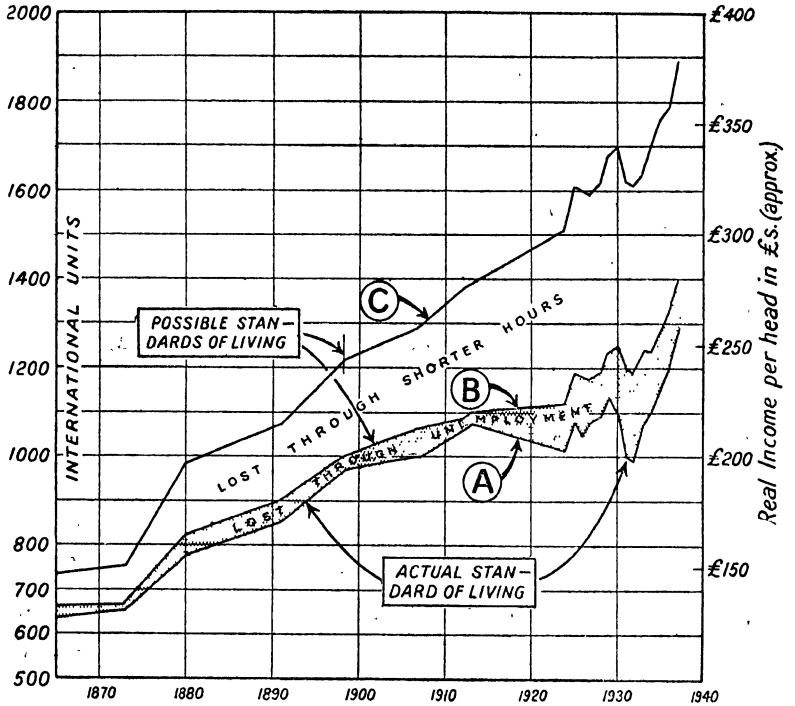


FIG. 2.—REAL COST OF UNEMPLOYMENT: (2) BRITAIN.

Similarly, this diagram shows the loss of material wealth due to shorter working hours and to unemployment in Great Britain. As before, the figures prior to 1924 are only available ten-yearly and do not show the effect of the trade-cycle. Note how small is the rise in the standard of living in thirty years between 1900 and 1930 compared with the rise in the period 1870–1900.

A. Average income for working man (including unemployed).
B. Average income for working man, if there were no unemployment.
C. Average income for working man, if there were no unemployment and everyone worked a 65-hour week.

is concerned? It is only slightly more intelligent to talk of 'stabilizing the boom at its peak', for even at the peak of the boom there are a million and a half unemployed. The politicians might reply that all these unemployed are the consequence of structural and transitional problems, but this is too much to swallow. It is too much to believe that even in a single country structural unemployment could by pure chance adjust itself over a period of forty years so as to keep output constant, meeting every technical advance in productive capacity with a new structural dislocation of just the right size. When we see something similar happening in other countries, the coincidence wears too thin. It is pretty clear that consuming power is for some reason remaining constant, and hence unemployment is absorbing every increase in productive capacity which does not happen to be absorbed by shorter hours.

How, then, are we to explain the appearance of this ghostly roof to purchasing power?

CAPITAL GOODS

Sooner or later in every discussion of economics you encounter the fact that the goods produced by man may be divided into two groups—things which are wanted for their own sakes, such as food, clothes, musical instruments, books, beer and films; and things which are only wanted as a step towards obtaining or producing the first group, such as machine-tools, mines, docks, power-plants, breweries and film studios. The first group is called *consumption goods*; the second, *capital goods*. Some writers call them consumers' goods and producers' goods, respectively.

There are many cases where, as a matter of strict philosophical accuracy, it is very hard to say which class an object falls into: for instance, a carpenter's chisel is certainly capital equipment as far as the carpenter is concerned, and so is a journalist's typewriter, but to the manufacturers of chisels and typewriters they are undoubtedly consumption goods, to produce which they have installed expensive capital equipment. We need not bother ourselves with such hair-splitting. For all practical purposes capital goods may be defined as goods which have been paid for by the process known as investment, *i.e.* with money saved up by firms or individuals and lent for an indefinite period,

in return for a share in the profits of the enterprise, if any. We include herewith any equipment purchased by firms from their reserves.

There is, however, one point worth making. The capital goods—the factories, power-plants, delivery-trucks and so forth—which supply us with consumption goods are collectively referred to as *consumption industry*. The factories, power-plants, mines, etc. which make the capital goods of which consumption industry consists are collectively known as *capital industry*. But confusion often arises because people fail to appreciate that capital industry also has to make the capital instruments of which itself consists. That is to say, Messrs. Armstrong-Vickers not only make lathes for installing in factories making such obvious consumption goods as motor-cars and radio sets; they also make lathes for installation in their own workshops and those of similar concerns. This fact will become significant when we come to consider changes in the size of the industry.

Capital goods, then, comprise not only factories, steel mills, power-stations and cargo-ships, but also hotels, cinemas, travel-bureaux, shops, railways and farms. The definition is complicated by the fact that the state has, in certain cases, taken over the provision of what are obviously capital goods, such as roads and docks, though it pays for them from revenue, not from saving; however, money which the citizen pays in taxes may be regarded as a kind of obligatory saving. The point is mentioned because expenditure on these kinds of goods does not depend entirely on calculations of profits and hence sometimes constitutes an important exception to general statements about the nature of investment.

RATIO OF CAPITAL TO CONSUMPTION GOODS

Clearly it is a matter of prime importance to divide the nation's energies in the correct proportion between the construction of these two types of goods. If you construct too few capital goods you will be unable to replace equipment as it wears out and so your output of consumption goods will fall, while if you construct too many you will find yourself with factories for which you cannot get operatives. You will have to decrease the

size of capital industry and so release labour to operate your new factories and you will have to push this process until there are exactly the right number of men left in capital industry to maintain and replace the equipment in use.

In short there is only one correct ratio in which labour can be distributed between the two types of industry. What this ratio is will depend on various factors, such as the rate at which equipment wears out, the speed at which public taste is changing, and the rate at which new discoveries are making old methods obsolete but for any given set of conditions there is only one ratio.

Now let us look at the monetary counterpart of the process we have just been considering.

RELATION OF SAVING TO SPENDING

Since, by definition, the construction of capital goods is financed by savings, it follows that the community as a whole must divide its collective income between saving and the purchase of consumption goods (spending) in precisely the same ratio as it divides its energies between capital industry and consumption industry.[1] To be dead accurate, since not quite all capital construction is financed by saving, the monetary ratio will not be identical with the physical one. There will, however, be but one appropriate ratio between saving and spending at any given moment, and it will be essential to maintain it. Neglecting this exception, we can say that the community must save exactly the sum of money required to finance the construction of the capital goods actually required, and this will normally leave it with exactly the requisite purchasing power for buying the consumption goods produced.

[1] Throughout the book I shall use the words *saving* and *investment* in their familiar senses, except that when I wish to stress that money which has been saved is not subsequently invested I shall say hoarded. This warning is necessary because professional economists use the words differently, and are not even consistent in so doing. For instance, they often use the word 'saving' to mean the physical process of adding to the stock of capital equipment. It is particularly stupid to use monetary words for physical processes, since the whole discussion centres round the fact that the monetary process and the physical process get out of step.

Unfortunately the community does no such thing. In point of fact, it constantly tends to save far too much. We shall see why in the next chapter.

Let us keep this quite clear. There are two distinct, though parallel, processes. We can construct too much capital equipment —the physical process can be too large; or we can save too much— the monetary process can be too large. Often both errors occur at once, though they do not necessarily march in step. What usually happens is that we start by saving too much at a time when the rate of construction of capital equipment is reasonably correct. Then suddenly the rate of building capital equipment is raised so as to absorb all the stream of saving. Thus investment becomes equal to saving, but not by the sensible process of dragging saving down to the level of investment, but by the stupid process of dragging investment up to the level of saving. To describe the problem, as so many people do, as one of 'equalizing saving and investment' is dangerously misleading. It is not only necessary that they be equal; it is also necessary that equality be reached at the level dictated by real needs. In practice the problem presents itself in terms of saving exceeding investment. Many authorities write as if the proper course were to find new excuses for investment, while leaving saving to regulate itself. This is the fatal mistake, warned against in the previous chapter, of letting money dominate our actions instead of real needs. The proper course is to ask what level of investment is called for by real needs, and then to adjust saving to this level.

In real life it frequently happens that the volume of saving and the volume of investment are both remote from real needs, and by different amounts. But, to start with, let us assume that the volume of investment, that is, the volume of capital construction, the physical side of the process, is correctly adjusted to the community's needs, and see what happens when the monetary counterpart gets out of step.

BALANCE OF SAVING AND INVESTMENT

Suppose that the public, after a period in which saving and investment have been correctly proportioned, for some reason

begins to save too much—though its total earnings remain unchanged.

And suppose, for the moment, that they cannot find any opportunity of investing their additional savings and so are compelled to hoard them. What happens? Since they are saving more they must be spending less on consumption goods, and so demand for them falls off. Faced with a falling demand, manufacturers begin to reduce output and to lay off hands. Since these men and women are now on the dole, their buying power is reduced and this causes a further contraction in demand. This process will tend to continue with increasing speed and volume like a snowball rolling downhill. Naturally entrepreneurs [1] will not regard a period of falling demand as a good moment to build new factories or start new enterprises; there will therefore be little or no demand for new capital and the public will find themselves unable to invest even their normal amount of savings and will have to hoard most of those as well. As a result capital industry will find itself idle, and will discharge many hands. The contraction in the volume of investment has enlarged still further the discrepancy between saving and investment.

But as men are fired right and left, and cease to buy as much as before, so the profits of business will fall and fall; consequently, the volume of saving will soon be drastically reduced—for you cannot save if you have no income. In this way the excess of saving over investment will in time be eliminated, and the downward movement will be brought to a stop. Thus these changes are really *attempts on the part of the system to adjust the volume of saving to the volume of investment.* The adjustment is brought about by the drastic method of altering the size of the whole system. If saving is excessive, men are thrown out of work, productive activity decreases: the whole system becomes smaller. The success of this corrective mechanism depends chiefly on the fact that the bulk of savings comes from profits. The period of

[1] *Entrepreneur* means a person who starts and operates an enterprise. In a modern community this may involve many people: issuing houses, underwriters, directors, managers, etc. The word entrepreneur conveniently enables us to treat the whole group as if it were a single individual.

contraction is one in which profits drop almost to zero—or a loss may even be made—so that the reduction in savings is very drastic. They are brought down with such a run that they rapidly fall below the figure which would have represented the correct amount of saving before the slump started and soon reach the even lower figure which represents the amount of saving required in the now much smaller system. Conversely, when expansion is taking place and demand outruns supply, the raising of prices enables profits to expand with great rapidity.

As the decline of profits is the medicine Dame Economics applies (in a 'capitalist' economic system[1]) to cure the disease of over-saving, it will be seen that any attempt to prop up profits is vain: it only leads to greater over-saving and a more catastrophic slump. But in a crisis business men always appeal for the 'restoration of profitability' by the reduction of taxes and so on. If the government is foolish enough to answer their cry, it only makes matters worse. If the business men had any sense, of course, they would appeal for their taxes to be made heavier. There is also much talk of 'tightening one's belt' and wage-cuts are imposed all round—the very policy guaranteed to make things worse.

A growing amount of saving is done not from the profits of enterprise but from wages and salaries. The slump process does little to reduce this type of saving. True, every time a man is discharged, his saving capacity is reduced—but so is his spending capacity. Moreover, much of the saving from income is done in the form of life-insurance, etc., which lapses unless payment is kept up, with the result that desperate efforts are made to continue payment, *i.e.* to save more and spend less—precisely the opposite of what is required. As a result of the growth of middle-class saving the corrective mechanism is beginning to work less and less effectively; the slump has to be ever more violent to achieve its end.

[1] In this book I shall use the word *capitalist* simply as a convenient label for the sort of system in which we live. I do not use it as a term of abuse, nor of praise, nor do I wish to split hairs about its accuracy as an economic term. I use it because I do not know any less controversial word.

Basic unemployment is thus the consequence of the contraction of the whole system in an attempt to eliminate over-saving by reducing the size of incomes. To eliminate basic unemployment, we must reduce the volume of saving by more direct means.

Untrained critics frequently pooh-pooh the suggestion that over-saving is taking place, saying that if it did, huge hoards of uninvested capital would be lying about unused, which is not the case. But it will be seen from the foregoing description that this is a misconception. The emergence of over-saving is rapidly corrected, so there is no time for large hoards to form. The trouble lies not so much in the existence of actual over-saving, as of a tendency or urge to save too much—an urge which is nipped in the bud, by the development of a slump, before it can lead to large visible accumulations. References to over-saving in the following chapters must be understood in this sense.

CONCLUSION

Here you have the bones of the business—but it must be said at once that in real life the story works out in a very much more complicated way. We assumed that when people began to save too much they could find no means of investing it and so were constrained to hoard. But if entrepreneurs are minded to make use of these savings to construct more capital equipment, regardless of the fact that the existing volume of capital equipment is adequate, then things will proceed very differently. In point of fact, instead of a slump developing immediately, a boom will develop and be followed by a slump.

We will postpone consideration of this embroidery on the full story and proceed to ask why it is that people tend to save more than is needed, and why this habit has only developed in certain countries and of recent years.

Summary

Goods made by man may be classified as *consumption* goods and *capital* goods. A community's energy must be divided between these two types of production in precisely the right ratio.

This means that incomes must be divided between spending and saving in precisely the right ratio also.

If saving exceeds the needs of investment, and hoarding results, there will be a shortage of purchasing power, and industry will contract until saving has been forcibly cut down. Unemployment will be increased. Basic unemployment is the result of this tendency to save too much.

3

Why We Save Too Much

'I say, this isn't fair!' cried the Unicorn, as Alice sat with the knife in her hand, very much puzzled how to begin. 'The Monster has given the Lion twice as much as me!'
'She's kept none for herself, anyhow,' said the Lion.

OVER-SAVING might emerge either through an increase in the proportion of incomes being saved or through a decline in the demand for capital equipment—that is, a decrease in the opportunities for investment. Actually, in countries undergoing industrialization both trends are at work.

Let us consider the factors controlling the growth of saving first.

IS SAVING GROWING?

The chief factor influencing the amount of money a community saves is the gross size of the national income. (The national income is defined as the sum of the incomes of all the inhabitants.) The richer the community the more it will save—that much is obvious. But the point is that the increase is disproportionate. A rich community will save a greater percentage of its income than a poor.

We can see that this must be so by considering the extreme case. A community so poor that its members can only just keep alive will save nothing and will spend any small additions to its income. A community so rich that its members will have everything they need will save the whole of every further addition to its money-incomes.

The story of the last hundred years in Britain, America and many other countries has been a story of rising productivity. Matching this rise in output, the incomes of those in work have

risen too. If we refer again to Colin Clark's calculations, described in the last chapter, and take the average income per head of population *in work* as being the best index to the growth of personal incomes, we find that in the case of Britain it has risen from just over £90 per annum in 1845 to £200 per annum in 1914 and to nearly £250 per annum by 1937. For the United States the rate of increase is only slightly slower, from $820 in 1850 to $1490 in 1900, and then erratically to $1696 in 1937. And in both cases this increase was achieved despite a steady decline in the length of the working day.

This great increase in income has naturally caused an even greater increase in the amount of saving. Figures show that if an American's income goes up 100 per cent, his savings will on the average, go up 150 per cent. (No similar calculation has been made for England, owing to the absence of statistics about personal savings.) As regards the income of business concerns, the proportion saved seems to remain constant: however the proportion distributed as dividends becomes part of the personal income of the shareholders, who will save a part of it. So a rise in profits tends to produce an even greater increase in savings.

The amount saved from the national income depends, however, not only on its size but on its distribution.

INCOME DISTRIBUTION

The more equally and fairly national income is distributed, the less the nation will save. We can see that this must be so by considering the effect of taking £10 from a rich man and giving it to a poor man, thus making income distribution slightly fairer. The rich man will not make a point of cutting down his expenditure by £10; the chances are that he will spend as much as before, and the £10 will come out of his savings. On the other hand, the poor man, if really poor, will spend the whole of his gift on necessities.

Investigations of the amount of saving done as income distribution changes confirm this prediction and show, what is more, that the volume of saving is remarkably sensitive to changes in income distribution. Accordingly, if the distribution of incomes

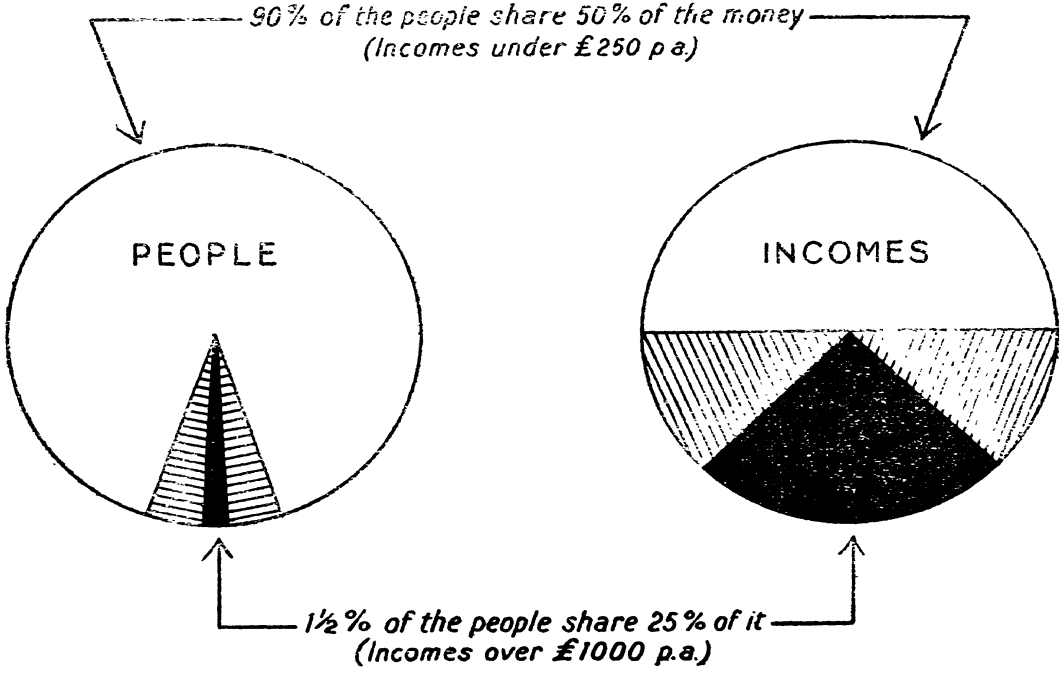


FIG. 3.—HOW INCOMES ARE DISTRIBUTED AMONG THE WORKING POPULATION.

is becoming more equal—or, as economists say, if *income dispersion* is increasing—this will postpone the onset of over-saving.[1]

At present, in every civilized country, income is very unequally distributed. In Britain in 1935 nearly one-quarter of the total of personal incomes accrued to 1½ per cent of the population. The poorest 90 per cent of the population had to make do with one-half of the total of personal incomes. The situation in the United States is scarcely better. Dispersion can be measured by a mathematical technique which eliminates the influence of population-size or average level of income. It shows that in the United States dispersion hardly changed between 1870 and 1916; during the first World War there was a temporary improvement; since then no further change has taken place. In Britain dispersion actually decreased between 1850 and 1910, since when it has improved considerably, though it must be said the necessary statistics are available for too few years to give a proper picture.

Here is the relative dispersion of a number of countries in 1932 or the nearest year for which figures are available:

		Dispersion Factor
Australia	(1934).	2·25 (more equal)
New Zealand	(1934).	2·21 ↑
Finland	(1934).	2·03 |
Germany	(1934).	1·96 |
Denmark	(1935).	1·94 |
France	(1934).	1·82 |
U.S.A.	(1934).	1·77 |
Holland	(1931).	1·70 |
Great Britain	(1932).	1·68 |
Japan	(1930).	1·66 ↓
Hungary	(1932).	1·64 (less equal)

As can be seen, neither Britain nor America make a very good showing; it would have been much worse had we taken the boom year 1929, when Britain's factor was 1.61 and America's 1.42—the most unequal distribution of any country for which statistics are available!

[1] This refers, of course, only to personal saving; the proportion of income saved by commercial concerns is practically independent of changes in the size of the income.

There is a tendency to think that the heavy taxation of the rich goes a long way to make incomes more equal, but this is largely illusion. Some of the money is spent on services beneficial only to the poorer sections of the community, such as education and pensions, but much goes on government, police, highways which are of general benefit, and much on the national debt, which benefits the rich rather than the poor. At the same time the poor contribute fairly heavily, mainly through indirect taxation; in Britain, in 1935, for instance, they supplied one-third of the revenue raised.[1]

With these facts in mind, we can now attempt to test our explanation of the emergence of over-saving as the probable reason for the failure of purchasing power to expand as it should.

THE PROOF OF THE PUDDING

In a general way, we shall expect the countries with a large national income per head to be more liable to over-saving than those with a smaller average income. As each country reaches the higher income-levels, its rate of advance will tend to decline but the precise level at which this occurs will be higher in cases where income dispersion is marked, lower when the distribution is relatively unequal.

If we examine Professor Clark's figures again with this in mind we find that they conform remarkably closely with this prediction.[2]

To start with, the countries which have made little or no progress in recent years are all countries with high levels of income, *e.g.* Britain, U.S.A. and Canada, with real incomes exceeding 1000 international units per head of occupied popula-

[1] If the reader is interested in this point he should see *Redistribution of Incomes through Public Finance in* 1937, by Tibor Barna (O.U.P. 1945).

[2] In order to be able to compare different countries, the figures for each have been converted into 'international units'. One I.U. represents the purchasing power over goods of one dollar throughout the period 1925–35. In this way the effect of changing prices and exchange rates is eliminated and a fair comparison effected, subject only to the technical difficulties of the calculation.

tion, and, to a lesser extent, Germany, France and Holland, with real incomes about the 700 I.U. mark. On the other hand, all the countries with incomes below 700 I.U. have continued to make uninterrupted progress.

Two notable exceptions strike the eye, however, Australia and New Zealand, with very high and rapidly rising real incomes. But turning to the figure showing dispersion of incomes, we see that these two countries have the least unequal income distribution of any in the world. The correlation between these two factors, the rate at which incomes rise and their degree of dispersion is striking. For instance the U.S.A., which has the most unequal income distribution of any industrial country, and which has made no progress in redistribution except a slight improvement during the last war, is the country which has made least advance in real income since 1900. Britain, though still one of the world's most unequal countries, has made continuous progress in dispersing incomes since 1909. It is therefore interesting that the British real income, though its rate of increase greatly diminished at the end of the nineteenth century, has continued to make a certain amount of progress since 1909.

In France, income distribution remained very stable for many years until 1931, when it improved somewhat. Real income has remained virtually stable since about 1904. That it did not improve after 1931 may well be due to France's great internal difficulties during the thirties. (See Chapter 19.)

Japan is an example of a country with a markedly unequal income distribution, which has nevertheless maintained a steady and indeed a very rapid rise in real income. But the explanation is to be found in the very low level of real income in absolute terms: it had still not reached 400 I.U. per head when the last reliable statistics were available. No figure of income dispersion is available for Canada; it is however notable that her level of real income closely follows the changes in the United States level, and it is probable that her failure to make progress since the last war is due less to internal causes than to American influence. Finally we may quote Russia as a country which, after the establishment of Communism, achieved a much greater equality of income, and turned a slowly rising real income into a very rapidly rising

one. (Subsequent to 1930 income dispersion may have decreased, but no satisfactory statistics are available.)

Let us now ask what is to be done with these growing savings. Is there any reason to suppose that the outlets for saving are growing at a similar rate? The answer must be 'no'.

INVESTMENT OUTLETS

When a country first enters on the task of self-industrialization it needs a wide range of capital goods: steel-plants, coal-mines, railways, power-stations, factories and the like. It has, so to speak, a lot of leeway to make up. But in fifty or a hundred years it will have provided all its main needs. All it will now require in the way of capital goods is sufficient to replace existing equipment as it wears out or becomes obsolete.

The attainment of this state of satiety is postponed, however, if the population is growing. The more people there are in a community the bigger the volume of goods they will make and consume and the bigger the quantity of capital equipment needed to produce those goods. As is well known, for Britain and America the nineteenth century was a period of continuous population-growth but in Britain at least the population has ceased to rise—a factor favouring the emergence of over-saving.

A third factor affecting the volume of investment-opportunity is the rate of technological progress. If inventors are continually putting forward new and better ways of doing things, entrepreneurs will be found to finance their schemes. The outlet for capital thus created differs rather from those just considered, for if these enterprises succeed they will displace more primitive undertakings, as the car displaced the horse. Money invested in the failing enterprises will be written off. As one investment is set up, another dies. Thus the new investment does not necessarily increase the total amount of invested wealth. Frequently, however, the new techniques require much more capital equipment than the old.

Technological progress has been so rapid recently that, left to itself, it might well have absorbed all the sums of capital available; but to-day there are many reasons why entrepreneurs

are slow to take advantage of new discoveries. Most of them may be catalogued under the general head of 'the decline of competition'. The classical economists did not foresee this: they imagined that there would always be some enterprising fellow ready to step in and exploit a new device if those in the business ignored it. They overlooked the possibility that monopolistic groups of traders might agree to suppress such inventions rather than see their expensive equipment superseded. They overlooked the patent laws which made it possible for firms to prevent potential rivals from using new processes; and they overlooked the establishment of private research laboratories whose main purpose would be to secure these protective patents in good time. They also failed to foresee the development of various ingenious techniques, such as cutting off raw material supplies or means of distribution, by which established firms can sometimes hamstring the newcomer.

There is, in any case, a qualitative difference between providing more of the same thing and providing new things or a higher quality of the old. If a family is without a house, the urgency of its demand for one is obvious both to builders and to the family itself. But if a family is in a house of poorer standard than need be, the family may or may not be aware of the kind of housing technically possible at the price, and the builder may well be doubtful how successfully he can sell such superior houses if he builds them. Similarly, a family without a water-softener or a television set is a less reliable prospect for the entrepreneur than a family without a bedstead or an armchair.

The matter is also closely affected by the modern tendency to buy services rather than goods. If a man invented a more economical oil-lamp, he had only to make a few and demonstrate their superiority to get them adopted by a growing number of households. But to-day, if a man invents a cheaper way of making electricity, he cannot set up a rival power company. The most he can hope for is to persuade existing companies to introduce his device. But they may not be interested in spending good money in order to lower the cost of electricity, for they know they can sell it just as well at the present price. The public has no choice but to buy from them. It is true they might enlarge their sales if

they lowered the price, but the question they are interested in is: would the profits on these extra sales pay the interest on the extra capital involved? They do not know, and they do not wish to risk finding out.

As a matter of fact, the instance is not entirely imaginary. Electric power companies could save enormous quantities of current, at present dissipated in heat, if they would scrap the iron cores of their transformers and substituted high-permeability alloys. They prefer, however, to go on drawing their very satisfactory guaranteed profits without embarking on the great capital expenditure involved.

To an increasing extent, also, big established concerns have a monopoly of the capital needed to launch a new invention. It is almost impossible for the man with an idea but no assets to obtain the capital to put his idea to the test. Enterprise is coming more and more to rest in the hands of powerful, established concerns and they are more and more inclined to preserve the profit-making machine they have built up than to risk everything on some new development, especially when this will make their costly plant useless.[1] Thus razor-blade manufacturers are not interested in the invention (now many years old) of an 'everlasting' razor-blade, nor match-manufacturers in a match which can be struck again and again. And they can often use their control of distribution and other facilities to prevent others exploiting such devices.

The whole productive machine tends to develop hardening of its main arteries. It wants to go on turning out more and more of the same things; it finds it harder and harder to adapt itself to new demands. The complaint has been often made before, but always in connection with the brake it puts on efficiency or opportunity. It is seldom realized that it is also a major factor in contributing to mass unemployment. As a footnote to all this it may be added that a wealthy country requires an increasing amount of equipment of a kind which does not earn profits—hospitals, schools, roads, etc.—but these naturally offer little attraction to the ordinary investor.

Finally, among the factors causing a decline of investment

[1] See, for example, Lucas, *The Decline of Competition.*

outlets, we may mention investment abroad. Britain formerly lent large sums abroad, and during the 1920's so did America, but for reasons which will be discussed fully later, such lending has greatly declined in recent years.

To sum up, then, an industrialized country tends to reach a state of something like satiety as regards capital equipment; and while capital might be absorbed by scrapping obsolete equipment and substituting newer, the owners resist the writing off of the investments which provide them with their income. In illustration of this we may mention that Britain, for example, managed to invest at home some 14 per cent of her national income during the nineteenth century. Since 1910 the figure has been a uniform 4.5 per cent.

In fact, it is possible to define three main stages in a country's economic development.

1. An initial stage characterized by a low degree of industrialization, a low national income, a low volume of saving, and a big volume of investment opportunity. This is called the *capital-hungry* stage.

2. A development stage in which industrialization is proceeding rapidly, the national income is growing and saving is adequate for internal investment needs. This is the *capital-using* stage.

3. A final stage in which the income is very high, saving remains large, but domestic opportunities of investment have shrunk. In this stage the country seeks to lend its superfluous savings overseas. This is called the *capital-sated* stage.

Britain and America are definitely in the capital-sated stage, with France, Germany, Holland and a few other countries approaching it. Countries like Canada, Russia, Japan are in the development stage. Countries like Poland, China, India and Brazil are still capital-hungry.

In the capital-sated countries the only thing which will do anything to restore investment opportunity is a high rate of technical progress, making existing equipment obsolete, or a rising population curve.

In short, as a country gets richer, over-saving (*i.e.* an excess

of savings over investment opportunity) will tend to appear, and so there will be a decline in consuming power, giving rise to unemployment and still further decreasing investment opportunity.

Hitherto it has been customary to try and interpret the same set of facts in a completely different way. Fastening on the fact that investment was declining, and seeing how it created unemployment in heavy industries, people concluded that the main object of employment policy should be to *increase* investment. They then went on to make the quite unjustified assumption that the reason investment had declined was that people were saving too little; hence their recommendation for restoring prosperity was that people should save more. Naturally this advice only makes matters worse.

How then are we to set about a cure?

CURING OVER-SAVING

On the one hand investment opportunity might be increased; on the other propensity to save might be reduced.

To increase investment opportunity in a capitalist economy means that the industry must be exposed to the full blast of competition. All the forces which prevent the entry of better equipped competitors or the adoption of new devices must be smashed. Monopolies, cartels and trading groups must be broken up, the patent laws must be redrafted, government protection or subsidy must be removed. Special measures are needed to deal with such ingenious techniques as those by which industries combine to close down their inefficient plants and concentrate production at the efficient plants, thus lowering costs while maintaining the old prices.

The present trend of industrial organization is all the other way. Monopoly, overt or concealed, is on every hand.[1] Though the industrialist loudly praises 'free competition' as superior to government control, in reality free competition is the last thing

[1] See *Monopolies, Cartels and Trusts*, by H. Levy, and my forthcoming book *The Web of Power*.

he desires. What he means is, he would rather have control of industry by industry in its own interests than control by the state in the common interest. If forced into the open, he dignifies this programme with the name of 'industrial self-government'. There are, in truth, strong arguments against state control, but it is hypocrisy to depict free competition as the real alternative.

In any case, the question is not simply one of achieving the highest possible rate of obsolescence for capital equipment in order to create investment outlets. It is wasteful to scrap equipment too soon after it is made. To do so involves the devotion of an undue amount of the nation's manpower to capital construction and reduces the output of consumption goods. In short, there is a limit to the lengths that enlargement of investment opportunity can usefully be carried.

Now let us turn to the other possibility—reduction of the volume of saving. Here we have two lines of attack; we can seek to make income distribution more equal. Alternatively, we can seek to change the saving habits of the individual and make him save less; as economists say, we can seek to influence the *propensity to save*. Unfortunately, both these courses are more difficult then they sound.

PROPENSITY TO SAVE

The classical economists, with their unique gift for being wrong, taught that saving is carried out solely in order to earn interest. In reality, saving is performed for three main reasons. Private individuals save in order to obtain a buffer against the dangers of sickness, unemployment and old age; or in anticipation of exceptional expenditure, *e.g.* the education of their children. Business concerns save in order to provide capital for future expansion or a reserve against lean years, or misfortune. There is also a numerically small class of individuals who save from a pathological desire for money, but these we may neglect. The fact that savers can earn interest on their savings is an additional attraction and simplifies the task of obtaining security, but it is not the cause of their behaviour. Even if there were no interest,

they would still wish to save; indeed they would have to save more carefully than before. The peasants and poorer people of many countries still save in this primitive 'precapitalist' way. Such saving naturally cannot be controlled by altering the rate of interest—the method which classical economics tells us regulates the volume of saving.

No problem is created by that part of personal and business saving (whether invested or not) which is intended for subsequent expenditure, on consumption goods or their equivalent, as in the case of saving against school-fees. Such saving does not contribute to over-saving, for at any given moment there will be people saving and other people 'blueing' their savings at the same rate. (In the short run this is not strictly true, because people tend to draw on their savings during slumps, and replace them in the subsequent boom, but we are considering the long-term trend at the moment.) Such behaviour does not contribute to over-saving unless, as is probably the case, people and firms are unduly pessimistic and save more than they subsequently require. Any over-saving caused in this way could be met by a wider use of the principle of insurance, which enables provision for the future to be accurately adjusted to needs.

The problem is created by the fact that there is another outlet for saving: investment. If there were no investment at interest, the savings problem would be simple: it is the possibility of securing an income which will continue without further effort which creates the danger. For as a result everyone is engaged in trying to accumulate a capital sum big enough to provide a perpetual unearned income sufficient to meet all their needs. The capital sum which would provide everyone in the community with an income equal to their normal income is far larger than industry can make use of. Even if we were more modest and remained content with an income of (say) half our normal amount, the capital sum would still be far greater than industry could absorb. It must be.

The matter becomes clear if we fix our attention on the process as a whole. The sum total of personal incomes—the national income—is made up of (1) wages and salaries, (2) dividends and rent, the first a reward for work done, the second for putting

up capital.[1] As it happens, we are all busily trying to *enlarge the proportion* of the national income we receive in the form of dividends or rent: evidently this can only be done at the cost of reducing the proportion we receive in the form of salary or wages. People, collectively, can only get their entire incomes paid in the desired form of dividends if they are prepared to pay the cost of dispensing with wages and salaries entirely.

That is one half of the story. The full futility of our behaviour is that in this situation we think we can somehow increase the total of dividends by *saving* more. What madness! For it is obvious that even if industry accepted our proferred loans it could only give us back the same total sum as before spread thinner—unless we are prepared to accept reduced profits or wages, which we are not. Actually industry refuses our loans (or takes them and fails to pay interest on them) and reacts to our diminished spending by a slump, so that our attempt to get more ends by getting us less than ever.

It is hard to see how this frantic pursuit of investment-incomes can be diminished. Even if we could explain the issues to everyone, they would still try and invest. Rationing investment by means of some kind of investment board has often been proposed, but this is merely suppressing the symptom, not curing the disease. We might reduce the urge to save by providing a greater degree of security for the ordinary man; we can guard him against ill-health, unemployment and old age by state insurance and pensions. Since there has been a considerable increase in such provision in Britain, we should expect savings from smaller incomes to have declined. Figures show this expectation is correct. In 1907 12.2 per cent of middle-class incomes was invested; in 1935 the figure was down to 6.9 per cent. But there is a limit to the lengths the state can go. We could indeed provide everyone with a 'Social Dividend' as it is sometimes called—a

[1] To the extent that profits are a reward for work done, as in the case of a small shopkeeper, for instance, they should go in with wages, for the basic distinction is between incomes which continue regardless of effort and those which do not.

Hereafter, I shall cease to specify rent separately, as, for our purposes, it can be regarded as a variety of dividend. In formal economics, however, the distinction is important.

payment which would continue whether one was in work or not. If this is to be provided over and above wages, it comes into the category of income redistribution which we are about to discuss. If, on the other hand, it is proposed that wages be correspondingly reduced, an enormous array of administrative difficulties appears. Apart from economic difficulties, there may also be sociological objections to excessive paternalism by the State.

In any case, saving by private individuals is the smaller part of saving; it is saving by business concerns which presents the major problem. The provision of greater security will avail us little here, for business concerns will wish to save to provide funds for expansion, or to guard against reverses of a kind outside the ambit of normal security, *e.g.*, the competition of better-equipped rivals. The trouble is the business concern is at once too pessimistic and too optimistic about its future. Every firm saves against rainy days and also against a golden morn of prosperity when it will need funds for expansion. But only a proportion of them ever experience these extremes of fortune for any length of time. It is as if every householder were to save enough to rebuild his house if it should burn down, or enlarge it in the event of his having quintuplets. This comparison suggests that we might make use of the principle of insurance to free industry from saving more than it will need. But while some such scheme might protect it from adversities, it could hardly be used, in a competitive system, to finance extensions.

It almost seems as if the only course is to make a radical revision of the whole principal by which investment is carried out.

INCOME REDISTRIBUTION

Then what of income redistribution as a means of reducing over-saving? At best it is only a palliative. As the nation grows richer, income will have to be redistributed more and more drastically: finally when incomes are absolutely equal or as near equality as is practicable, some more radical solution must be found.

But if you say, never mind the long run; let us use income redistribution now to cure unemployment and win a few years

grace while we work out some more radical line of attack. The proposal is still difficult to put into effect. I will explain why.

We are dealing in practice with a community whose output is steadily increasing. Simultaneously the volume of incomes is being steadily increased so that the additional goods can be consumed. But to whom are these additions to income to be given? If they are given to the richer people they will be wholly saved, and so the extra production will remain unconsumed and over-saving will develop. If they are given to the poorest people, they may be wholly spent, which solves the consumption problem—but how are investors going to like this? They are putting their savings into investment and so are bringing about the construction of the new machinery which is raising output, but they are to receive none of the results of this activity. Investors invest because they think it will make them richer. But we cannot permit them to become richer, because we know they will save part of the increment. In these circumstances investors will not invest; they will prefer to hoard, and the system will collapse.

This is not even the full extent of the difficulty. For even if we give the extra income to the poorer people—which in practice means raising wages—it is probable that some of the increment will be saved. In fact as time wears on and the wage-earners become steadily richer their saving will become considerable. But any increase in saving by the poorer section of the community must be compensated by a reduction of saving on the part of richer individuals and institutions. In other words, we have got to ensure that investors, however wisely they invest, *will grow steadily poorer.*

Unfortunately, the obstinate fact is, if we tax enterprise as heavily as this, it will feel the taxation to be 'penal' and so heavy as to make the conduct of business not worth the candle. Actually taxation is an unsatisfactory weapon against over-saving anyway. For we have no guarantee that when we impose super-tax on a man he will pay for it by reducing saving; he may meet part of it by reducing expenditure. Thus we may have to take from him in taxes considerably more than the amount by which we wish to diminish his saving. Nor is this all: for his diminished expenditure will further unbalance the equilibrium between saving

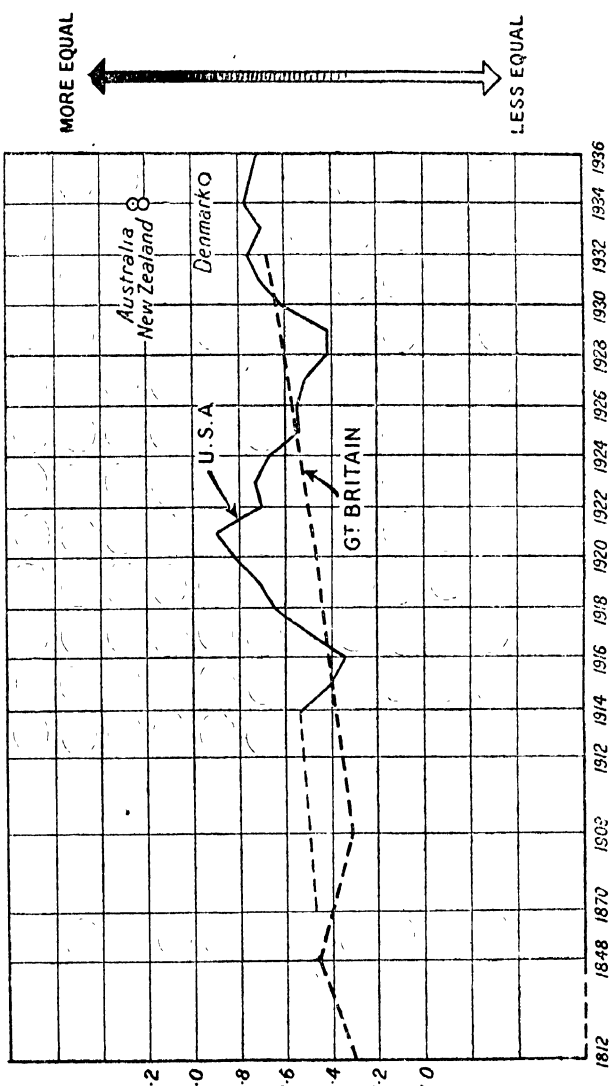


FIG. 4.—DISPERSION OF INCOMES.

The degree of equality with which incomes are distributed (income dispersion) is a major factor affecting the volume of saving. It can be measured by a mathematical technique in a way which is independent of the size of incomes or of the population.

The United States is the only country for which a consistent series of figures is available, and then only since 1909. British figures are known for 1812, 1848, 1909, 1929 and 1932 only. They appear to show that dispersion has been increasing since 1909. American dispersion has increased but little.

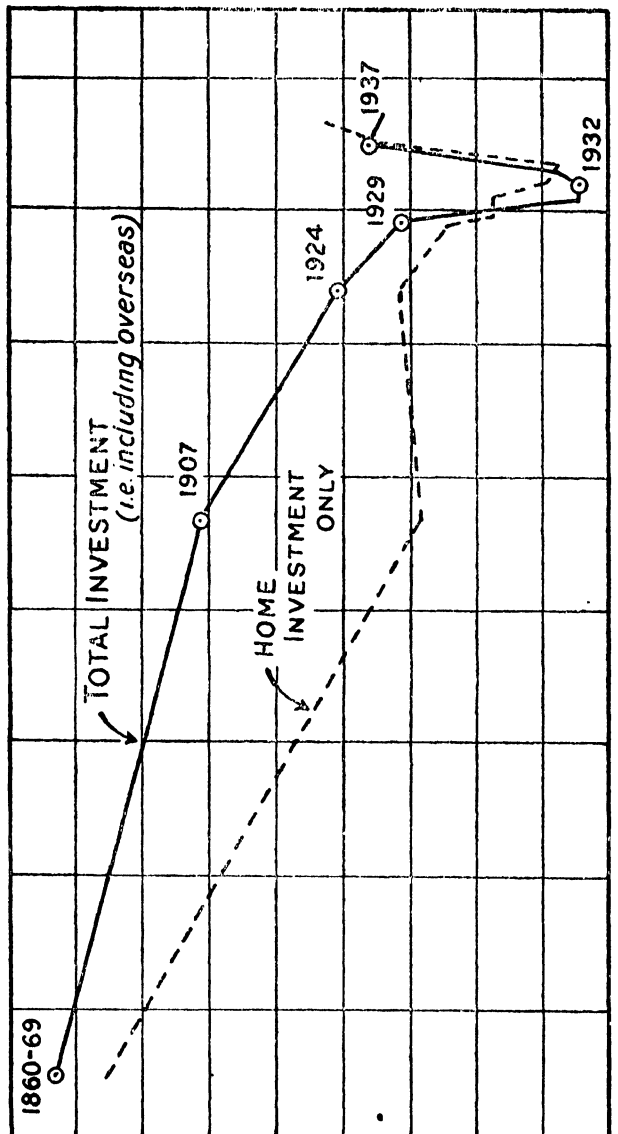


FIG. 5.—THE RELATIVE DECLINE IN INVESTMENT.

The main curve shows the total of investment (including overseas investment) as a percentage of the national income, for certain years for which figures are available. Since 1907 and 1929 were both boom years, for which investment is always above average, the decline is more uniform than appears at first sight. The absolute size of investment grows steadily, of course, throughout the period. (Home investment rises above total investment in the slump because foreign investment was negative, *i.e.* foreign loans were being sold up.)

and spending, and so we must somewhere obtain the money to make up this deficiency.

The same is true if we try and attack over-saving by restricting profits, whether by raising wages or lowering prices, or both. If profits fall, dividends will be cut as well as appropriations to reserve.[1] Whichever course we choose, investors will prefer to hoard their money rather than invest it so unprofitably, and as a result the community will be plunged into a slump. Investors will then point to the government's policy as the cause of the slump, as in a sense it is.

In short, the degree of profit which the investors regard as the minimum justifying operations is too large for the needs of the system as a whole, since it causes over-saving. The question remains: could we save the situation by persuading entrepreneurs to accept a lower rate of profit?

To this question we must return a regretful 'no'. We can postpone collapse in this way, but we cannot avert it. For as the poorer section of the community grows richer it will eventually reach the stage when it is capable, without help, of saving all the sums needed to provide the community with capital equipment. At this point, then, saving from profits must be zero.[2] But saving from profits will only be zero if profits themselves are zero—for

[1] Instead of taking money from people year after year in taxation, a more direct method would be to confiscate part of the wealth (investments) which brings them this money. In the case of human beings, this can be done conveniently at death, by so-called 'death duties'. But the biggest savers are commercial enterprises—and they are potentially immortal, so in their case we should have to fall back on simple confiscation.

Needless to say, confiscation of wealth would lead to even bitterer opposition than taxation, and it is impractical to suppose that anything of this sort could be done on anything like the scale required, this side of dictatorship.

[2] I need hardly say that in thus imagining the present trend extended to the logical limit I am only using an expository device, not making a prediction. Long before such a point was reached, even if over-saving and its consequences could be avoided, people would begin to demand more leisure instead of higher wages. Indeed, a possible solution of the over-saving problem would be to prevent any further growth in the national income by turning every increase in productivity into shorter hours: but here again investors would object to receiving a constant return on an increasing investment.

whenever firms make profits they will think it prudent to set some part, however, small, aside for contingencies.

In other words, the size of permissible profits is always decreasing and tends towards zero. Should ever it fall below the figure which entrepreneurs regard as constituting a reasonable return for their efforts, breakdown is unavoidable.

It is of course true that single individuals or firms may succeed in making satisfactory profits at a time when the total permissible profit of industry is small, for they may be making them at the expense of other individuals who are losing money; that is, their profit is negative. In this case the situation appears to the individual entrepreneur not so much in terms of an unsatisfactory rate of profit as in terms of excessive risk: his chance of a satisfactory profit seems to him too small.

It is clear that we are in a complete impasse. If we burden business sufficiently to prevent over-saving we so discourage entrepreneurs that they will not operate at all.

CAPITALISM BREAKS DOWN

It is therefore no exaggeration to say that the present system of employing capital has broken down. People sometimes claim that the 'profit-motive' has broken down because it is failing to produce the kind of world we wish to see. It is not in this qualitative sense that we use the expression here. This is something much more serious. It is not the failure of the machine to make the *best* use of resources, it is its failure to make *any* use of part of them which is at issue. It is no longer 'profitable' to employ the millions of men who want a job. It is no longer profitable to supply the starving with food and the naked with clothes. Such a state of affairs cannot be described by any word less emphatic than 'breakdown'.

The paradox is that the very people who have most to gain from the resuscitation of the present system are rigidly opposed to the only measures which could make it work. If business men could be induced to operate for smaller margins of profit, breakdown could at least be postponed beyond their own life-time.

Every tax on profits is a blow struck for the preservation of capitalism. Every new invention which puts an older device on

the scrap heap is a blow for private enterprise. Every lowering of tariff barriers is a pint of blood plasma to the dying man. Yet it is business men who wail about penal taxation. It is business men who set up price-rings. It is business men who ask for protective tariffs. Like pigs that cut their own throats trying to swim, entrepreneurs are the victims of their own defective intelligence and distorted development.

In the last analysis, the cause of the trouble is the depth of humanity's desire for a type of income which will continue despite adversity. All over the place people are saving in the hope of providing themselves with an investment income. But the volume of such incomes which the present system can provide is strictly limited: it is far too small to go round, and if anything it is growing smaller. So we have the spectacle of everyone struggling for a type of income which, in the nature of things, they cannot all get. Their efforts, their frantic desire to save, creates over-saving.

Summary

As a country grows more productive and its national income rises, it tends to save an ever greater percentage of its income. But opportunities for investing these savings do not grow at the same rate; in the end they even decline. So the volume of saving comes to exceed the opportunities of home investment.

Technical progress is capable of enlarging investment-opportunity, but the decline of competition stifles the use of new inventions. A rising population also postpones the evil day, but in Britain the population has ceased to rise.

A more rapid absorption of new inventions; greater security for the individual: these are measures which would reduce over-saving, but they are limited in scope.

Income redistribution diminishes saving, but is only a palliative, for even were incomes equal, over-saving would eventually appear, thanks to man's unquenchable thirst for the security of an income from investments. He wants more of this type of income than is possible in a competitive system.

Moreover, income-redistribution, to be effective, would have to be on such a drastic scale that 'entrepreneurs' would cease to think enterprise worth the rewards: they would strike and cause a slump. But lack of effective redistribution will also cause a slump. In short, the system has broken down.

4

Breakdown of Capitalism

And it certainly did seem a little provoking ('almost as if it happened on purpose,' she thought) that, though she managed to pick plenty of beautiful rushes as the boat glided by, there was always a more lovely one that she couldn't reach. 'The prettiest are always farther!' she said at last, with a sigh at the obstinacy of the rushes in growing so far off, as, with flushed cheeks and dripping hair and hands, she scrambled back into her place, and began to arrange her new-found treasures.

What mattered it to her just then that the rushes had begun to fade, and to lose all their scent and beauty, from the very moment that she picked them? Even real scented rushes you know, last only a very little while—and these, being dream rushes, melted away almost like snow, as they lay in heaps at her feet—but Alice hardly noticed this, there were so many other curious things to think about.

THOUGH the reader will have followed and grasped the arguments which have led to this disconcerting conclusion, probably he is secretly possessed of an uneasy feeling that there must be something wrong somewhere. After all, he probably argues, lending money is a service; there cannot be anything wrong in paying for it as you pay for any other service. Or he may quote the familiar justification which says that if the result of investment is to increase the world's output of goods, then the lender is entitled to a share of the new stream of wealth which he has helped to call into existence; only if the loan proves unproductive can there be no justification for the payment of a reward. This argument gives us a clue to the reason why this familiar process of saving and investing has run amok.

The confusion arises because of our obstinate refusal to dis-

tinguish between money and goods. If a man (or a firm) performs a useful service, we can, if we wish, agree to reward him by bestowing on him a large share of the *goods* produced by the community. To achieve this end we give the person concerned a large sum of money: but the essential corollary is that he shall go out and *spend* the money on the goods. If he does not—if he simply puts the money away in an old sock—the whole system breaks down. The goods to which he is entitled remain unsold. He has, in effect, pocketed part of the conveyor-belt by which goods reach the public, thus wrecking the distributive machine for everybody.

This diagnosis is still valid even when the man in question succeeds in investing the money he receives, if the effect of this is only to cause other people elsewhere in the system to keep their money in the bank because they cannot find a means of investing it.

The assertion that hoarding money wrecks the distributive machine may seem to the reader to clash with the familiar fact that one can 'save' for a rainy day; I will digress for a moment to deal with this point. To be quite accurate, it is permissible for people to hoard if elsewhere in the system there are other people spending their hoards. The two processes naturally offset one another. Strictly speaking, therefore, we should say that a shortage of purchasing power will develop if the rate at which people are hoarding exceeds the rate at which they are dishoarding.

To resume: we can if we wish reward a man generously, even lavishly. But it would be insanity to bestow on him more gifts than he had use for. A grateful people, anxious to display to some military hero their gratitude, might bestow on him banquets, a wardrobe and a castle. But they would repent of their generosity if they saw tons of food mouldering because their hero could not eat it, the castles standing empty, because he could not live in more than one at a time, and the fine clothes providing a diet for moths. No community would carry gratitude to such a ridiculous extreme.

Yet that is precisely what we do to-day, thanks to the intervention of money. We reward people for their services with quantities of money so great that they have no desire to spend

it all. (Or at any rate we tolerate a system which rewards them on this scale.) As a consequence the castles which they might buy with this money stands empty, and farmers cease to produce the food they might consume rather than let it lie in the shops unsold.

Why then, do people bother to accept these superfluous sums of money? Answer: because our curious system of investment provides them with the opportunity of *converting it into money of a different type:* from capital into income. Thanks to investment, they can take a sum of money which, once spent, is gone for ever, and can convert it into a kind of money which keeps renewing itself for the whole of their life and perhaps beyond. In reality, therefore, what we are doing when we give a man an excessively large income is this: we are giving him the opportunity to obtain a share of this specialized kind of income which goes on indefinitely. But—and this is the crucial fact—the amount available of this special kind of income is strictly limited. The mistake we are making is, therefore, to try and give certain people more of this special type of income than in fact exists.

How have we been led into this strange and absurd behaviour?

The difficulty in answering this question is that we are all so familiar with the process of investment that it is very difficult for us to see it objectively and see it whole. As individuals, we are only interested in investment as a means of obtaining a certain type of income. But investment is not provided primarily for that purpose: it owes its existence to the need for supplying the community with a stock of capital goods. The realities of the situation are further obscured by our tendency to think in terms of money rather than goods. I propose, therefore, to tell you a parable—to construct, as it were, a kind of working model of investment with the money process eliminated. If you will follow it with attention you will, I believe, find the investment process revealed with a new clarity.

PURPOSE OF INVESTMENT

Let us suppose that a community of one hundred people is living on a desert island and is subsisting by picking bananas.

For the purpose of the story these are the only 'consumption goods' in which they are interested. They cannot pick as many as they would like, even though they pick all day, so someone suggests that they make themselves some knives ('capital goods') with which they can increase the output of bananas. A number of men, say ten, are taken off picking to undertake the task of knife-making. In orthodox language, they have become workers in capital industry.

Here we come to the great cross-roads of economic development. How are these men to be supported while at their not-immediately-productive labour? The kind of economic system we get depends largely on the answer to this question.

The answer which will occur to most people is that the bananas picked by the remaining ninety men shall be divided equally among everyone. Everyone will now get fewer bananas than before—10 per cent fewer to be exact. This is the price of expansion. All investment involves a temporary economy in consumption in order to be able to consume more in the end. In this instance (which we might call the communal, or communist case) the burden is borne by everyone. Since everyone is to benefit from the increased output when the knives come into use, it is right that all should economize.

When the knives are completed, the knife-makers might return to picking, and the income of the community would then rise from its reduced level to a point higher than its original level, thanks to the effect of the knives. Let us suppose, however, that the knife-makers go on to make a second batch of knives, and repeat the process until all are equipped. At this point the task of the knife-makers is virtually ended: most of them can return to banana gathering, a few will remain to repair and replace knives as they wear out. In orthodox language, capital industry contracts.

Note that the making of the knives is 'paid for' once and for all by the temporary reduction in the standard of living; as soon as the knives are in use, no further 'payment' for them is necessary.

All this it may seem too obvious to be worth stating. But its significance becomes clear when we consider the second, or capitalist, method of dealing with the problem of knife-making.

CAPITALISM ON BANANA ISLAND

Before we start, we must specify that in the original knifeless community the banana-income is not distributed equally: ten fortunate inhabitants get a much larger share than the others. Accordingly, when the idea of making knives arises and the question of how to support the knife-makers is raised, this wealthy group offers to supply enough of its own bananas to keep the knife-makers alive. This minority ('investors') drastically cuts its own banana consumption and diverts a supply to the knife-makers—but demands in return to be allocated 10 per cent of all bananas cut with the knives when ready, this rake-off to be paid until the knives wear out. The rest of the community raise no objection, for the plan enables them to obtain an ultimate increase in banana-income without the trouble of economizing.

So far so good. The investor is a benefactor to the community: he is taking the whole burden of economizing upon himself. That is as far as orthodox economics takes us. But let us continue the story further.

The invention of knives is followed by many other ideas for increasing banana-income. Baskets are made, stores for bananas constructed, and a road laid down to the banana grove. And so month after month and year after year, the investors divert a stream of bananas to support the erstwhile knife-makers, now engaged in these new activities. And as the banana income steadily mounts, 10 per cent of it accrues to the investors. At first, no doubt, the investors have no difficulty in eating this growing stream of bananas, and before long their consumption has risen as high and higher than it was at the start. But eventually the day comes when they cannot cope with the swelling flood of bananas. Though they eat until they are nearly bursting, there are still bananas left over. This is the crucial moment. Breakdown is imminent.

In a moneyless community, the investors' unconsumed bananas might rot upon the ground and the community might tamely go on paying them their unwanted rake-off. No breakdown would

then occur. A certain number of banana-pickers would be engaged in the futile task of gathering bananas for the investors, only to let them rot, but at least they would not be unemployed. But in a money-using community, as we have seen, breakdown comes because the investors fail to spend their surplus income, and so banana-pickers fall out of work, and the system contracts until this surplus income has disappeared.

However, breakdown can also come in another fashion. If at about this stage the community finds itself with all the knives, baskets, etc., that it needs, knife-makers will become unemployed and the investors will be unable to divert to them as big a stream of bananas as formerly. The bananas then remaining in their possession may be more than they are willing to consume. The investors have been for some time in possession of a total income larger than they can consume and have relied on getting rid of the surplus through the channel of investment. Such a situation in inherently unstable. At any time, the excessive character of the investor's income may become apparent. This may come about either because the unconsumable surplus becomes bigger than the investment channel, or because the investment channel becomes smaller than the surplus.

Sometimes breakdown can be postponed for a brief period by enlarging capital industry. If the community is still in need of knives, it is possible to transfer more men from picking to knife-making and thus enlarge the investment channel. But unless the population is rising, this is not a measure which can be carried far, and this over-distention of capital industry only makes contraction more certain in the long run.[1]

What is to be done? Surely it is obvious that the only possible course is to deprive investors of their 'right' to this immoderate flood of bananas. This is confiscation, however we try to disguise it, but no other course has any hope of success. This suggestion naturally arouses the feeling that there is something 'unfair' about such a course. Can it be possible that there is really a split between justice and necessity in this matter?

[1] The constant pressure to enlarge capital industry which develops in a system at this stage is the main cause of the trade-cycle as we shall see in due course.

THE MORAL ISSUE

The orthodox approach to the moral issue is that the investor performs a service by economizing ('abstaining from consumption' is the textbook phrase) and is entitled to his reward. This is a fair analysis in the early stages of the story we have just considered, but as soon as the investor's income exceeds his power to consume, he can no longer truthfully be said to be abstaining from consumption when he invests. There is no self-sacrifice involved in devoting money to investment if you had no intention of spending it anyway.

Moreover we can attack the orthodox interpretation on more fundamental grounds. Admittedly, true abstinence deserves its reward—but how big a reward? Civilization's historic error has been to grant the reward on far too generous a scale. As already said, no service, however noble, merits a reward greater than the recipient can consume. This suggests a possible mode of cure. We might modify this really very curious arrangement whereby abstinence receives a reward of indefinite size and duration into one whereby the reward gradually diminishes and finally disappears. We might devise a system whereby the nominal value of invested money is written down by some convenient percentage every year.

The argument supporting the payment of interest throughout the period of a loan is that the lender is deprived of the money all this time. But this is mere sophistry. The lender can only spend his money once, and it is the right to do this that he gives up. Our ideas on the subject are confused because the loans we make in private life are intended to be repaid; but money lent to industry must eventually be written off when the capital goods produced therewith wear out. What we are doing is giving, not lending. This is clear if we consider the communist method of investment first described. The capital equipment is paid for during the abstinence, after which the matter is closed. The fact is, if a man saves £100 in one year, he has performed a definite limited act of economizing, for which he must be rewarded. The length of time during which the £100 is subsequently made use of by industry is neither here nor there.

Our curious system of investment may also be considered from a practical aspect.

A SYSTEM OF DEBT

It is sometimes said that we live in a system of debt. Thanks to our dishonest habit of calling what is really a payment a loan, almost every factory, every coal-mine, every steamship, every tramcar represents a debt on which interest is being paid to someone, somewhere. The bulk of the complex apparatus of our civilization has been brought into existence by borrowing.

What makes it possible to pay interest on these loans is that they have added to the national income. If a machine is built for £100 and brings into existence £10 worth of goods every year more than would have been produced without it, then it is feasible to pay the man who puts up the £100 the sum of £5 a year—that is, to give him a claim on half the extra production. But if the machine produces only £1 a year extra, it is not possible, and the machine will not be built. Now many of the capital goods required by a progressive community are not productive in the monetary sense of the word; schools, roads, libraries, laboratories, hospitals provide a service which either cannot be sold at all, or cannot be sold at a price which represents its true value to the community. Thus hospitals and schools, for instance, yield benefits not only to those who attend them but also to manufacturers generally in the form of reduced sick-leave, more capable employees, etc. Similarly, the discoveries of research laboratories (cf. atomic power), though of obvious importance, are quite unsaleable. In consequence such enterprises rarely earn a profit and it is therefore very difficult to raise capital for these all-important additions to our stock of capital goods.

The debt system also stands in the way of providing new housing, since rents are directly related to the prevailing rate of interest. If a builder borrows money at 7 per cent. to build a £1000 house, he must charge at least 27s. a week for it, whereas if he can borrow at 2½ per cent. he need only charge 9s. 7d. weekly—plus his profit in both cases. Hence when interest rates

are high it is impossible to provide houses at a price at which people can afford them, as happened, for instance, in the 'twenties.

With the communal method of borrowing employed by our banana-pickers in the first instance no such problems arise. Once the economy has been performed the construction has been paid for, once and for all. No debt persists. For this reason and because they suspect its connection with unemployment, a great many people to-day are coming to the conclusion that, rather than try and patch up our defective system of financing, it would be simpler and quicker to make a clean sweep and instal something radically different.

A NEW SYSTEM?

The essential feature of the banana-pickers' first method is that *everyone* in the community shares in the economy. Whereas if a minority bears the sacrifice, then the community as a whole finds itself in debt to the minority. There is thus a tendency to disequilibrium in the system: the continual payment of money by one part of the community to the other must inevitably produce a more and more lop-sided distribution of incomes and this favours the further development of sacrifices by the minority and the creation of new debts to them.

What caused the banana-pickers to choose the second method was the unequal distribution of incomes to begin with. It was because some people were too poor to save, while others could do it easily, that the business of minority-sacrifice started. Injustice breeds injustice. That constitutes no reason for preserving injustice. The sensible course would seem to be to return to the rational system of mass-abstinence in order to create the goods which the whole community wants.

We have arrived, in fact, at the conclusion that we should revert to communism. Not necessarily Communism, with a large C, the system they use in Russia, with all its political and social implications, but communism—such as is practised in a monastery, where the spades, looms, stills and other plant is communally owned and paid for. Soviet Russia, of course,

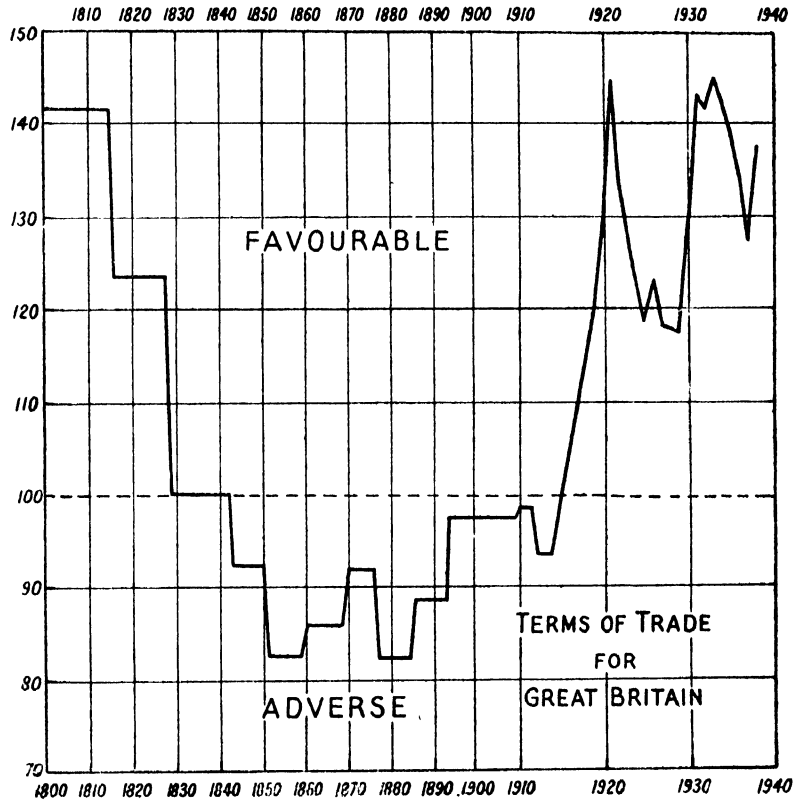


FIG. 6.—MONEY VALUE *v.* REAL VALUE: THE TERMS OF TRADE.

Owing to variations in prices and exchange-rates, the money value of a country's exports is no guide to the volume of goods sent abroad or received. The relation of real value to money value is called the *terms of trade*. When the volume of goods needed to make up a given money-value of exports is relatively small, the terms of trade are said to be favourable.

As seen above, from 1840 to 1860 Britain was importing an increasing share of the national output by volume, though the money-value remained practically constant: the terms of trade were moving against her. In fact, throughout the eighteenth and in the first part of the nineteenth century the price of exports fell more rapidly than the price of imports—making a policy of jam to-morrow still more ludicrous. Later, the expansion of agricultural output in countries overseas depressed the price of foodstuffs and reversed the trend.

practises communism, *i.e.* mass-abstinence to obtain the means of production. Basically, the Russian technique is to pay all the takings of the industrial and distributive machine into a central banking account, abstract whatever sum is required to finance the new capital projects which the government has authorized, and to divide up the remainder among all the workers in the country, including those working in administrative posts and not in industry.

In a general sense, therefore, the cost of saving in Russia is borne by the whole community, since the amount which remains to be divided becomes smaller as investment becomes larger. However the weight with which this falls on the different sections of the population depends entirely on the method of dividing the sum allocated to wages. The method is therefore compatible with the existence of an unequal distribution of incomes.

Since every enterprise has recourse to the general fund of savings, they are under no temptation to save more than their quota. And since those who are responsible for the laying out of savings on capital construction are uninfluenced by the need to make any particular enterprise show a profit, provided only that the sum total of enterprises do not make a loss, there is no danger of reluctance to invest.

The adoption of mass-saving on these lines undoubtedly creates nearly as many problems as it solves. Above all there is the danger that the administrative bureaucracy may prove less responsive to public demand, less encouraging to new ideas than the system we know. Nothing I have said must be taken as unqualified advocacy of communism; still less must it be taken as support of Communism as practised in Russia, where these methods of solving certain economic problems are allied with political and social policies which this book does not even attempt to discuss. All I wish to do at this point is to show one way in which certain problems can be and have been met. (I shall discuss some of the obscurer aspects of Communism and other systems in the sequel to this book, *Conditions of Happiness*.)

To sum up: the crucial question of our times—as far as economics are concerned—is, whether to prevent the emergence of over- or under-saving by battling with the complex of blind forces producing it, or whether to substitute a new system for the old.

Either way, it is clear that the Liberal dream of an economy in which high wages are associated with high profits is an illusion. This capitalist Utopia is an even more fervent article of belief in the United States than in England; in that country it is the faith not only of employers but of wage-earners too. But the fact is that high profits (as employers interpret the word high to-day) will always drain off *additions* to the national purchasing power—additions which should be going into wage-raises—into a form in which they are sterilized, viz. additions to investment-incomes.

This, then, is the economic significance of large profits. Propagandists often attack large profits on the ground that they are 'unfair'. Apologists of the capitalist system defend them with equal pertinacity. With these issues I am not here concerned. I only wish to point out that at present, in highly industrialized countries, profits are, in general, of such a size that—present saving and spending habits being what they are—over-saving tends to develop.

Up to now we have dealt only with self-contained communities. We have made only a passing reference to the fact that investors, when all internal opportunities of investment are exhausted, can invest overseas. In real life however, this is of great importance, for it offers a means of postponing the otherwise inevitable collapse. Let us turn then to the subject of overseas investment, sometimes known as the *export of capital.*

Summary

The service of lending merits its reward—but no service can justify a reward so great that the recipient cannot consume it. Yet lenders accept the money which would bring them this

unconsumable reward because investment offers them a way of converting it into *income.*

The task of lending has been shouldered by a minority, and their reward, at customary rates, now far exceeds their desire to consume. Hence they are all competing to turn it into income—but the opportunities of so doing are limited. There is no course open but to take back part of this over-generous gift.

The formal argument justifying the payment of reward is that lenders have abstained from consuming—but this is quite untrue in the case of many investors, who do not raise their consumption when they cannot lend, but hoard instead. The system is also unsatisfactory as a means of providing capital goods, since many types of capital goods cannot earn a dividend for the investor.

In short, unemployment is inherent in our system of investment; there is much to be said for the view that the best course would be to replace it with a new one.

5

Jam To-morrow

'You couldn't have it if you did *want it,' the Queen said. 'The rule is, jam to-morrow and jam yesterday —but never* jam to-day.'

THE EXPORT of capital is the salvation of the capitalist economic system. It is the magic wand which banishes over-saving.

As long as the surplus sums which the owner does not wish to spend and cannot invest are lent to people in other countries, and these people then spend them on the goods manufactured by the lending country, the industrial machine spins merrily. Money which might have been given to British workers as wages is now being put in the hands of (for instance) Argentines, who are thereby enabled to buy goods from Britain equivalent in value to what the British workers might have bought. (Of course, it is not necessary for the transaction to be so elementary; the Argentines might spend the money on Australian goods, the Australians might spend it on American goods, and the Americans on British goods, which would have the same effect. The first is called a *bilateral*, the second a *multilateral* transaction.)

Accordingly, as long as it remains possible to lend abroad the surplus saving, year after year, decade after decade, the decline of purchasing power, the collapse of industry, can be averted. But as time goes on foreign lending becomes harder and harder. There are more and more countries anxious to lend, fewer willing to borrow. To this general tendency, at present not far advanced, there was added in practice the disorganization of the inter-war years, when the widespread defaults on loans sadly discouraged further lending. As a consequence, over-saving took place; domestic consumers could not absorb the increasing output of industry; unemployment grew rapidly; the roof to progress became evident.

In this situation the war came as a blessed relief. The unspent surpluses were milked away from the savers by drastic taxation and handed to military buyers who had no compunction in spending them. Unemployment vanished.

If, after the war, an attempt is made to re-establish the export of capital, the difficulties will re-appear. More and more capital-sated countries will be seeking fields to fertilize with their bulging bank balances, while the number of unfertilized fields will dwindle. In the end we shall have the whole world frenziedly competing for the right to get rid of its money. And then what will happen? Presumably, general collapse. The record slump of all time. Or once again the tried and trusty pick-me-up: war.

As the export of capital is the mainspring of the capitalist economic system, it will pay us to investigate it more closely.

THE GROWTH OF LENDING

Being the first country to industrialize itself, Britain was first-comer in the lending field, and the success of her industrialization soon made her the largest lender. Lending has been one of her specialities ever since. In course of time other countries became big lenders too, but the City of London's experience and organization made it the best place from which to organize international loans. This is what is meant by the phrase: 'Britain is the financial centre of the world.' Britain achieved this position not only because of her extensive industrialization, but also because she owned a large part of the world's gold-mines. Hence for a long time she was in a predominant position for supplying other countries with the equipment they needed to industrialize themselves, and for lending them the money with which to buy it.

Accordingly Britain's foreign lending has been on a stupendous scale. It has been estimated that in 1913 the amount of British money invested abroad was about £3750 million—about £100 for every man, woman and child in the country. Had its growth continued unchecked, it would by 1939 have totalled well over £5000 millions. But, owing to the collapse of international lending in the '30s, Britain's foreign assets by 1939 stood at a mere £4000 millions.

When a country borrowed money from Britain it naturally did so because it intended to spend it; and usually the country in which it spent it was Britain—in fact it was sometimes a condition of the loan. Thus what was occurring in terms of goods was that a continuous stream of British manufactures was flowing abroad and being paid for with borrowed British money. On these loans, of course, interest was due to be paid. Now if money is a means of exchanging goods, the proper course was for Britain to spend this interest in buying goods from the country concerned. Thus the sort of thing which should have been taking place in terms of goods was that Britain supplied the Argentine (let us say) with locomotives, trucks and railway lines and took in return as interest on the debt an annual payment of beef. But in actual fact the rich men and concerns who were doing the lending had no desire to acquire large quantities of beef and did not in fact spend the money with the borrowers. What they did was to invest it in some other country, which in turn spent it on British manufactures and not on beef and other primary products. (This again simplifies the picture to a simple bilateral operation, where in reality a multiangular group of transactions would occur.)

The debtor countries accordingly found themselves being drained of money, as each year they made payments to Britain which were never returned, while at the same time they found themselves with quantities of produce which no one in their own country had money to buy. Their position was an impossible one, and sooner or later they all did the only thing they could do: they defaulted. In honesty it must be added that there were often other more immediate reasons for default, ranging from unwise expenditure of the loans to corrupt administration, but behind them lay this compelling reason which made ultimate default almost inevitable. What the borrowing countries were mainly able to supply was foodstuffs. The expansion of population in industrial countries at first provided a market for them, but as population growth declined, the market failed. The great agricultural productive power of countries like Australia, while preserving themselves from default, brought it nearer for the others.

THE BORROWERS DEFAULT

The scale on which these defaults took place is almost too fantastic for belief. In the first quarter of the nineteenth century we lent abroad £100 million. Of this £25 million *never returned any dividend whatever*. Much of the remainder defaulted or partly defaulted after a preliminary attempt to pay. For example the Argentine defaulted in 1833, and Colombia and Guatemala paid nothing for years. It is estimated that between 1854 and 1914 the British investor lost by default some £2000 million. That was while the system was considered to be 'working'. Since the Great War there has been little pretence that the system has been working at all. In 1932 it was estimated that sixteen countries were in default to the tune of more than £200 million. This figure does not include the vast defaults of Soviet Russia.

Sir Arthur Salter, writing about the causes of the 1931 depression, went so far as to say: 'I venture to challenge a denial from any responsible person acquainted with the public borrowings of the years 1926–8 of the assertion that, with the exception of loans recommended by the League of Nations and the Central Banks, the bulk of the foreign loans in these years to public authorities in debtor countries would better not have been made.' However, as it transpired, not even loans recommended by the League were safe. In 1935 £61 million was outstanding; full service was maintained on £23 million (38 per cent) only. Defaults after 1931 are harder to reckon since many countries, notably Germany, adopted ingenious exchange arrangements which were equivalent to partial default. Many Latin-American bonds defaulted in 1931, Central Europe did likewise in 1932; in 1933 Germany declared a wholesale Moratorium. It was calculated that the nominal value of British capital invested in defaulting countries in 1935 was £117 million out of £335 million invested outside the empire (not counting Mexico and Russia)—just half.

In fine, what has been happening during the last hundred years is that England has been virtually giving away a vast part of her total industrial production. And while the British working public was thus being the world's fool, supplying it with goods

for nothing, it was being dazzled by the assurance that Britain was the greatest exporting country in the world. It did not seem to occur to anybody that it is not very difficult to be a great exporting country if you give away goods for nothing.

These were the historical reasons why Britain got itself into this position. But if it had not been Britain it would have been some other country, for development on these lines is inherent in the economic structure we possess. So if we want to work out a cure we must dig deeper and try and find out what piece of economic mis-organization is at the bottom of it all.

THE DUAL SYSTEM OF PAYMENT

We can say that this situation developed as a result of thinking in terms of money, instead of goods. Lending, as we pointed out in the last chapter, is an attempt to convert capital into income. If Great Britain had been a single person, it would have been a fair description of the situation to say that she abstained from consuming goods (sending them abroad instead) in order later to be able to increase her consumption by spending the interest as it came in. But this description fails to fit the picture when we consider Great Britain in reality, because while the economizing was really done by the whole people of Britain, inasmuch as they were not consuming a large part of the goods produced by their labour, yet the interest paid in return accrued to a very small minority of investors. This small minority was unable and unwilling to consume the vast mass of consumable goods which Britannia might have bought with the interest. Instead they continually re-lent the money abroad. In short, the general standard of living was kept down against a promise of subsequent rise in that standard, but the day when that increase would be realized was continuously and ceaselessly being postponed. Like the White Queen, Britain lived in anticipation of jam in a perpetually receding to-morrow. All around there was the spectacle of productive capacity—in the cupboard there was piling up an ever larger quantity of jam, but jam was never on the menu to-day.

Now how did this extraordinary thing happen, that the

standard of living of the majority was depressed, but that the reward only accrued to a minority? It happened because, for some strange reason, *we do not regard the whole volume of goods which is annually produced by the people of Britain as belonging to the people of Britain.* Instead we divide the population into a class A and a class B, and we regard class A as entitled to a certain fixed amount, and class B as entitled to the balance. To be more exact, we pay incomes to people in two forms: *wages* which remain fixed unless altered by a tedious warfare of threats and negotiation; and *profits*, which are completely elastic and indeterminate and mop up the remainder of the national income whether large or small. As a result, whenever the national income is growing larger, the tendency is for the whole of every increment to accrue to profit-earners. To avoid this, wages must be raised or prices lowered—but such movements take place much too sluggishly.

In Britain in the nineteenth century, wages remained low; large profits accrued to profit-earners, or as we usually call them, entrepreneurs, who were consequently in a position to save and invest. Let us try and interpret this familiar bit of history in a manner free from all preconceptions. The traditional visitor from Mars would say: 'I see that the rising output of goods was the result of the labours of the whole population, wage-earners and profit-earners together. And I note that the share each wage-earner received grew more slowly than the national income was growing. It is clear to me, therefore, that it was really the wage-earners who were as you put it, 'abstaining from consumption'—and they, accordingly, who are entitled to the rewards for this abstention. No doubt the entrepreneurs did a certain amount of abstention too, but relatively it must have been very small.

'Where you seem to have gone wrong,' the Martian might add, 'is in not paying to the workmen the money corresponding to the goods they were abstaining from consuming. You appear to have made the odd mistake of paying it all to this small group you call entrepreneurs, and so they and not the wage-earners inadvertently got credited with the income it brought in when invested. Still (the Martian concludes) it is only an error in book-keeping; now you've spotted it, you can easily put the matter right.'

But can we? We are so used to the astonishing fact that Smith

and Brown, the postman and the prime minister, get paid a predetermined sum for their services, while Jones and Robinson, the coster and the K.C., get the margin between prices and costs, that we have great difficulty in not taking it for granted. We assume that some magic will ensure Jones and Robinson do not get more for their labours than Smith and Brown. But the magic is missing.

The inherent rigidity of wages must inevitably tend to create maldistribution of incomes in any expanding economy. This is in part what is meant when it is said that the 'profit system' is to blame for our economic ills. It does not mean, as the writers of letters to the *Daily Telegraph* so naïvely pretend, that no one should work for motives of self-interest; it does not mean that income should not be proportional to skill or effort.

It simply means that a certain group of activities is paid in a different way from the other groups; and this way is such that the whole of the benefits of increasing productivity tend to accrue to the people in this one group. And this goes on until they are receiving a far greater quantity of goods and services than they wish to consume. Since, however, they do not receive the actual goods but merely claims on them (money), the situation speedily arises where these people are receiving large numbers of claims which they have no wish to exercise. At first they can dispose of them by financing home investment, but when this proves inadequate they have only two alternatives; to make no use of the claims, in which case you have the spectacle of goods and services standing idle, while part of the population engaged in producing them is in dire need of them (which rapidly changes into the spectacle idle machinery and unemployment), or alternatively to lend their claims to foreigners who then consume the surplus goods. This at least preserves the level of employment, while depriving those employed of the full fruits of their labours.

Please note this carefully: I am not asserting that the dual payment system is the direct cause of over-saving; only that it creates the initial inequality which enables profit-earners to undertake investment. Investment constantly repeated is the process which then enlarges their incomes to the point where over-saving occurs.

As this curious system is the root of the whole economic trouble, both external and internal, let us ask ourselves how we came to adopt it? Is it, as some claim, the only 'natural' system, or is it a freak of economic development?

THE 'PROFIT' SYSTEM

When a man works solely for himself (let us take a village carpenter for instance) he owns the *whole* of the goods he produces and the whole of the income which he can get by selling them, or by selling his services. Similarly, if a group of men find it necessary to work in co-operation it would be perfectly natural to regard the income they collectively earn as belonging to *all* of them. I do not say that it should be distributed equally—one man might get 5 per cent and another 2½ per cent; but while there may be arguments for giving different individuals different *proportions* of the whole, there is no perceivable argument for giving nine out of ten men a *fixed* sum, and the tenth the whole of the balance. It is sometimes argued that if the tenth man provides the whole of the capital required for the venture he deserves to be paid in this special way. Certainly he deserves to be paid appropriately (provided we accept the system of the private provision of capital) but why not simply a larger percentage of the takings?

In very many primitive and some modern communities this is what happens. But as soon as the technique of production has become so complicated that very large amounts of capital are required, then the person in command of capital finds himself in a position to dictate to the others, and uses this position to interpose the dual method of payment (*i.e.* the profit system) because it is so much to his own advantage. This job of obtaining capital, though it is only one of the things necessary to production, bestows on the man who accumulates (or inherits) it the power to dictate his own conditions to all the other types of worker whose co-operation he needs. In short, the profit system is not the 'natural' development of productive activity, but the chance outcome of the sudden need for large sums of capital arising in a society which has not devised a suitable means for supplying it.

It is not difficult to imagine a world in which some other essential factor was so scarce—sight in a world of blind men, perhaps—that those who fortunately possessed it would be able to impose a profit system in which *they* were the recipients of the margin between receipts and costs, while entrepreneurs would have to haggle for their reward, as wage-earners do to-day.

RATIONAL FOREIGN LENDING

If indeed we wish to lend abroad, no doubt it would be possible to devise a method which would prevent these ceaseless defaults, a method which will enable the whole body of workers to enjoy the reward for their abstinence. A socialised state can do it easily. It can invest on behalf of its population and devote the proceeds to reducing taxation, for instance. And I suppose it would have to confiscate the bulk of existing foreign loans and distribute them equally among the population. A capitalist state can do it too, though its methods will be more roundabout. But do we want to lend? How far is foreign lending really desirable?

When a private individual invests, he may be tempted to severe economies in the present in order to enjoy a large income in his retirement. But if he knew he was immortal and would never retire—and that his wages would continually be increased, there would not be the slightest object in saving. A country is like an immortal individual. It cannot retire, and there is no one to whom it can bequeath its wealth. Rising productivity ensures that incomes will be higher in the future; why, then, should we depress our own standard of living in order that our children (who will in any case be richer than ourselves) should have a yet higher one?

Furthermore, there is a limit to the extent to which our descendants can make use of this gift. The most they can do is to obtain all their imports gratis. A man can retire and take up golf; a nation cannot. It will need trains, doctors, administrators and even caddies, and that means that some of its members must work. Services cannot be imported. But is even this modified degree of 'retirement' really feasible or desirable? Can we really look forward to a world in which a few favoured nations will

bask in luxury while the remainder labour to support them? Apart from the virtual certainty of default or war if such a state of affairs developed, there is the fact that, under private ownership of industry, the people of the country itself would never permit it. For the owners of factories working for the home market or making exportable goods would have to close down their works, a thing to which they would never willingly consent. The people then discharged would be without a living. I hardly think we need trace out the details of this imaginary situation, for it is clear that it could never be permitted to develop. The need of industrial power for use in possible wars alone would rule it out.

Nevertheless, to say that the export of capital is never a sensible policy for the lending nation does not mean that it may not be valuable to the borrowing nation. A prosperous country should be ready to aid a backward country to develop more rapidly, or to overcome the ravages of natural disaster or war. A rational lending policy, in the international sphere, would be governed solely by the needs of the borrowing nations.

In order that such loans shall not lead to the absurd state of affairs just described, in which a group of nations is maintained in luxury by the others, it is essential that no obstacle be put in the way of the borrowers repaying the principal of their loans in due course. If they do this, both borrowers and lenders will end up on equal terms. This is the basis of rational foreign lending.

But if borrowers repay their loans, what are the lenders to do with the money? At first, perhaps, they can make more loans, but finally and at long last they will have to reduce their volume of saving, and cash in on the abstinences they have effected. 'Jam to-morrow' as a policy will have worked itself out.

Seen against this background, what is the proper policy for international leading in the post-war years?

POST-WAR LENDING

The centre of the problem is America. The huge profits ground out by booming war industries will be seeking investment. Since over-saving cannot be avoided without abandoning the capitalist system, it will be necessary to restore the machinery of

international investment on an enormous scale in an attempt to prevent a colossal slump. Certainly, a rational policy would provide for a moderate amount of overseas investment, particularly in the immediate post-war years, when ravaged countries will be seeking to rebuild themselves, but nothing on a scale sufficient to absorb the whole of the funds which will be available; a direct attack on over-saving would also be essential.

In Britain the situation is similar, though on a smaller scale. Britain, moreover, has further weighty reasons for seeking the restoration of 'jam to-morrow'. She is a great exporting country, and a country which has specialized in the manufacture of capital goods. If foreign loans cease, her export trade dwindles, spreading depression and unemployment, and necessitating a drastic change in the structure of industry. Steel-mills and engineering works must close, giving place to light industries for home consumption. In addition the financial houses in the City specializing in foreign loans, will feel the draught. In Britain, therefore, we shall hear a great deal about 'the importance of restoring our overseas investments'.[1]

But if 'jam to-morrow' is to be given a new lease of life, it will be vital to prevent it collapsing as it did in the '30s. Dictatorial governments, with their nasty habit of repudiating loans, must be cleared out; more important, borrowing countries must be given the opportunity to pay the interest they owe. This means that they must have the opportunity of exporting, so as to win the requisite money. So far, however, there have been no signs that the creditor countries intend to lower their tariff-barriers or even that their manufacturers realize the necessity of admitting foreign goods.

The war has provided the 'jam to-morrow' interests with a unique opportunity for reinstating their policy. In smashing Fascism we have smashed a force which offered a serious threat to the safety of international loans. The destruction done by the war necessitates a high rate of saving to replace wrecked capital equipment for many years to come. In assisting the emergence of a progressive China we are opening up a vast new market for lending.

[1] The foreign trade aspects of this argument will be discussed later in the book.

Furthermore, the new spirit of co-operation between the United Nations, while it lasts, provides an unequalled opportunity for setting up machinery to eliminate defaults. It is no coincidence that one of the earliest conferences held to discuss post-war affairs —the monetary conference at Bretton Woods—was primarily devoted to the restoration of international lending. As we shall see in detail later, their various schemes for restoring trade were all subordinated to this end.

It would be an over-simplification to suggest that the second World War arose from the need to rescue capitalism (and it certainly developed in ways that no one can have foreseen) but it may not be far from the truth to say that, when all is done, the war will be found to have served the purpose of making the world safe for international finance.

THE FOREIGN LENDING RACKET

By way of appendix to this story, it may be interesting to describe the profitable 'racket' which has been built up in floating these huge loans. It reveals yet one more reason why financial interests are anxious to restore the system, and it shows vividly that often the floating of loans is not so much a service to the borrower as an unscrupulous attempt to dispose of the huge sums which are seeking an outlet.

Loans are generally floated by the private banks. There are only a few of them and they work in such complete co-operation as to constitute a tight monopoly in their field. In theory the only reward they receive for their services is a small commission—but it is a poor sort of financier who cannot draw the same commission twice or three times, or even six times as in the case of the Dawes loan. These little tricks of the trade are usually kept well out of sight, but occasionally some particularly intriguing example causes a public investigation. The story of the Dawes Loan to Germany in 1924 was unearthed seven years later by the United States Senate Committee on Finance. The loan was for $110,000,000 (£22 million or thereabouts). 'The house of J. P. Morgan subscribed that loan, paying 87 for the shares. They then formed an "originating group" of themselves and nine other

banks, to whom they sold at 87¼ what they had bought at 87. The "originating group" sold on to an "under-writing group" of 146 firms at 87⅜. A "selling group" of 1094 members bought from the "underwriting group" at 89, and sold to the public at 92. Thus the difference between the original price at which J. P. Morgan bought and the price at which the public bought was 5; or in other words, of every $100 which the public subscribed only $95 ever reached Germany at all.[1] The other $5 went straight into the pockets of a financier. In all, a total of $5,500,000 (£1,100,000) went thus into such pockets. J. P. Morgan's, who had sold to themselves at every stage of the proceedings until it came to unloading on the public, made a profit of $865,307 (about £173,000).'

The quotation is from Christopher Hollis's *The Breakdown of Money*, but the full story can be found in the Committee's report. I cannot improve on Mr. Hollis's telling of it, nor on his comment: 'It may be urged in defence of all this that floating a loan is an expert and technical business and that experts must be paid. There is no reason to question this. But must they be paid $5½ million—a sum which they earned by a few days' work and which is about equal to the total of the annual earnings of some 6000 British working men? Their risk of loss was negligible. Can it be seriously pretended that this ridiculous complication of underwriters and originators and sellers served any functional purpose at all? Is there any doubt that all the technical business which the financiers did could have been done just as well in a few days by a handful of competent and conscientious civil servants, who would have been amply content with an income of some £1000 or £2000 a year? Can anyone who has ever seen a financier seriously believe that the members of that class are possessed of any esoteric skill which is denied to ordinary mortals?'

A classic example is the loan to Greece in 1824. The amount raised was £800,000. Only £280,000 ever reached Greece. Consider also the tale of Messrs. Dillon, Read & Co's. loan to the city of Rio de Janeiro. The Banking and Currency Sub-Committee of the United States Senate brought it to light and the matter

[1] The Committee's report showed that a difference of 5 was somewhat below the average for foreign loans; in the Rio loan (see next page) the difference was 17⅜.

was reported in *The Times* of 14th October 1933. The loan was for $12,000,000 (£2,400,000). It was taken at 80 per cent and sold to the public at 97¾ per cent, a profit to the financiers of 17¾ per cent of the loan. A large part of the money was immediately spent by the city of Rio with an engineering firm in which a Mr. Clarence Read and members of his family held a 45 per cent interest. And who was Mr. Clarence Read but the head of Dillon, Read & Co. The sum of £60,000 was 'drawn down' by the mayor of Rio and then apparently disappeared. The money 'went into general funds,' said the witness, a member of Dillon, Read's, he 'could not say' what became of it after that. It would of course be libellous to suggest that the Mayor of Rio was in any way influenced into accepting the loan on these terms by the money which he 'drew down.'

Particularly when I add that the sinking fund of these bonds has been in default since October 1931, and the interest since April 1932.

Mr. Ferdinand Pecora, the attorney who conducted the U.S. Senate investigations, tells many similar stories in his book, *Wall Street Under Oath*. For instance the National City Company floated three loans to Peru despite the fact that its own investigators had repeatedly reported that it was a bad risk. In 1927 they floated a £3,000,000 loan; it was followed by a £10,000,000 loan. 'So anxious were they to obtain this business' says Mr. Pecora, 'that the sum of about $450,000 was paid to Juan Lequia, the son of the President of Peru, as an ambiguous "gratuity".' The following year a further £5,000,000 loan was raised. In 1931 all three loans defaulted. The profit made by the selling groups was just under £1,000,000, the National City Company itself making £136,000.

Mr. Pecora's comment is much the same as Mr. Hollis's. 'Is it really necessary, in order to bring together the corporation and the investing public to follow this complicated procedure and pay the bankers such large commissions? It is much to be doubted.'

As you see, the loans, once raised by the banks are promptly 'unloaded' on to the public. Once having got its commission, the bank naturally does not give a hoot if the borrower repudiates the next day. Consequently such bodies have a direct financial

interest in passing as many loans as possible, worthy or worthless, on to the public.

Why do the stock market operators consent to buy these risky investments? Because they hope to hear in advance of the general public of any serious depreciation in the value of the shares and so to be able to pass them on to the clergymen and widows in time.

The result of this iniquitous system is that banks actually go so far as to force on reluctant governments and municipalities loans which they would rather do without. That is why we here often hear of the payment of large sums to highly-placed members of such bodies: they are simply bribes to them to connive in the saddling of their own taxpayers with an unwanted loan.

Another consequence is that naturally such countries frequently default, for they undertake the loans without seriously considering their power to repay. What, in ordinary business, deters a borrower from defaulting is the knowledge that he will never be able to raise another loan. This deterrent does not act in international borrowing, because the debtor country knows that however often it defaults it can always raise a loan if it really wants to: the acceptance houses will be only too delighted to arrange it.

To this general picture we can add two more reasons why financiers in general raise no objection to the behaviour of the acceptance houses. Firstly, foreign countries usually offer a higher rate of interest (in fact they have no option: acceptance houses have a 'gentleman's agreement' not to underbid one another). Secondly, the borrowing government is often prepared to offer inducements to lenders which are even more attractive than high rates of interest. They will for instance agree to accept a much smaller sum than the nominal amount of the loan. For instance for every £80 you lend them, they may agree to give you shares value £100 on which you are to receive (say) 8 per cent, or £8. But since you have only forked out £80 you are getting in reality £8 on £80 or 10 per cent. The object of this tortuous device is as follows: when the shares are sold to someone else he has to pay £100 for the block of shares, (if they are still at par) so that he only gets 8 per cent on his investment, while the seller makes a clear profit of £20. It is clear that this device gives a fat

rake-off to the original lender which acts as a strong inducement to lend. That is not all. As the benefit of the device is only reaped if the shares are sold it is clear that the first lender goes into the transaction with the full intention of selling at a later date. Now no one in their senses is going to sell shares on which they are getting a better dividend in reality than the nominal rate (already a high one) so it is clear that the lender fully expects that the shares will one day depreciate. The financier hopes to be able to unload them on to the public just before this occurs. The whole device is a direct incitement to financiers to organize the lending of money on risks which they distrust.

In fine, the risk which these gentry run is not that the loan may depreciate—they know it will—but the risk that they may not be able to pass the buck to the public in time. And it is for this danger that they receive their reward.

The existence of large foreign loans creates dangers which can only be mentioned briefly here. The sudden withdrawal of loans, or even the cessation of further lending without warning, can plunge a borrowing country into difficulties. We shall see how this occurred in the inter-war years when we come to Chapter 19. International loans have also been the cause of war. Not only are industrialists content to instigate violence in the protection of their investments, as in the case of the revolutions in Mexico engineered by the late Lord Cowdray and his American opponents in the oil business; not only are they prepared to lend political and economic support, as when Britain connived in the Japanese attack on Manchukuo in return for a Japanese promise that the dividends on the China-Manchukuo railway should be paid; but they have even been ready to send British soldiers and sailors in defence of their investments as in the case of the international expedition to Mexico, not to name any more recent and embarrassing example.

CONCLUSION

We have now completed the sketching of our main thesis: we have shown how basic unemployment arises from over-saving, and over-saving from the breakdown of the policy I have called

'jam to-morrow'. Two important matters have, however, been left untreated: the origin of the alternation of booms and slumps known as the trade-cycle and the relationship of these internal policies to the conduct of international trade. I propose to deal with the origin of the trade-cycle first; but before either can be tackled properly, it is necessary to know something of the functioning of our peculiar monetary institutions, what we usually call comprehensively 'the banks'.

In a sane world this would not be a difficult subject, but our monetary machine, instead of being designed for its job like a Spitfire or a Sherman, has evolved blindly from the operations of the mediæval goldsmiths. It is as full of useless vestigial remains as the human body (which the great anatomist Wiedersheim claimed to have 107 useless and even dangerous parts). It will take us four chapters to deal with the subject of money.

Summary

In the past, Britain's foreign loans have been on a vast scale. As the lenders refused to take payment of interest in terms of goods, the borrowers were obliged to default, also on a big scale: So that in effect we have been giving away our surplus production. we have been economizing in the hope of a reward which generally never arrived.

This futile policy was born of the *dual system of payment* as result of which the interest due on loans was not considered to belong to those who had done most of the economizing. This odd system arose accidentally from the shortage of capital in the early days of industrialism.

A rational lending policy could easily be devised, but at the moment financial interests are busy planning to restore this 'jam to-morrow' policy on a larger scale than ever. The vast profits made in organizing loans provide an additional motive for so doing.

We now turn to the subject of the volume of money.

6

Scarcity Economics

'I should like to buy an egg, please,' she said timidly.
'How do you sell them?'
'Fivepence farthing for one—twopence for two,'
the Sheep replied.

DURING THE 'thirties Brazil burnt one bag of coffee for every two she sold. Altogether she burnt more than 75 million bags in twelve years or enough to keep Britain in coffee for the next 300 years. In the inter-war period, the producers of wheat, sugar, rubber, copper, cotton, tin and other basic commodities engaged in over-production on an only slightly less spectacular scale.[1] It is natural to ask why they painfully laboured to produce far more of these goods than they could possibly have hoped to sell.

We can answer this problem without reference to the fact that all over the world there were millions of people suffering from malnutrition who would gladly have consumed, if nothing else, at least the foodstuffs concerned, but lacked the purchasing power to do so. For the factors which caused these countries to produce too much would have acted with just as much violence even if everyone in the world had as much of these commodities as they could desire. Even were we able, with one stroke of our wand, to solve the problem of purchasing power overnight, it would bring only temporary relief to producers; before long they would again be producing more than was needed.

[1] The apologists of the existing system frequently attempt to minimize the scale of these colossal destructions. Thus Professor Hayek, in *The Road to Serfdom* sneers, at those who refer to what he calls 'the occasional burning of wheat, coffee, etc.' and has the cheek to accuse them of intellectual dishonesty. The reader will be able to judge from the figures given above who is being intellectually dishonest in this matter.

PRICES

When you read that wheat has been burnt or fish have been thrown back into the sea, the story usually ends by adding that this was done 'in order to maintain the price', or because the seller 'couldn't get a reasonable price'. The question therefore arises: How are prices determined? What makes them high or low?

When goods are scarce, their price goes up; when they are plentiful, it falls. We see the process happen every year with strawberries. The reason is obvious enough. The dearer a thing is, the fewer people want to buy it, so that when a dealer only has a few early strawberries to sell, he raises the price until he has frightened off all except the few who are willing to pay a high price. Then more strawberries come on the market. If the price is kept at the old level, a few of them will go to the original buyers but the rest will remain unsold; therefore dealers reduce price somewhat so that more buyers become interested. As strawberries become scarce again the reverse occurs.

The same sort of thing is true when the supply of goods remains unaltered but the public demand for such goods increases. If the public suddenly becomes willing to buy at the current price more goods than are actually available, dealers raise the price and so choke off a part of the demand. They must not raise prices too far or they will not sell all their goods. The ideal price from their point of view is the one which leaves neither unsold goods nor disappointed customers.

In other words, price depends on the relation between *supply* and *demand*. If supply is large and demand is large the price may be such and such; if supply is small and demand is weak, the price may be exactly the same, for it does not depend on the absolute size of either, but on the relation between them. But if supply is small and demand is normal, or if supply is normal and demand is high, the price will go up. And if supply is small and demand is strong, the price will be very high indeed.

Unfortunately, the extent to which a rise in price will choke off demand (or a fall encourage it) is not constant. A rise in the price of foodstuffs will cause little decline in demand, because

people must have food and will, if necessary, give up other things to get it. The demand for food is therefore said to be *inelastic*. Contrariwise, the demand for many luxuries is highly elastic. The extent to which demand is affected by price not only varies as between different goods, but varies at different times with the same goods. It is therefore impossible to tell, by any means short of practical experiment, precisely what change in demand a given change in price will effect.

It is necessary to emphasize this fact because the experiences of Mr. Ford have given widespread currency to the idea that it always pays manufacturers to lower prices, on the grounds that sales will increase so much that the reduced profit on each item will be more than compensated by the higher turnover. In reality this by no means follows; in fact it is the exception rather than the rule. If a thing is already so cheap that even the poorest families can get all they want, as pretty nearly in the case of sugar, a further reduction in price has no effect in increasing sales. Not many goods are as cheap as this: but there are more important reasons why demand does not always respond to a fall in price. The demand for electric-light bulbs, for instance, is practically independent of their price. It depends solely on the number of electrified houses in the country. If you halved the price of bulbs you would hardly sell any more of them. On the other hand you could double the price, and people would still buy as many. The manufacturers of bulbs have realized this interesting fact, and by mutual agreement hold the price far above the real cost.

Another point to note about prices fixed in the open market is that they are quite unrelated to the cost of production. They may be higher or lower. Of course, if a manufacturer expects them to be lower he will not normally go into production, but it often happens that producers make a bad guess, or conditions between the time they begin production and the time the finished goods appear on the market, and in this case they may very easily have to sell at a loss.

'STICKY" PRICES

While it is easy to see how strawberries, or grain or fish, or any goods which are bid for in auctions at some stage in the

marketing, vary almost from day to day in price according to the supply demand situation, it is not quite so obvious how this applies to the case of manufactured goods sold at prices which are advertised in advance and which, as we all know, vary at long intervals only. Price movements are sluggish in such instances because the manufacturer who finds he has produced more goods than can be sold at the moment simply holds back part of his output for release later, and meanwhile slows down his rate of production. Such policy is possible with all non-perishable goods. In this way small lapses in demand and small amounts of over-production can be ironed out. But if demand has permanently fallen off this will not work and the price-mechanism reasserts itself. If the manufacturer has produced button-boots and these are now out of fashion no amount of holding them back will avail him, and his only hope is to offer them at ridiculously low prices. The same is true of the retailer. At first he will not reduce prices—or anyway not below the figure he himself paid for the goods—and will hang on in the hope of selling them but as soon as he has to face the fact that the market has permanently vanished, he has to cut his losses and hold a 'bargain-sale'. Thus the price-mechanism does operate in the case of manufactured goods, only more sluggishly.

But there are certain prices which are even more sluggish in their response to changes in the supply demand situation than the prices of manufactured goods. These are prices which are fixed by contract, the most important example being rent. You may have signed a ninety-nine-year lease for your house. Before a quarter of that period has gone by the supply demand situation in housing may have changed considerably. A war may have made houses scarce and put the price up—or improvements in building may have made your house antiquated and worth less than you are paying. Many transactions are carried out by means of long-term contracts, and it is therefore in practice far from true to state that current prices reflect current conditions. For example a manufacturer may be making goods from raw materials bought at a contract price fixed years ago, and so be able to sell them more cheaply than a man who has to buy his raw materials at current prices.

The movement of prices, if not obstructed, matches supply and demand. To start with it acts by cutting down demand; but that is not the end of it—ultimately it expands supply to meet the full demand.

THE PRICE-MECHANISM

The job of an economic system is to decide to what use the available raw materials and labour shall be put, and also to decide to whom the resulting goods and services shall be given; to determine what shall be produced, and how much, and who shall get it. (In the text-book phrase it is 'the application of scarce means to alternative ends'.) Fifty years ago it was widely and firmly believed that the price-mechanism was perfectly adapted to carry out this task.

The way in which it was supposed to work is as follows: Women develop a taste for (say) cosmetics. Demand is growing strong, but the supply is weak. The price rises. Since there is now a good profit to be made in the manufacture of such articles new enterprise is attracted into the trade. The output of cosmetics is enlarged, and the public desire for them catered for. At the same time the public is protected from paying unduly high prices, because the increasing competition will before long cause prices to be lowered, and this will go on until the price reaches the point at which entrepreneurs looking around for something to do, no longer think it worth their while to enter into this particular industry. Moreover, the willingness of the public to pay a high price for cosmetics will enable manufacturers to outbid the makers of less popular articles for the necessary raw materials. Thus scarce raw materials will be allocated to those types of production which are in greatest demand.

Conversely, when demand falls off the price will begin to sink and will finally reach a point where the least-efficient producers begin to show a loss. They will then go bankrupt, while the more efficient producers, whose costs are lower, carry on. In this way supply will be diminished and efficiency maintained. Such, in theory, is the working of the price-mechanism.

This precarious little device occupies a position of unique importance in our economic system. Here we have our complex

civilization, in which we have to mobilize our labour and resources in a million different ways, with a million different priorities, for a million different ends, as a general disposes the manpower and equipment of a great army. But instead of employing a trained General Staff, we leave the whole thing to run itself automatically. Only when the results are outstandingly unsatisfactory do we abandon the price-mechanism and substitute deliberate, conscious decisions. One is so used to the *idea* of the absence of conscious regulation of the economic machine (though it has never been quite so absent in reality as appears on the surface) that it is peculiarly difficult to open one's mind to a realization of the really extraordinary nature of this practice. It is as if we should operate an aircraft factory by making each department an autonomous unit. Imagine the muddle which would ensue! The design department might decide to change the motor from an in-line to a radial type. It would give its order to the engine department—perhaps the very day after they had installed additional equipment for making in-line motors. Meanwhile the airframe makers would still be producing fuselages designed to take an in-line type and would only discover their mistake when a message arrived from the assembly lines. In every direction waste and delay would ensue because no department would have a clear idea of what other departments were doing.

To-day in many directions we have abandoned the price-mechanism; the history of economics could almost be told in terms of the steady supersession of the price-mechanism by conscious decision. Nevertheless the price-mechanism still operates, jerkily, in the greater part of the economic system and all our major economic problems arise from our reliance on it.

Let us start by seeing how this curious device operates in the case of the production of commodities, such as wheat or coffee.

THE PRICE-MECHANISM IN PRACTICE

The price-mechanism is reasonably successful when it comes to expanding output (though even here there is often a serious delay in response) but it wears a very different complexion when it comes to contractions.

Where the theory chiefly goes wrong is in assuming that a fall in price will bring about an enlargement of demand. We have already pointed out that the response of demand to price-changes varies in different cases—it may be 'elastic' or 'inelastic' as the economists say. But the reality is much worse than this: demand may be totally unconnected with price. The trouble is, the instance taken by the economic text-books is far too simple. In real life there is usually more than one stage between supply and demand. Consider wheat. The price of a loaf depends chiefly on the costs of milling, baking and distributing. Hence a big change in the price of wheat will produce little or no change in the price of a loaf, and therefore no change in the volume of consumption. The fact that the price of wheat responds to supply does not affect the situation. Again, the consumption of tin depends chiefly on the number of motor cars and tin cans produced. There are 5 lb. of tin in a car, costing perhaps 9s. when tin is £200 a ton. A fall in the price of tin to half that figure would not cause car manufacturers to buy any more nor would doubling the price cause them to buy less. Conversely, supply may be unconnected with prices as in the case of silver, which is produced as a by-product of the manufacture of lead, or coke, the supply of which depends on the output of gas.

In cases such as these the effect of over-production is simply to leave the market flooded with tin or wheat which no one will buy. In consequence the price drops practically to zero; producers are willing to accept nominal sums from people who would not normally be buyers, rather than get nothing at all. (At very low prices a product may reach a new market: for example, wheat will be brought for the manufacture of grain alcohol.)

Thus as long as the world's wheat-farmers produce rather less than the world-demand, they will get a reasonable price for their grain. If, however, they produce a few bushels more than the world-demand, they will get not just a poor price but a ruinous one. In a year of good harvests the money brought in by the sale of the large quantity of wheat on the market will come to less than the sum realized by the sale of a much smaller quantity in a 'bad' year.

It must not be supposed that this ruinous price applies to

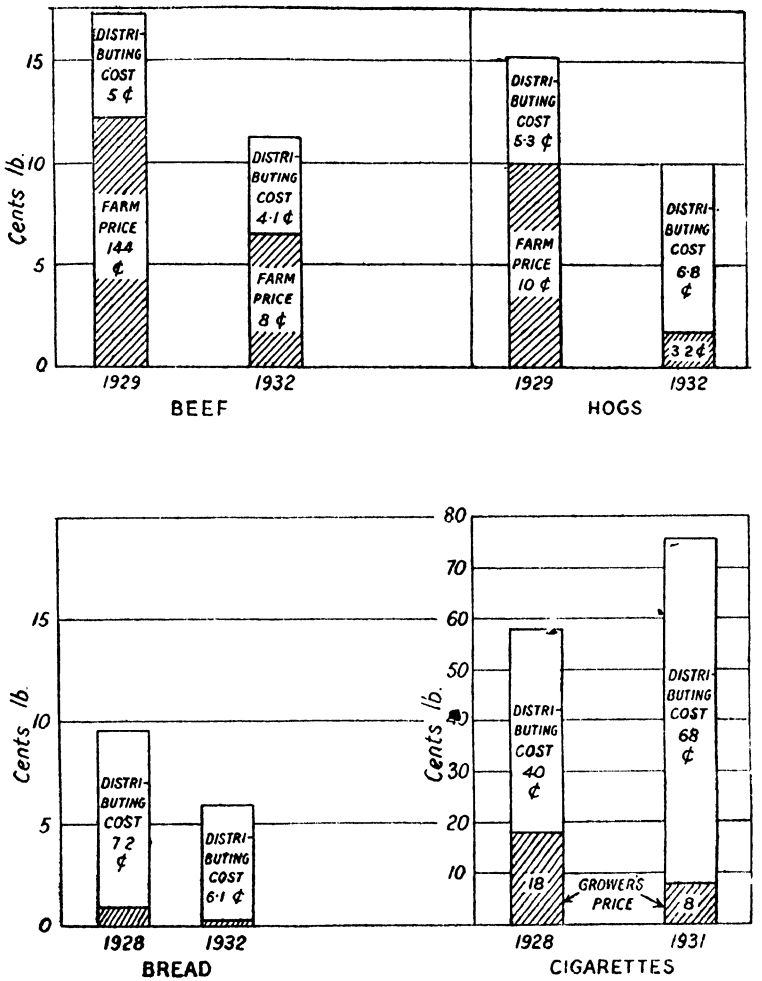


FIG. 7.—FLAWS IN THE PRICE MECHANISM: DISTRIBUTION COSTS (U.S.A.).

One of the many reasons why the price-mechanism does not operate as predicted is the comparative rigidity of distribution costs. Thus, in the case of hogs and bread, when the producer cuts his price by two-thirds in face of falling demand, the market price falls by only one-third.

The case of cigarettes is still worse. Total distribution costs are much the same for a large quantity or a small, so that on the small quantity the cost *per packet* is much higher. Net result: though the manufacturer halves the price at which he sells to the wholesaler, the price to the public (or tobacconist) actually rises.

the surplus left over after world-demand has been satisfied: it applies to the whole crop. For as soon as it becomes clear that over-production has occurred, each farmer hastens to sell, even at a loss, rather than find himself unable to sell at all. Buyers, seeing prices are falling, hold their hands, so that demand contracts yet further and prices drop still more. In a very short time prices have 'hit the floor'.

In short, the price-mechanism depends on the maintenance of scarcity if it is to function at all. Before the machine age, production could only be increased by small amounts and never proceeded far before the error became obvious—except in the sphere of fishing and farming where unexpectedly bountiful harvests, or lavish catches might arrive without warning. To-day, however, it is possible to double or treble the output of almost any product within, at most, a few years. To match this vastly increased productive power, we need an economics of plenty.

WHY OVER-PRODUCTION OCCURS

We are now in a position to see why over-production occurs. The simplest cause of over-production of primary commodities is the capriciousness of harvests, affected as they are by weather, insect pests and other unpredictables.

Cotton is one of the most serious victims here; in 1930 the United States average yield was 158 lb. an acre, against 268 lb. in 1937.

But weather and pests affect only a limited number of commodities. A more general cause of over-production is the entry into the field of new and more efficient producers.[1] According to the theory of the price-mechanism the old-fashioned producers should now quietly go bankrupt, leaving the field open to the newcomers. Sometimes they do, as grooms and harness-makers yielded to garages and car manufacturers. But sometimes they put up a fight for it—as shipping and rail interests are now fighting to control air transport.

There is one case in which the process works especially badly:

[1] When we turn from primary commodities to manufactured goods, many other factors will appear.

when the supplanted industry is in one country and the supplanter in another. For if both industries are in one country, the prosperity of one counterbalances, to some extent, the loss of the other; but if they are in rival countries this does not occur. We all know how Japanese cotton supplanted British cotton. Similarly the low-cost Rhodesian copper developed during the '30s ousted the high-cost United States producers; and low-cost Malayan tin displaced the dearer Bolivian product. In such cases the government of the weaker country is strongly tempted to intervene. For instance the United States government put a prohibitive tariff on the import of copper into the United States, thus restoring part of the trade of the Montana copper-mines—but leaving the world as a whole with excess capacity.

And sometimes the reason an industry becomes inefficient is that the owners have refused to spend money in modernization of the technical equipment—as in the case of the British steel industry. In such cases a subsidy or tariff is inexcusable.

This tendency of states to supply artificial respiration to obsolete industries creates a very serious situation, for it prevents technical progress; by preserving indefinitely the life of relatively inefficient producers it throws away a potential rise in the general standard of living.

The problem is thorniest when a country depends heavily on a single industry, as do the West Indies on sugar and Bolivia on tin. The bankruptcy of the key industry plunges the whole country into depression, and the government has no choice but to intervene.

The problem was disguised during the last century by the rapid expansion of production in every direction; the entry of new producers merely cut down the rate of profit of older firms, it did not turn it into a loss. To-day it has become especially serious not only because expansion geographically and demographically has ceased (perhaps temporarily) but also because technical progress is creating new ways of doing old things, so that on every hand old-established industries are suffering eclipse. Light metals threaten steel; oil cuts into the market for coal; air travel displaces road and rail. What we now must do is evolve a definite *technique of change*. We can no longer rely on superseded

industries finding their own way out of the world; we cannot afford to preserve them by artificial respiration. We must assist them to die in an orderly manner. It is, you appreciate, the debts represented by each machine which the owners wish to preserve. Who will devise a system of euthanasia for debt?

While still on the subject of government intervention, there is one variant of the story which requires mention. Governments do not only impose tariffs to protect antiquated industries from the challenge of newcomers: they may even impose them in order to build up inefficient industries deliberately, when they think this is desirable for political reasons. For instance Australia maintains sugar production in Queensland at a cost of about three times the world price, and Germany developed such substitutes as artificial rubber by similar means. Before the war Germany, Italy and France protected their inefficient wheat-growing from the competition of imports, and Britain, like other European countries, fostered a beet-sugar industry at a cost far above the world price.

There may well be cases in which efficiency of production must take second place to political or social considerations; but what we fail to give due weight to is that such decisions create great problems for other countries and are a cause of international friction and of distress affecting thousands of people. It is incredible that we have no international council at which such proposals can be tabled and discussed, so that other countries can lay their plans accordingly; I shall have more to say on this subject later in the book.

A danger attendant on policies of protection is that, though established in the first place to prevent an industry contracting, the protection is granted on such a generous scale that the industry begins to expand! Now while a case can be made for subsidising inefficiency in order to prevent unemployment, at least as a temporary policy, it is quite impossible to justify expansion, which will only make the inevitable final contraction harder, and in the meantime forces the public to pay more than necessary for imported goods. The tariffs on steel and cars, imposed by Britain in 1931, fall into this class.

In short, the failure of obsolete producers to disappear is the

chief reason why the world comes to find itself with excess productive capacity. Now for the result.

DESTRUCTION OR RESTRICTION

Since even low-cost producers are seriously afflicted by the violence of the price-fall, they are willing to forego the advantages of their greater efficiency and enter into agreement with other producers to restrict output to a point where prices will be restored to a profitable level. In their simplest form, such agreements take the form of the allocation of quotas to each country. But where the producers are strongly organized, as happens in a single industry within a single country, matters go much further. All production is concentrated in the most efficient plants, and the least efficient plants are closed down completely. Profits are pooled and are then divided up among all the firms, including those which are no longer functioning. Since costs have been lowered by the reorganization, the total volume of profits is larger, and hence all firms benefit, even if no change is made in prices to the public. (I doubt if even the most ardent capitalist can produce any convincing justification of paying money to a firm for not functioning at all; in addition, such policies reserve all the benefits of present and future progress in lowering costs for the producers.)

In some such way as this does 'private enterprise' restore prices to a profitable level. But these methods cannot be applied in the agricultural sphere, where the exact size of the annual harvest is unpredictable. Since it is impossible to prevent the periodic production of excess output the only thing to do is to destroy it after it has been produced.

Do you see the significance of this fact? It means that the cases we read about in which grain has been burnt and coffee ploughed under are merely the spasmodic exceptions to the general policy of restriction. In the case of food we destroy a surplus; in the case of goods we destroy it before it even appears. To see the true enormity of our economic mismanagement, one must imagine that every factory, every coal-mine, every foundry is working full blast pouring out goods and raw materials and

that all the huge, unconsumable surplus of this activity is being methodically burnt, smashed and destroyed. The destruction of wheat in Canada and coffee in Brazil is remote and perhaps not quite credible. But if in every town in England clothes were daily burnt on a bonfire, machinery smashed up, houses dynamited, what a cry of indignation would arise! Yet that is what, in effect, is happening. Not all the ferocity of the Nazis in Russia has achieved one-hundredth part of the annihilation of potential wealth effected by our own domestic policy of invisible devastation.

This is why it has been truly said that our economic system is an economics of scarcity. Nor is this all.

PERILS OF THE PRICE-RING

Having once entered into combination, producers seldom rest content with restricting output merely to the point which will prevent a disastrous slump: they restrict it still further and force prices up to a preposterous level. Often they can do this without any appreciable loss of sales for precisely the same reason that prices fell so drastically in the first place; to wit, the fact that demand is little affected by price. In 1925 rubber-growers, for instance, raised the price of rubber to nearly 5s., after agreeing that the fair price was 1s. to 1s. 3d. So doing they raised the average dividend of the industry from 1.8 per cent to just under 20 per cent. Later, when the scheme broke down, the price fell in 1927 to 8d. a lb. and by 1931 to 2½d. a lb.

An added danger of these practices is that people outside the ring are tempted to enter production, either to take advantage of the profits being made or because they refuse to pay inflated prices. In the case of rubber, Firestone started its own plantations in Liberia, and Ford did the same in Brazil. Thus world's productive capacity, already excessive, is again increased, and in the end the competition of these newcomers may cause the scheme to break down.

The most serious objection to organized restriction as practised by producers is that it holds down the efficiency of production. It is obviously desirable, as a general policy, that

low-cost producers should take the place of high-cost ones. That is to say a given quantity of goods should be produced with the least possible labour, thus releasing manpower to provide for other human needs.[1] But restriction schemes divide up the market between all producers, thus giving an indefinite lease of life to the less-efficient concerns.

What is more, once a ring has been formed its members seek to prevent the entry of any new enterprise; they seek to stifle all improvements in technique except those which reduce costs or enlarge sales; and they may even take action to suppress products which might supplant their own. In any long view of economic development this is obviously fatal. As Lamartine Yates says: 'Imagine for a moment that schemes had been started a hundred years ago to protect the tin-mining of Cornwall and the lead-mining of the Pennines. If they had successfully maintained their quotas there would have been no Malayan tin and no Australian lead. If there had been a similar scheme for coal, it is more than probable that petroleum production would have been stamped out at its birth as a dangerous and uneconomic rival to coal.' Furthermore, when associations of producers agree to fix prices they ensure that the benefits of any improvement in productive technique which may be introduced shall accrue to themselves in the form of higher profits, and not to the public in the form of lower prices.

The fact is, the existence of such associations means that we have abandoned this self-regulating device, the price-mechanism and substituted conscious decision—but when we do this, it is essential to see that the decisions are in the hands of unbiassed administrators and not of sectional interests.

However, restriction has not always arisen from attempts to escape the peril of over-production. Sometimes it has been the outcome of sheer financial piracy. Let me tell you, very briefly, the story of copper.

[1] For accuracy's sake it should be added that low-cost production is not always the result of greater efficiency, or not wholly: costs will be low if wage-rates are low; this applies particularly to the case where native labour is in competition with white labour (*e.g.* sugar).

STORY OF COPPER

To get this story in proportion you want to bear in mind that copper can or could be mined for about £25–35 a ton, not counting capital costs. At any price over £40 a ton, the producers may be regarded as making a handsome profit.

The first attempt to corner the copper supply of the world came as early as 1887. A Mr. Secretan contracted to buy the output of mine after mine until finally he had contracted to buy three-quarters of the world output; this forced the price up to £85 a ton. At this unprecedented price the mines' output leaped ahead, while consumption fell. Secretan could not continue to buy, and the crash which followed caused the failure of Baring Bros. and a general slump. Less than ten years later came the next attempt: Standard Oil and the National City Bank formed a $55,000,000 company to corner copper. It forced the price up to £78 a ton, but in the ensuing crash (1901) it dropped to £50. In 1907 the same interests made another attempt. They succeeded in forcing the price up to £115 before the financial panic of that year broke the market.

After the war an American copper cartel was formed to wrest control of copper from the London metal market. Having succeeded in this aim by cutting off the supply of copper until the stocks of London brokers were exhausted, it pushed the price up until by 1929 it stood at £111 a ton. Buyers then declared a strike and the Cartel moderated its demands to £83 a ton, which price held until the 1930 slump brought all prices down.

Meanwhile millions of pounds were being spent by British interests in developing Rhodesian and South American copper in order to break the U.S. control; coupled with the slump, this development brought about gross over-production, and the price sank as low as £24 a ton. As low-cost copper flowed into world markets in increasing quantities from the new mines, output from American mines dwindled. Employment dropped to a fifth of the 1929 figure, and the copper-mining states of Montana, Arizona and N. Michigan were nearly bankrupt. Instead of accepting the supersession of their mines, the U.S.

government, not surprisingly, imposed a tariff of 4 cents a lb.; this, in relation to the current price of 5–6 cents a lb., was prohibitive and preserved American markets for costly U.S. copper. The rest of the world, after a good deal of squabbling, agreed in 1935 to scale-down production to some 60–70 per cent of full capacity.[1]

After hearing this story, can there be a moment's doubt that if the world wishes to produce its copper efficiently, there must be a world production plan drawn up by an international authority, and this authority must not be composed of producers but of the *representatives of consumers?*

OVER-PRODUCTION AND THE TRADE-CYCLE

So far we have considered only the production side of the picture. But it must also be stated that the trouble is not wholly due to productive capacity increasing; it also happens that demand falls off.

We have already noted the well-known fact that prosperous periods and depressions follow one another alternately, this periodic movement taking about eight years and being known as the *trade-cycle.* These alternations of prosperity and slump naturally cause marked fluctuations in demand, especially in the demand for semi-durable goods such as motor-cars; consequently the demand for tin and rubber—to name but two examples—varies widely.

Naturally over-production tends to take place during the slump. This likelihood is intensified by the time-lag which necessarily occurs in adjusting production to consumption. To take the case of rubber, it takes six years before new rubber trees begin to bear. During the boom years, producers plant new trees, and tin-mining concerns bore new shafts—but these increases in capacity only begin to yield about the time that slump replaces boom, thus intensifying over-production.

The existence of the trade-cycle makes it very hard to distinguish between temporary and genuine over-production—and

[1] This story, like most of the other facts in the chapter, is taken from *Commodity Control* by Lamartine Yates (Cape). I strongly recommend the serious reader to get hold of this most interesting study.

hence very hard to persuade producers to agree to any permanent reduction of productive capacity. They delude themselves that when the good times come again their capital outlay will prove justified.

This fluctuation in demand can be evened out quite easily if producers will agree to limit output to the world's average requirements. Then in bad years the surplus can be stored up for release in the years when demand outruns supply. In the past twenty years several industries have set up *buffer stocks* on these lines. But the schemes have often broken down, for two reasons. The schemes were not based on any general agreement to restrict production to average needs. Instead, the authorities simply undertook to buy the output whenever the price fell below a certain level, and to sell whenever it rose above another level. In other words, instead of going to the heart of the problem, the volume of demand, they attempted to maintain an *agreed price*—and this price was fixed so as to provide a satisfactory profit even for high-cost producers. In these circumstances of what amounted to a guaranteed price, producers increased output as much as they could (blind to the consequences of their self-seeking) until the authorities could no longer afford to buy the stuff, when the scheme collapsed.[1]

WORLD PRODUCTION PLAN

We have told this story in some detail because of its importance: what have we proved? First, that when producers seek only their own profit under a regime of free competition, they simply work their own ruin. The price-mechanism fails to achieve the needed readjustments. And second, that when producers combine to stifle competition, they ensure their own profits at the cost of inefficiency and restriction.

[1] And sometimes the controllers of buffer stocks fail to perceive genuine changes in the volume of world consumption. Thus in 1922–5 the (government-operated) Bandoeng tin pool by slowly unloading the buffer stock on to the market concealed the existence of a genuine increase in demand. Suddenly the day came when the stock was exhausted, and productive capacity was found to be much below what was needed, and prices rose sharply.

What is the alternative?

Regulation of production in the interests of consumers rather than producers. It may be true, as some argue, that only those with experience in an industry can be relied upon to govern it efficiently. In this case it would be worth paying a few former producers a princely salary to work in the service of the world's consumers. The cost, however great, would be trifling compared with the savings which would be effected.

A rational world production plan would allot quotas to producers, but year by year it would decrease the quotas of the less efficient producers (except where some over-riding consideration of consumers' interest dictated a different course) and increase those of the more efficient, all the while ensuring that the total output was consonant with the world's real needs. In this way the less efficient producers would be gradually superseded.

It goes without saying that the plans for each industry would have to be integrated into a master-plan which would take into consideration every aspect of the problem, social needs as well as economic ones. It would be suicidal to close down an important industry in any country unless alternative means of employment were being opened up at the same time.

There does not seem, however, much hope of achieving such a solution. Admittedly the difficulties are great. Producers would accept elimination by order of an international council with much less resignation than they bow to the hard law of competition. It would be difficult to prevent a recalcitrant nation from wrecking the programme by its refusal to adhere to the scheme. And there are other difficulties, as will appear in the course of the book. Nevertheless the principle stands. We shall return to the subject in the last chapter.

In the immediate post-war years, the most we can hope for is the setting up of a number of unco-ordinated international Commodity Councils: the danger is that they are likely to be run by producers for producers. The immediate need is therefore to press strongly for representatives of consumers to constitute a majority on the board. Another step forward would be the formation of an international advisory council to point out, loudly and often, where production schedules were departing

from the logical trend. A responsible press (if any) could help by publicising its warnings. Machinery such as this might be gradually developed, by an extension of its powers and responsibilities, into an effective weapon for rationalizing production.

CONCLUSION

In this chapter we have digressed from our main line of advance to consider the inadequacy of the price-mechanism as arbiter of our economic structure. Practical evidence of that inadequacy has already been given and more will be forthcoming in the course of the book.

Now let us resume the main thread of argument by considering the medium in which the price-mechanism works, money—and, in particular, the question of how much money we need.

Summary

Prices serve to adjust demand to supply, but the amount by which prices have to change to do so varies according to the *elasticity* of demand. Some prices are 'sticky' and respond only after a lapse of time to a change of conditions.

Through the *price-mechanism*, prices are supposed to bring about changes in supply so that it is adjusted to demand: this is successful in expanding supply, but far less so in contracting it. The great question is whether to rely on this erratic system any longer.

Over-production occurs because the price-mechanism fails to weed out superfluous producers. It creates such misery that the government is usually forced to intervene. Alternatively, producers themselves take action: they combine to restrict output and fix prices. This usually leads to the other extreme, excessively high prices. Restriction of industrial output is the counterpart of the destruction of agricultural output.

The story is complicated by the periodic fluctuations in demand known as the trade-cycle. The hope of a return of prosperity persuades the superfluous producers to hold on. These fluctuations can be evened out by means of buffer-stocks; but they must be combined with a world production plan.

7

How Much Money?

'I gave her one, they gave him two,
You gave us three or more;
They all returned from him to you,
Though they were mine before.'

'Oh, I'm not particular as to size,' Alice hastily replied; 'only one doesn't like changing so often, you know.'
'I don't *know,' said the Caterpillar.*

YOUR BLOOD flows round your body about once every minute and a half. In so doing it assists in many different processes. You have probably, at some time or another, asked questions about these processes. But the most important question of all you probably took for granted.

How much blood?

That we should have exactly the right quantity of blood *is* a thing we usually take for granted. Yet it is very remarkable; from infancy when we weigh 7 lb. to manhood, when we weigh around 160 lb., the quantity of blood is always adjusted to our requirements. Or if it is not, we fall ill.

Exactly the same thing is true of money. In any economic system, the amount of money must be just right. So in this chapter I want to deal with the question of how much money there is on circulation. When should it be increased or decreased in amount? How can this be effected? What happens if it is not done?

When the amount of money in a system is increased, prices rise. When it is decreased, they fall. This is simply an extension of the proposition we considered in the last chapter. There we considered the case of an increasing supply of goods, such as strawberries, and a constant amount of money: prices fell.

Similarly, with a constant supply of goods and a decreasing supply of money, prices fall. And *vice versa.*

Or look at it this way: in any economic system a great number of transactions are taking place every day. If the amount of money in the system decreases the amount available for each transaction is less, and if it increases it is greater.

We can also take the proposition further. If in a given system the output of goods is getting larger, but the supply of money stays constant, then prices must fall. An increasing number of transactions is taking place—more goods are being bought and sold—and the supply of money for financing these transactions is not increasing, so the amount involved in each must be less. Conversely, if the output decreases while the supply of money remains constant, prices will rise. Note, however, that these statements differ from those in the previous chapter in that they refer to *all* prices, whereas there we referred to the price of some particular kind of goods, changes in which did not noticeably affect the price of any other line.

When prices rise, due to an increase in the supply of money without any corresponding increase in the supply of goods, *inflation* is said to be taking place. When prices fall, for the converse reason, *deflation* is occurring.

I want to define these two rather misused words more carefully. For instance, if the supply of money is increasing at exactly the same rate as the supply of goods, so that prices remain level, no inflation is taking place. Inflation does *not* mean simply an increase in the supply of money. It means an increase *relative* to the volume of goods. Thus if the supply of goods were decreasing. and the volume of money remained steady, it would be strictly correct to say an inflation was taking place, because prices would be rising. We can go even further. The volume of money might be actually decreasing, but if it were not decreasing as rapidly as the supply of goods, prices would rise and the effect would still be inflationary. Conversely, the supply of money may be increasing, but if it is not increasing fast enough, the effect will be deflationary.

This, at any rate, is how we shall use these words in this book. But in reading others, it will be well to remember that some

writers use them to mean simple increases and decreases in the supply of money irrespective of the direction of price-movements, if any—this is particularly common when the context refers to banking operations and government borrowing. And some writers use both senses indiscriminately.

Since these principles are of fundamental importance and recur throughout our arguments let us try and illustrate them by constructing a simplified model of an economic system.

THE MODEL

Somewhere away from all outside interference, in the middle of a desert, say, there is a factory. The manufacturer employs 1000 men, paying them £1 a week each, and they produce 1000 articles every week; only a part of these men is engaged in the actual production of finished articles, the others are preparing the raw materials, replacing worn-out equipment, performing administrative jobs and so on, for the manufacturer has his own sources of raw materials and power.

The manufacturer counts himself among the workmen and pays himself £1 a week too. He has no outside obligations as he owns the land and financed the undertaking himself. Let us also say that he makes a variety of goods and that these goods satisfy every need of the men employed. (Lest the description seem too fanciful, let me remind you that it would fit the colonist-farmer of 150 years ago reasonably nearly.)

Every Saturday the manufacturer pays out £1000 in wages, whereupon all the workmen troop round to the back of the factory where he sells the output in his own shop, and proceed to spend all their money. Now, *if the goods are priced at £1 each*, there will be none left over, neither will any man have to go without. Thanks to the price being correctly adjusted to wages, there is thus a perfectly free movement of money to and fro between manufacturer and consumer, and everything spins merrily.

1. Next suppose that the manufacturer *doubles his output* by compelling his men to work longer hours. On Saturday half the output will remain unsold. What is he to do? There are two obvious courses—either he can double wages or he can reduce

prices. If he reduces prices to exactly half, all the goods will be sold without trouble.

Now we live in a world in which output is constantly increasing thanks to technical progress and the mechanization of more and more branches of production. In the absence of any corresponding alteration in the level of wages, it will be necessary for prices to fall in proportion as output increases. Unhappily, this price fall is by no means easy to achieve in practice. Manufacturers who achieve economies in production rarely pass on the whole benefit thereof to the public. In conditions of intense and perfect competition they might, perhaps, but the existence of patent rights, secret process, trade agreements and the like (to which can usually be added the need to pay interest on a larger volume of capital) enable them to retain at least part of the benefit for themselves. But if they fail to reduce prices to the full extent of the economy effected, then the prices of other kinds of goods must be reduced in compensation—for if more money is going to the one there is less for others. In this way price reductions are forced on manufacturers whose costs have not been lowered and will drive the weakest of them out of business. In short, the effect of each technical advance is to depress business generally.

2. Let us, therefore, consider the alternative course open to the manufacturer of our example: doubling wages. He must write another £1000 worth of I.O.U.s on his own credit and pay everybody £2 on Saturday instead of £1. Naturally he receives £2000 back at the shop, (we are to assume the demand for his goods is insatiable) and consequently he is in a position to pay everybody £2 on the following Saturday without further difficulty.

What can we learn from this? We note two things, both of great practical importance.

1. He had to expand wages to keep up with expanding production. This was therefore *not* an inflationary procedure, and only good resulted.

2. In order to finance the increase in wages he had to create £1000 of new money-tickets, which were not there before.

Now let us apply this to the real world in which, as we know,

productive capacity is constantly increasing. We see that this increased output will not be successfully consumed unless (1) we raise wages, (2) we create fresh supplies of money. And in fact we cannot expect manufacturers to raise wages unless we give them this additional money to do it with; but once having given it to them, rising receipts follow and enable them to maintain the new wage-levels. We also see that once the new money has been created, once the expansion has been financed, as it were, no further injection of money is necessary until a new expansion takes place.

Naturally, this is not the whole story. Increasing the supply of money alone will not solve the problems of under-consumption, for as we have already seen there is the problem of over-saving, too, but it is definitely one of the essential steps. (And in real life of course, the extra money can be injected at a number of points other than via the manufacturers' pay-packets. But we are not at the moment concerned with the How of reform so much as the Why.)

3. Now let us use the model to show an inflationary expansion. The manufacturer doubles wages without any previous increase in output. At the shop chaos reigns since the purchasers are in a position to buy twice as much stuff as there is in stock. Possibly the first-comers take twice their quota, so that late-comers have to go without. But more likely the shopkeeper sees what is happening and raises prices. If he is skilful enough to hit upon doubling them, calm will be restored. Each man's pay-packet will buy just one article, as in the past, and the supply will exactly go round.

4. What would have happened if our manufacturer had deflated by halving wages? Prices would have had to have fallen to half to restore the balance.

If a deflation consists in a decrease in the amount of money relative to the number of goods, then clearly an increase in the number of goods relative to the amount of money has precisely the same deflationary effect. Hence the expansion engineered by our manufacturer in the first instance simply offset the deflation which would have occurred if he had increased output without taking any further action. His action was stabilizing in its effect.

HOARDING

Apart from genuine changes in the quantity of money a further way in which the effective quantity of money in a system can be altered by individual action is the process known as hoarding. Hoarding is hanging on to your money and refusing to exercise your claim on the output of the system. We agreed to use the word *saving* to mean investing some of your money instead of spending it; hoarding, by contrast, means keeping it idle at the bank, or sticking it in an old sock and hiding it up the chimney. For the time being the system is deprived of that amount of money. For all practical purposes it is not in circulation, and so in effect the total amount falls, with the usual deflationary result.

When the manufacturer halved wages he only needed £500 to operate the system with, and could, as it were, hoard the other £500. Hoarding is thus a special case of deflation, in which the individual rather than the government abstracts money from circulation—the difference being that the government presumably does not intend to reissue the abstracted money without due consideration, whereas the private hoarder can release his hoard when and how he likes.

In real life, a certain amount of hoarding is permissible because it is counterbalanced by the simultaneous *dishoarding* of other people. But any *increase* in the amount of hoarding is equivalent to a contraction in the volume of money. As we have seen, such increases are constantly occurring, and create a difficult problem for the monetary authority. For if it injects new money in an attempt to maintain prices, it is only feeding these private hoards and creating a potentially inflationary situation which might become disastrous if ever these hoards were suddenly disbursed.

In constructing this simple model we specified that each worker received the same wage as his mates, but this was not really necessary. All the conclusions we have drawn would be just as sound however the wage-bill were distributed, so long as the total remained the same and everyone spent all they received.

Thus some men might receive 10s. a week and others £2. Or 800 men might receive 10s. 100 men £1, and another 100 £5 each. Nor is there any reason why all of these men should work. We might have specified that 900 men worked while the other 100 did nothing for their salary, so long as the 900 men were capable of producing the stated output of 1000 articles. Thus it can be seen that the model can easily be made to represent a community of workers, a smaller staff of salaried officials, and a number of non-workers living on dividends. Our conclusions are therefore valid for such a community without much modification. Now let us look at some further results of changes in the volume of money.

RISING-PRICE SITUATION

When prices are rising all round as a result of a steady, continuous expansion in the supply of money, certain very characteristic effects are noticeable.

Manufacturers buy their raw materials in January, let us say, and when they come to sell the finished goods in August, prices are higher. Their profits are therefore greater than they would have been if prices had remained stable. Furthermore, the prices in their budget which are 'sticky' such as rents and wages will not rise, so that their costs tend to remain stable while their receipts are increasing.[1] Hence a rising-price situation is *invariably a prosperous situation.* Not only are the manufacturers who are in business prosperous, but since good profits are being made others decide to launch new businesses, employment accordingly increases, this provides new buying power and so on. Rising prices are therefore a sign of prosperity, and not as the man in the street innocently supposes, a cause for gloom.

Conversely, a falling-price situation reduces the profits of business, increases the burden of costs, and always causes a trade recession.[2]

[1] Another factor is the declining weight of the national debt. We shall come to this in Chapter 17.

[2] This refers exclusively to the general falling of all prices due to a shrinkage in the volume of money and not to the falling of individual prices due to technical progress.

(Of course this does not apply to the situation in war-time so simply. Prices are rising not because of the increase in the supply of money so much as because of the shortage of goods, and manufacturers are not free to take advantage of these high prices owing to the shortage of raw materials and labour.)

These rising and falling price situations also produce other effects which matter deeply to individuals affected by them. Rising prices penalize all those who live on fixed incomes (wages, pensions, insurance, dividends from fixed-interest stocks), while benefiting those who live on profits. Falling prices penalize those who live on profits, while benefiting those who live on fixed incomes. Falling prices also penalize those who are bound by contracts (including rent-agreements) to pay fixed sums, and benefit those who receive money as a result of such contractual arrangements, including manufacturers who have sold their output in advance at agreed prices.

Fluctuations are also unfair on those who lend or borrow. A man who lends £100 may have to accept repayment in money which will buy only half as much, if prices have risen; and this includes those who lend to the government by buying bonds. Alternatively if prices fall, every borrower must pay back a sum of money which will buy more than the sum he originally borrowed. We want, as President Roosevelt once said of the dollar, a pound which will be worth as much when you come to pay it back as when you lend it.

Finally, the reader should note that price fluctuations are a source of industrial bitterness. For when price-rises occur, trades unions struggle to obtain corresponding rises in wages; when price-falls occur they dislike accepting reductions, both because their members do not appreciate the economics of the situation, and because they have no guarantee that these reductions will be annulled in the event of a fresh rise. In short, changes in the price-level are always unfair to somebody.

Now this is one of the key facts in our argument. The history of the last hundred years is a history of madly fluctuating prices, sweeping descents interspersed with periodic sharp rises, as floods of new money were unthinkingly pumped into circulation.

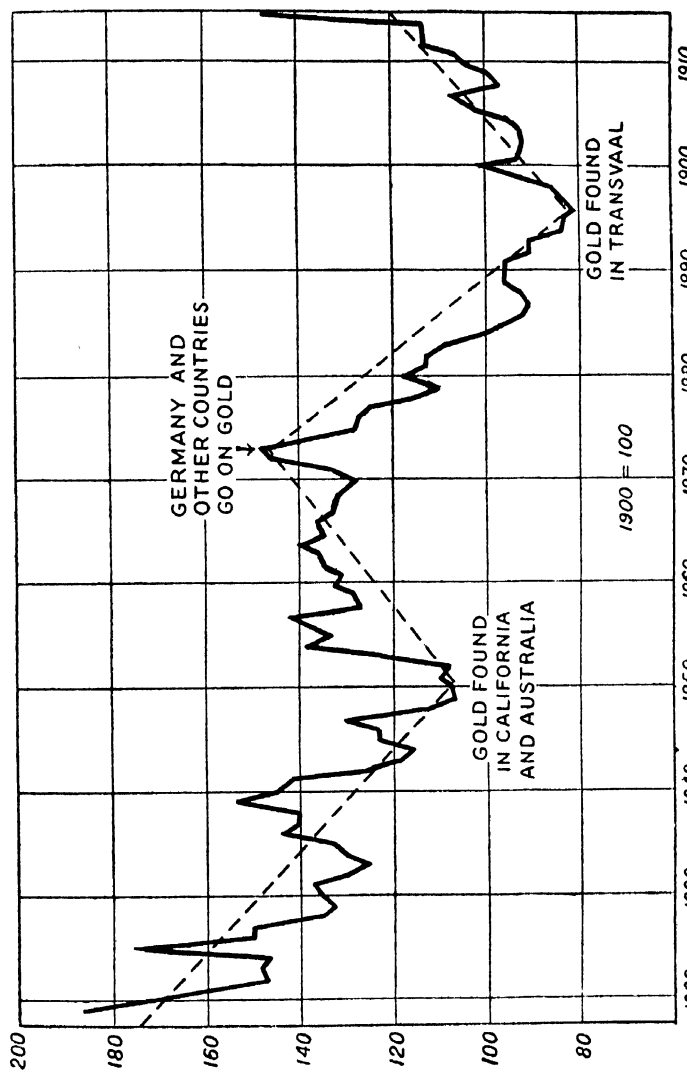


FIG. 8.—THE TREND OF PRICES—BRITAIN.

Three movements can be seen: the seven-yearly rhythm of the trade-cycle and a long-term tendency for prices to fall, interrupted by sudden increases in the supply of money.

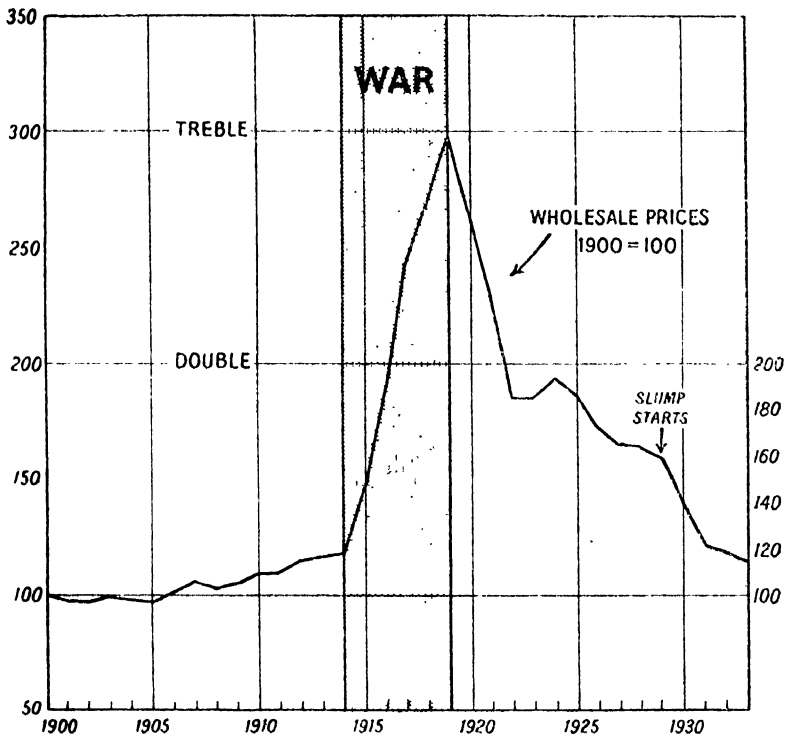


FIG. 9.—PRICES IN THE FIRST WORLD WAR—BRITAIN.

When war-time scarcity was relieved prices began to settle down at about double pre-war levels, but a deliberate deflation slowly forced them down to the starting-point, at the cost of a prolonged depression.

This is insanity. The foundation stone of all economic policy must be to expand the volume of money in harmony with the volume of goods and services produced so as to produce a *stable price-level*—that is, one that is neither depressing to trade nor unduly stimulating to it.

Since this objective of price stability is going to dog us right through the book, let us pause to consider exactly what we mean by it.

STABLE PRICE-LEVEL

What we are aiming at is not a rigidly fixed price-level, but a price-level free from variations springing from changes in the volume of money. Let me specify further what this means. It is certainly not our object to prevent price reductions which are the result of greater efficiency of production. On the contrary, such falls are most desirable, for if prices were completely standardized the benefits of lower cost of production would accrue only to manufacturers. It is only price changes due to changes in the quantity of money that we want to eliminate.

The difficulty is, our technique of price-measurement is at present defective. The normal procedure is to take the prices of several hundred commodities and average them, allowing greater weight to those which play the greatest part in trade: the resulting figure is called the *price-index*. This index will fall if the price of its constituents is falling whether they are falling because of monetary shortage, or because of falling cost of production. The index does not discrimate between the two causes. Therefore in saying that we should aim at a stable price-*level*, I by no means say we should aim at a stable price-*index*.

There are other difficulties: for instance, the index might remain stable despite the fact that some prices were rising violently and others were falling, owing to the two effects cancelling out. Such violent fluctuations would create excessive prosperity in one industry and intense depression in another, a state of affairs incompatible with either full employment or prosperity. Price

stability implies, therefore, a considerable degree of stability in individual prices.[1]

Yet, despite the technical difficulties of defining and measuring price-stability, the intention is clear. It is not technical difficulties in measurement which have given us an unstable price-level hitherto, but deliberate policy complicated by defective monetary technique. The violence of price-fluctuations is, perhaps, not generally realized. To quote D. H. Robertson's *Money*: ' . . . we find that between 1821–5 and 1846–50 wholesale prices fell by 25 per cent; between 1846–50 and 1871–5 they rose by 20 per cent; between 1871–5 and 1894–8 they fell by 40 per cent; between 1894–8 and 1909–13 they rose by 30 per cent. Since then they have been even more irregular. During the first World War they rose over 300 per cent and by 1931 had returned to the 1913 level, with further fluctuations since.' Each of these fluctuations has meant the disruption of trade and a crooked deal for one section of the public or another.

It is difficult to get people to realize that a stable price-level is not some vague theoretical desideratum which will simplify things for bankers, but a matter of the keenest personal importance to them. I could call on many people to back this assertion; I choose two—not fanatics, not theoreticians, but sober, practical men of international reputation:

> A statement after dinner that a change in the price-level in the last three years has increased the burden of the national debt a thousand millions or added an invisible shilling to the income tax is treated much on the same level as an interesting anecdote—it is not challenged, it simply does not 'bite'. I do not believe that more than one business man in a hundred, on opening his newspaper, observes the monthly fall in the price-index with a sinking heart, or any consciousness of its effect on the nation's fortunes.
>
> When I have said quite seriously, as I have done on a number of occasions, that the problem of the price-level is the most

[1] For a slightly fuller summary of the difficulties see *The Intelligent Man's Guide Through World Chaos*, p. 200 ff. Some economists propose a gently rising price-level rather than a completely stationary one, arguing that this would stimulate trade and reduce the weight of debt. This is not a rival theory, but a refinement. Stability is not the same as rigidity.

important single problem of our age, I have been accused either of exaggeration or flippancy. 'What about trade depression in the basic industries, unemployment, labour unrest, class hatred, high taxation and the rest?' My answer is that the problem of the price-level is fundamental to a solution of them all.

SIR JOSIAH STAMP in the *London Spectator*, Nov. 23, 1928.

History has shown that apart perhaps from wars and religious intolerance no single factor has been more productive of misery and misfortune that the high degree of variability in the general price-level. This may sound like an extravagant statement, but so far from being of the nature of demagogic outburst, it is clearly demonstrable from the course of events in various countries ever since money became an important element in the life of civilized communities. A stable price-level is a thing to be desired, second only to international and domestic peace.

REGINALD MCKENNA, Chairman of Midland Bank, quoted by Norman Angell in *The Story of Money* (Cassell).

To achieve this essential objective of a stable price-level, we are obliged to engage in careful regulation of the supply of money. Let us ask ourselves exactly what we mean by this deceptively innocent term.

'QUANTITY OF MONEY' A VAGUE CONCEPTION

Up till now we have talked glibly about the relation between the quantity of money and the quantity of goods, as if it were simple enough to equate them, but the unfortunate fact is that it is impossible to say in terms of £. s. d. what is a suitable quantity of money for a system producing a stated volume of goods, since the number of transactions which a given quantity of money will finance varies considerably according to the habits of the people using it.

For example the number of transactions which a sum of money can make possible depends on the *rate* at which people spend it. If everybody kept each sum of money they received for a month before spending it again, only half as many deals would take place as would occur if they kept it only a fortnight. The faster money

circulates, the more work it can do, the more transactions it can make possible, just as a given quantity of blood can carry twice as much oxygen to the muscles if it circulates twice as rapidly.

Hence the amount of money required to operate a given system depends on the *velocity of circulation*, as it is usually called. Changes in the velocity of circulation are caused by psychological factors. When prices are rising people hurry to buy, when they are falling they postpone buying as long as possible. When times are bad they tend to put money by, when times are prosperous they are filled with a feeling of optimism and spend freely, reducing the amount they keep against a rainy day.

The result is, if you are trying to maintain a stable price-level, in times of prosperity you may have actually to reduce the volume of money in order to offset the increase in the velocity of circulation.

The unpredictability of the velocity of circulation adds greatly to the difficulties of monetary management. For instance when people hear you are reducing the volume of money they may be seized with the idea that a falling price situation is to be expected, and promptly stop spending, thus bringing on the very situation they want to avoid. The controller of money is thus constantly faced with the chance that unforeseen reversals in the money-using habits of the public may nullify his best efforts—and his efforts are quite likely to bring about the very thing they are intended to avoid.

While it is not easy to reduce the supply of money satisfactorily, the controller of money is in a still less satisfactory position when it comes to increasing the supply, since he cannot put money into circulation if people refuse to use it. In the extreme case a person may fail entirely to spend the money which he receives. He may simply hoard it. In this case the velocity of circulation of this bit of money has dropped to zero. If you spend £10 and the man to whom you give it also spends it, and so on, in a week that sum may make a dozen transactions. If you put it in a sock and stick it up the chimney perhaps none of those transactions will take place. A sum of money buried in the ground or lying idle in the bank for twenty years, is, to all intents and purposes removed from the system for that period.

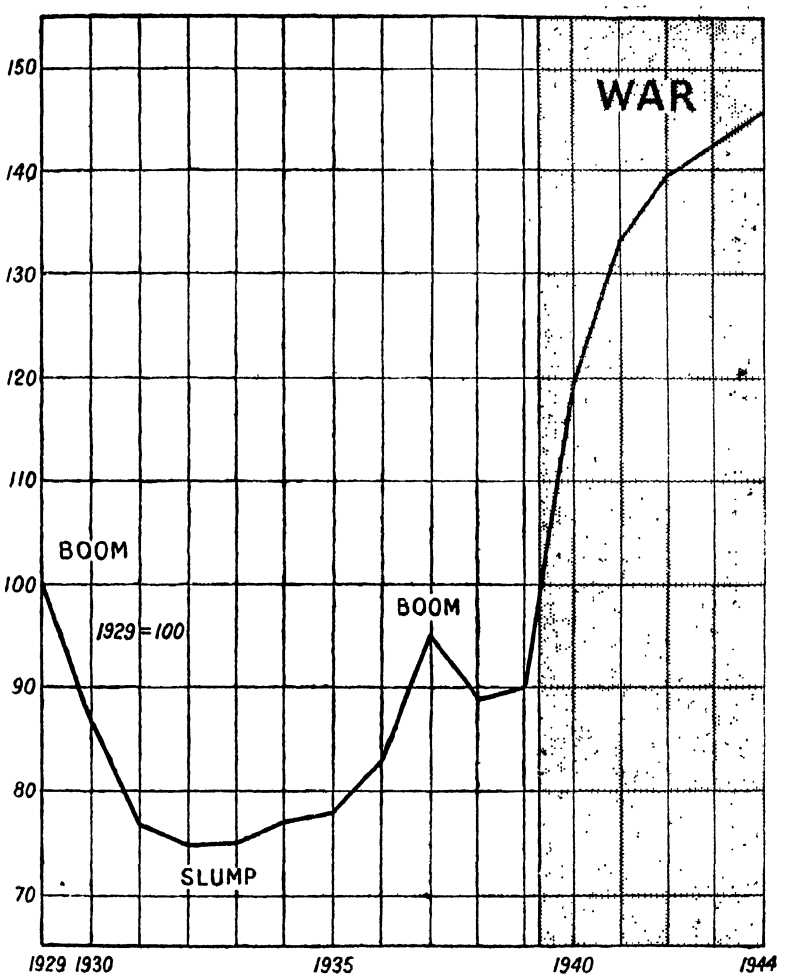


FIG. 10.—PRICES IN THE 'THIRTIES—BRITAIN.

In 1937 economists, noting the down-turn of prices (and business activity generally) prophesied a new slump. But rearmament came to save the situation. Government controls, however, held the inflation to a much more modest level than in the last war. (See Fig. 9.)

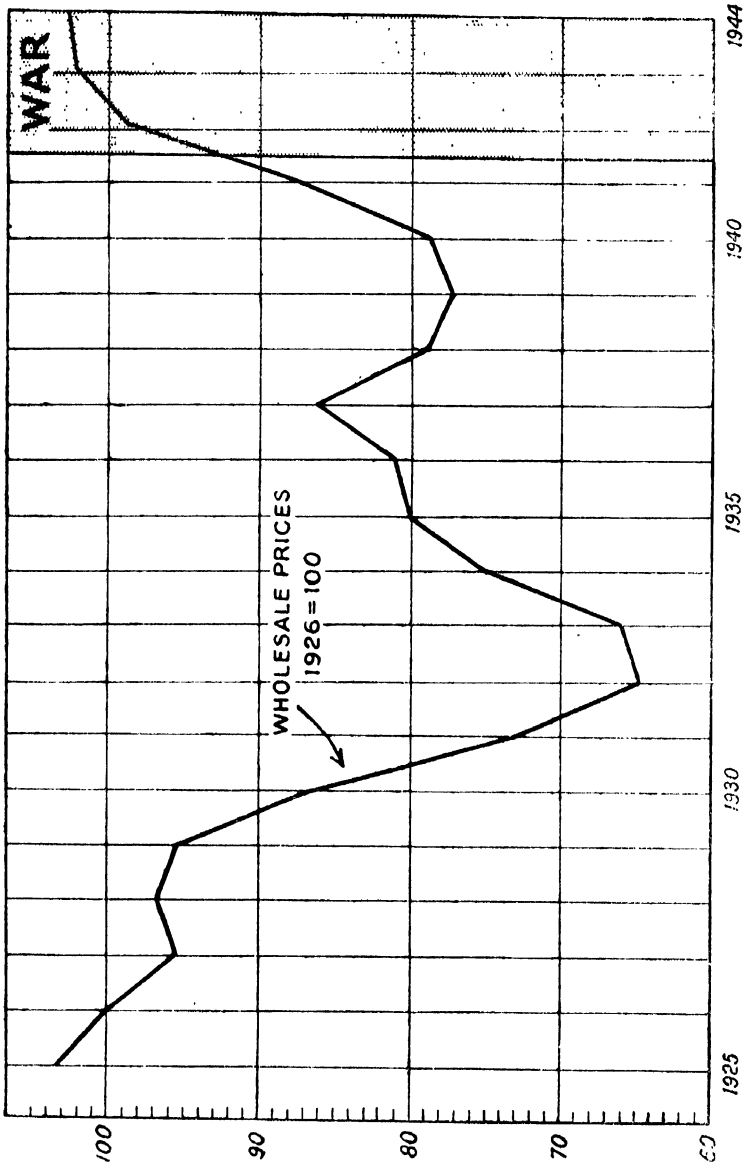


FIG. 11.—PRICES IN THE 'THIRTIES—AMERICA.

In an advanced country people do not hoard willingly. There is no point in keeping money idle when it can be safely invested and bring in dividends. People therefore chiefly hoard when trade is so depressed that suitable opportunities for investment cannot be found. In other words, the velocity of circulation is reduced by hoarding at precisely the time when it is most desirable to increase it, and the chances are that any further money pumped into circulation will be hoarded likewise. But when prosperity returns this hoarded money is brought out once again. In backward countries, however, where the would-be investor is uncertain whether he will ever see his money again, hoarding commonly takes place from sheer caution, both in times of prosperity and of depression and it has always been one of the bugbears of French finance. Every effort made by the authorities to put more money into circulation is frustrated by the strong propensity for hoarding of the French bourgeois and peasant who simply mop up the new supplies of money like a sponge instead of letting it circulate.

For these reasons the velocity of circulation is a major factor in any calculation about the volume of money, and economists now usually refer to the volume of money as MV, where M stands for the volume of money and V for velocity of circulation, in recognition of their close connection.

DEFINITION OF MONEY

Another reason why it is hard to adjust the supply of money correctly is that it is quite possible, in a pinch, to use as money various objects of value which are not normally classed as money. A business man who wishes to buy property and has no ready money available can, if the seller is willing, give in exchange 'negotiable securities'—that is to say, bonds, Treasury bills, mortgages or whatnot. When this happens the securities are virtually acting as money.

Then again the number of transactions involving money depends not simply on the output of goods but on the way the system is organized. If a manufacturer owns his own sources of raw materials, no money will change hands when he transfers

them to his factory; if he does not, it will—but the output is the same in each case. Hence if a big monopoly acquires a number of independent concerns which used to do business with one another a lot of transactions which were settled with money before the merger will subsequently be arranged by book entries and the quantity of money required will be less.

The fact is, when you try and define money, you find the only essential characteristic is that it should be *accepted* without question by those to whom it is offered. No one wants money for itself, they only want it to exchange for goods and services. Provided, therefore, that everyone is willing to accept it in exchange for goods or services anything will do as money whatever its intrinsic value. Hence at every period of history in which there has existed a government strong enough to prevent people forging false money—or a people so naturally honest as to be incapable of it—there has also existed a token money: from the baked earth money of the Chinese and the wampum of the Indians to the immovable stone symbols of the Uap islanders.[1] Similarly, the reason the branches of a big combine can dispense with normal money in their mutual transactions is that they are willing to *accept* book entries as satisfactory evidence of the exchange of goods: they know the parent firm will indemnify them if any false dealing occurs.

It is only when such mutual confidence is absent that people have to fall back on the use of a money of intrinsic value such as gold. The use of such money is in reality a modified form of barter in which one particular line of goods, sometimes oxen, sometimes slaves, sometimes gold, is used as a common term in all transactions.

The use of gold and silver is a sign of barbarism. In a perfectly orderly, perfectly honest world, an intrinsically valuable money, as we know it, becomes unnecessary. The symbols remain, but nothing changes hands. All that is needed is book entries. This important fact, that the definition of money rests on acceptability, enables us to answer the question:

[1] An interesting account of the evolution of money is given in *The Story of Money* by Norman Angell.

IS MONEY VALUABLE?

We have been talking cheerfully about altering the quantity of money in the system and the reader may be wondering how on earth money, once created, is injected into the system. There are two main ways, which I will only indicate briefly at present. The government, having printed a suitable supply of bank-notes, let us say, can use them to pay the salaries and wages of civil servants, postmen, etc. thus increasing the quantity of money in circulation; or, by arrangement with the banks, it can use these notes to supply loans to business men who wish to obtain capital for some new enterprise. If it wants to reduce the volume of money it can arrange to call in a number of these loans and as soon as the money is received to destroy it. The actual process is a good deal more complicated, of course; I shall describe it in the next chapter.

The suggestion that money can be printed and destroyed in this facile way will, perhaps, have raised a question in the mind of the reader who is accustomed to the idea of money as something intrinsically valuable. He casts his mind back a hundred years or so to the days when money consisted of gold and silver coins and he wonders how on earth it is possible to increase the supply any faster than the current gold- and silver-mining techniques permit.

Now the fact is that the money of the civilized world—our money—is in a process of transition from an intrinsically valuable money system to a system of a totally different kind: what I prefer to call a ticket-system, but what is more usually known as a system of credit.

The way the economist visualizes it is this: you have a lot of people working away producing goods and services which are then, so to speak, thrown into a pool. In return for their efforts the workmen are each given a book of tickets entitling them to draw a certain quantity of goods from the pool. These tickets have no value in themselves, aside from the insignificant value of the paper they are printed on; they are only valuable for what you can get for them.

In such a system you are obviously able to issue whatever number of tickets seems called for, and to vary the number issued whenever necessary.

The necessary condition for such a system to work is that

everybody should be willing to accept the tickets. To-day both bank-notes and cheques constitute tickets which everyone is willing to accept and there is no limit to the number which can be printed or written, and they can be destroyed equally easily. True, if you accept a bank-note there is always the chance that it may be a forgery; if you accept a cheque it may be a dud. We are able to make this system of paper tokens work because, with an efficient police system, we are able to reduce the risk of being landed with a dud, and because the system is accepted throughout the country. But in the past this was not possible, and people therefore found it necessary to use as money things which were valuable in themselves and which would consequently be accepted at sight.

But, you may object, the bank-notes which I use are backed by gold. I accept them because I know I can get gold, which is valuable in itself, for them if I wish.

This simply is not true. You cannot get gold for a bank-note, while if you ask for 'silver' you get given an alloy worth at most one-third of its face value. No, the fact is, a pound note is only worth a pound because everyone agrees that it shall be.

The confusion arises because we are in the midst of changing over from one system to another.

Pound notes were invented to save the inconvenience of having to carry about large sums in gold. Originally, they were simply receipts for a certain quantity of gold and consequently bore on their face the words 'I promise to pay the Bearer on demand the sum of One Pound', by which was meant a gold sovereign. As long as there was a sovereign in the bank for every note issued a pound note remained simply a receipt, and it was impossible to vary the supply of money except insofar as the supply of gold itself might vary.

Now the huge expansion of goods caused by the Industrial Revolution created a huge demand for fresh supplies of money. What was to be done? The authorities met the problem by the confusing device of permitting *more bank-notes to be issued than there was gold* in their vaults. The amount of extra notes permitted to be issued was gradually raised; in 1928 the Bank of England was empowered to issue £240,000,000 more notes than it owned gold; in 1939 the figure was increased to £400,000,000 and progressively to £1,350,000,000 by 1946.

By so doing the authorities threw overboard the system of having intrinsically valuable money. In 1928 there was only about 7s. in gold behind each one pound bank-note, and in 1944 little more than 1s. However—and here is the catch—instead of admitting that they had thrown the system overboard, and refusing to give people sovereigns for notes any more, they *pretended the system was still in operation.* They were able to do this because they reckoned that the number of people who would in point of fact ask for gold at any given moment would never be very large. They therefore let their promise to pay gold stand and continued to give sovereigns to anyone who demanded them.

Obviously, if for any reason a very large number of people had tried to convert their notes into sovereigns the banks would have run out of gold and would have had to suspend payment—a state of affairs known as bankruptcy in ordinary commercial circumstances. Now this is precisely what occurred, or would have occurred, in 1914; so the government suspended the undertaking to pay gold on demand; it did so again in 1931.

A similar process has taken place in respect of the coinage. Just as the banks wanted to issue more notes than they had gold available, so also they wanted to issue more coins than they had silver available. They contrived this by diluting the silver with other metals, so that with a given weight of silver they were able to mint more coins than before. Hence the real value of any silver coin is less than its face value, in much the same way as the face value of notes exceeds the value of the gold available to back them.[1]

You can now see why we say that the monetary system is in a process of transition. It is not a system of intrinsically valuable money, as it was when there was a sovereign for each bank-note, and it is not a full fledged ticket system except at such times as the government decides to suspend the agreement to pay gold.

To-day the situation is especially curious. Throughout the war the Chancellor of the Exchequer has firmly treated money as if it were a system of tickets, enlarging it regardless of the gold stock and raising the amount of notes issued progressively from £580 million to £1200 million; and now in peace he continues

[1] The proposed cupro-nickel coinage will complete the transition to a token coinage system.

to exercise deliberate control. Yet while the Chancellor of the Exchequer's attitude has been revolutionized, the public's attitude remains unchanged. We regard these as emergency measures. In particular bankers and financial interests, especially in America, hanker after the old system and periodically put out propaganda in favour of it.

In normal times the decision to enlarge the *fiduciary* issue (as the unbacked notes are called) is only taken at rare intervals and involves the passage of a bill through Parliament. If we are going to control the volume of money regularly this is an impossibly laborious method; but against this there is the fact that the Bank of England is not obliged to put into circulation all the notes it is legally permitted to. Thus it can issue or call in notes from time to time as may be necessary. In this way the Bank of England is able to exert a fairly close control of money.

If we wished to work the supply of money really scientifically we should simply forget about the gold and leave it to the Treasury to print as many bank-notes as were required. The reason we cannot immediately do this, is firstly that few people understand the situation and a wave of panic might ensue if gold backing were abolished, in which people would refuse to accept bank-notes at their face value. The confidence on which a ticket system inevitably rests would be destroyed. And secondly people fear to grant to any official the power to create money at will in case he should misuse it. They therefore prefer to let the volume of money be controlled basically by the supply of gold, which adjusts it automatically as we shall see, and to leave to bank officials the power to make minor compensating changes.

At least these are alleged to be the reasons by our financial rulers. But the public has shown no trace of panic at the huge increases of war-time. The real obstacle is the conservatism of our financial masters and their reluctance to take on the responsibility of publically acknowledged monetary management.

DANGER OF INFLATION

Nevertheless, the idea of a paper money issued at will, without any gold backing, and in particular the suggestion that it should be printed as required, may summon to some people's minds the

spectre of 'inflation'—by which they mean the disastrous effects of an uncontrolled inflation such as that which took place in Germany in 1923, when the government printed money in fabulous quantities, causing prices to rise to 100,000,000 times the normal level and consequently making all those who lived on fixed incomes completely destitute. The objection usually raised by such people is that governments will be liable to fall into the error of simply printing money with which to pay their debts, if once the money-issue is severed from gold.

In reality this is a somewhat naïve view, but since it is persistent we had better devote a paragraph or two to it. The fact which any government contemplating inflation would immediately think of is that rising prices penalize all those who live on fixed incomes—both salaries and fixed-interest investments—among whom all the members of the government are included. Therefore in permitting inflation they would be impoverishing themselves. Moreover it penalizes those to whom debts are owed, including the most powerful financial interests in the country. Consequently there is far more danger of the government forcing a deflation than an inflation, if the power is left in their hands.

Furthermore it is the government which will have to bear the burden of any disruption caused by inflation or deflation, so it is far less risky for them to meet their debts by the straightforward method of taxation. I suppose it is just possible that a political party which was not in very good favour just before an election might be tempted to risk the long term evils of inflation rather than antagonize the public by raising taxes or cutting down social expenditure. But it has never been suggested for a moment that the issue of money should be a party matter. If the issue of money is to be delegated to the government, it will no doubt be left to permanent officials of the Treasury, and a political party could not interfere with them without passing an Act of Parliament.

At present in any case, the power of inflation and deflation within fairly wide limits lies with the banking system, particularly the Bank of England. Thus the power of inflation and deflation is already in the hands of people over whom the community has no control. Why then are people so apprehensive about transferring that power to persons over whom at least a

considerable measure of public control exists? Is there really any good reason to suppose that salaried civil servants would be less responsible custodians of the power of money-issue than are business men actuated, in part at least, by the motive of personal profit?

The ordinary man tends to assume that the temptation to print money is very strong, because he knows how convenient such a course would be if he could engage in it himself. But a government already controls the disposition of all the money in the country and is therefore much more concerned with the effects of inflation and deflation produced by printing money than with the actual money printed.

There is, nevertheless, one extreme set of circumstances in which a government may choose to inflate, the circumstances in which the German government found itself after the Great War: namely, of owing an appalling and crushing debt to a ring of financiers. The German government deliberately caused this inflation not because it couldn't pay its normal budgetary debts but in a deliberate attempt to break its bondage to a few millionaires by making its debts to them worthless. With the rights and wrongs of this drastic policy we are not at the moment concerned. The question is, could it happen here? Of course it *could*. The government can at any time issue money by passing a suitable Act of Parliament, as it did in 1928 and as it has done again and again during the war.

Thus, in the last analysis, we are utterly dependent on the good sense and responsibility of the government we have elected, so that the question of the misuse of the power of control of money becomes merged in the general political problem of creating a reliable government. It is just as safe to give a specified ruling body the power of inflation as it is to give it power of any other sort.

CONCLUSION

All right, then. We agree that the quantity of money (MV) in a system must be increased when the supply of goods gets larger, and we agree that in a ticket system there is no insuperable difficulty in doing this, even though there are technical difficulties in calculating just how much the increase must be.

We next want to know something more about the methods used by banks in controlling the supply of money in order to see how far they manage to achieve this aim, and if they fail, why.

Summary

When the amount of money in a system is increased, prices rise. When it is decreased, they fall. In a system which is producing more and more goods (an expanding system) the volume of money must also expand, if prices are to remain level. *Inflation* and *deflation* describe a general rise and fall of prices, such as occurs when the rate at which goods are produced gets out of step, irrespective of the nature of the change in the volume of money. Hoarding is disastrous because it reduces the effective amount of money in the system without warning.

A *rising-price* situation stimulates trade (though it penalises rentiers) and a *falling-price* situation produces depression. The first object of monetary policy should be to ensure a STABLE PRICE-LEVEL (or even a slightly rising one). In a world of expanding productivity this means a constant expansion of the volume of money. But over the last 100 years adequate supplies of money have not been created and prices, on the whole, have fallen. Examined in detail, the correspondence of money and output is seen to be even less exact. The subject of how the volume of money is controlled is therefore of vital importance.

The concept 'quantity of money' is extraordinarily vague; (*a*) because the rate at which people make use of money changes its effective value; and (*b*) because people can dispense with money by using other objects of value in lieu of it, or can simply trust one another: all granting of credit is an addition to money.

Money as we know it is in a stage of transition from an intrinsically valuable money to a ticket system. It is all a question of being able to trust other people to honour the tickets. Banknotes and cheques are tickets of varying degrees of reliability. Originally, people were encouraged to use tickets by the knowledge that they could change them for intrinsic values if the worst came to the worst. To-day you cannot, but we maintain the fiction of a gold backing. In reality, we have issued far more tickets than there is backing for.

The existence of a ticket system does not mean a risk of inflation, since those who have the power to inflate are rentiers and have everything to gain from keeping prices down.

8

How Money is Made

'I can't believe that*!' said Alice.*
'Can't you?' the Queen said in a pitying tone. 'Try again. Draw a long breath and shut your eyes.'

WE OFTEN talk about people 'making a lot of money', when we only mean getting it from other people. The only people who really 'make' money are the officials of the Royal Mint, forgers and the banks. There is no mystery about how the first two do the trick, but how do the banks manage it?

We have already seen how the Bank of England is able to issue far more currency (bank-notes and coin) than it possesses in gold, but this is not the whole of the story, since very many transactions are carried out not by means of notes but by means of cheques drawn on one of the joint-stock banks—as the ordinary banks at which we keep our accounts are called. Cheques are a kind of money and we must now give some attention to it. Here again we shall find that the joint-stock banks are accustomed to issue—that is, to allow to be written—far more money in the form of cheques than they hold in notes or cash. Just as the Bank of England's note issue exceeds its gold stock, so the joint stock banks' 'cheque issue' (as one might call it) exceeds their cash holdings. And this is possible for just the same reason: they rely on the fact comparatively few people will ask for cash in return for cheques at any given moment. Most people, they reckon, will simply pay the cheque into their account, and subsequently withdraw the money by means of other cheques.

Banks did not always behave in this way. Originally they were simply places for keeping money safely. Let us tell the story of how they came to behave like this from the beginning.

CREATING MONEY

In 1819, when Britain 'went on the Gold Standard', there was about £18 million in gold in the country. In 1914 there was £124 million, chiefly as a result of the mining of new gold during the period. But what was happening to bank deposits during the same period? In 1819 deposits in British banks amounted to about £16 million. In 1914 they amounted to as much as £1200 million. In other words, while over a period of a hundred years the amount of gold in the country increased by about £100 million, bank deposits went up about £1000 million—ten times as much.

Where did the odd £1000 million come from? The answer is almost incredible: the banks invented it.

It happened like this. Originally banks (or goldsmiths as they then were) looked after money for the public in return for a fee; they were simply safe-deposits. And soon people when they had debts to pay took to writing to their goldsmiths telling them to transfer some of their gold to the safe-deposit of another of their clients. Thus the cheque was born, for a cheque is no more than a letter of instruction to your banker. Naturally it soon occurred to the banker-goldsmiths that they could turn the money in their vaults to good account by investing it, *i.e.* by lending it (although it was not their own) to people who were short of money and charging them interest on the loan. At first they only lent the money they actually held. The profits realized in this way enabled them to remit the fee charged for their services and actually to pay people to put money into their banks. This was profitable because they paid 1 per cent to depositors but lent at 3½ per cent and so the more money they could attract to their vaults the better.

But with the invention of the cheque bankers soon realized that they could go much further than this. Since they no longer had to produce the actual cash when making a loan, but only gave the borrower permission to write 'letters of instruction' up to such and such a sum, why should they stop at lending only as much as they had got? Banks started to lend (*i.e.* to let borrowers write cheques for) sums greater, in the aggregate, than they held on deposit. This was much more profitable. Previously they had

borrowed at 1 per cent to lend at 3½ per cent. Now they were lending at 3½ per cent money they had created at no cost at all.

In effect, a cheque is just a special variety of bank-note. At first bankers permitted themselves to utter such notes to the amount of deposits they held. These notes, or rather cheques, were 'backed' by deposits. When they permitted cheques to be written for larger sums than they held, they were in point of sober fact issuing money—without backing. They were unquestionably usurping the royal privilege of minting money. As Prof. Soddy puts it, they were counterfeiting. Money created in this way is technically called *credit* or *bank credit*.[1] This unexpected expansion of the volume of money was matched, by fortunate chance, by the great expansion of production which occurred during the nineteenth century, or heaven knows what might have happened.

Bankers soon found that the maximum point to which they could continue this creation of money was until they had issued a sum nine times their cash deposits. This was because, on the average, people who use banks only ask for about one-tenth of their withdrawals in cash. For the rest they use cheques. Thus as long as the banks did not permit the volume of business done to exceed nine times their cash holdings there would always be just enough cash to meet the demands of depositors.

But what, you may ask, if the depositors changed their habits and took to demanding more than one-tenth of their withdrawals in cash? Why, the banks simply banked on the fact the Government could not afford to let them all crash, and so would be

[1] But it is worth pointing out that the term is a misnomer. When a tradesman 'gives you credit' he permits you to acquire goods on the strength of your promise to repay him at your convenience; he relies on your commercial reputation, he does not demand security. Similarly, if a banker lends you money—gives you credit—*on the strength of your reputation*, he is creating credit. But if he demands security, he is merely creating a mortgage. In the early days of banking credit was often extended on reputation, but to-day this rarely occurs. I mention the point not from a pedantic desire for verbal accuracy, but because this change of habit will turn out to be important when we come to examine the underlying principles of our credit system.

obliged to step in and save them. This happened in point of fact in 1847, in 1857, in 1866, in 1914 and in 1931.

Of course, whenever a loan was repaid the sum of money in existence was reduced by that amount—as the economists say, credit was cancelled. But as, on the whole, banks were making new loans as fast as they were cancelling old ones, the volume of credit remained nine times the cash assets. In this way the banks created between 1819 and 1914 the sum of £1,000,000,000. During the Great War they invented about £4,000,000,000 more (of which £3,000,000,000 was subsequently cancelled). This expansion was as such eminently desirable, BUT, on all this new money, which according to the letter of the law it was the privilege of the state to create, money is continuously owed to the banks in the form of interest.

Naturally, banks are entitled to fair payment for the services they afford; if they did not get it in this way they would charge more for keeping our accounts. But each and every year we, as a nation, pay £100,000,000 to the directors and shareholders of banks for their kind permission to carry on the trade of this country with money which they have uttered, or counterfeited in plain words. Small wonder that the banks can pay their shareholders a dividend of £8,000,000 a year.

If our thinking is bounded by unquestioning acceptance of established institutions, we shall argue that banks are quite justified in paying a dividend to the people who have lent them the capital on which their operations are based. But if we come to the subject with the unbiased approach of the man from Mars, how does the system strike us? We see banks as bodies charged with the task of controlling the flow of certain pieces of paper. Why on earth should they also need to hold other differently coloured paper, and to pay for the privilege? If all the capital ever borrowed by banks were paid back to the lenders, by cheque, the system would function just as smoothly, provided only that no propaganda was started to disturb public confidence, *i.e.* their readiness to *accept* cheques. Fundamentally, banks need no capital.

It may be added that banks are not confined to finding willing borrowers when they wish to create money. They can also do so whenever they wish to make a purchase. If they want to buy

securities[1] or erect a new branch, they have only to mark up the accounts of the seller of the securities or of the building contractor by an appropriate amount, just as they would have if he had borrowed the money. Subject therefore to the banks' general policy about creating new money, no bank need ever 'pay' for anything in the ordinary sense of the word. It can make a 'loan' to itself without cost.

Banking, in short, is a colossal bluff by which people issue worthless money and then seem to prevent the public discovering the fact by honouring it with a small reserve of good money which has been entrusted to them. Since many intelligent people find it hard to credit the existence of this extraordinary system, when it is first drawn to their attention, let me quote what the experts say.

> When a bank lends, it creates credit out of nothing.—*Trade Depression*, p. 4; R. G. Hawtrey (Assistant Secretary to the Treasury).

> It is not unnatural to think of the deposits of a bank as being created by the public through the deposit of cash representing either savings or amounts which are not, for the time being, required to meet expenditure. But the bulk of the deposits arises out of the action of the banks themselves, for by granting loans, allowing money to be drawn on an overdraft or purchasing securities, a bank creates a credit in its books which is the equivalent of a deposit. The bank can carry on the process of lending or purchasing investments until such time as the credit created, or investments purchased, represent nine times the amount of the original deposit.—*The Macmillan Committee on Finance and Industry*, Cmd. 3897, Para. 74.

> Banks create credit. It is a mistake to suppose that bank credit is created to any important extent by the payment of money into the banks. . . . When a bank lends by granting an advance or discounting a bill, it is a clear addition to the amount of payment in the community. The bank does not lend money.—*Encyclopædia Britannica.* Article on 'Banking and Credit', 14th ed. Vol. III, p. 48.

[1] By selling securities a bank increases its holding of cash, thus its ability to lend. Banks do not, therefore, tend to buy securities except when opportunities of profitable lending cannot be found.

SMOKE SCREENS

In the endeavour to make it harder to understand this undoubtedly fraudulent proceeding, the 'gigantic interests behind the issue of money' have circulated a number of theories which try to obscure the facts. They say, for example, that banks do not create money because they only lend out again their deposits. And in fact it can be seen from the balance-sheet of a bank that the deposits are somewhat larger than the loans. For example the Midland Bank on 31st December 1932, held deposits of just over £419 million and had lent just over £394 million. (Its cash assets at the Bank of England were £43 million.) But of what do its deposits consist? Some 99.3 per cent of its deposits are made with cheques, only 0.7 per cent are made with notes or coins. These cheques either represent deductions from other people's accounts at other banks, *or* payments made on the strength of overdrafts or loans from banks.

Thus the extraordinary truth is that deposits increase because loans increase—and not, as you might suppose, that loans increase because deposits increase.

Another way the banker puts it is 'Every loan creates a deposit'. And it is true that when banks make a loan the borrower pays the money to someone who then most probably puts it into his own bank account. But the trick is that nowhere has the banker marked down a deposit account by the amount of the loan to counter-balance the increase in deposits when it is paid in elsewhere. The trick in fact is in the word *loan*: it is not a loan at all.

Another alternative counter-argument admits that money is created, but justifies this on the grounds that, since a banker demands the provision of some security before granting a loan, the money issued is not without backing by assets.

The confusion here is caused by vague terminology. The object of having notes to back cheques (just as in the case of using gold to back notes) is to provide security for the user of money. But the banker demands security for a loan to protect none but himself.

To put it another way, if the public using this created money

all try to obtain cash for it at the banks, the banks cannot meet the demand by selling the securities they hold—since these securities could only be bought by the payment of bank-created money. Thus the securities offer no security to the users of money. The bankers' argument is in fact a circular one; the money is backed by securities and the securities are worth money.

The confusion arises through not distinguishing between real and monetary wealth. The security offered, as a rule property of some sort, is part of the nation's *real* wealth; whereas what cheques are, or should be, backed by is *monetary* wealth in the form of coins and bank-notes. *All* money wealth is secured by the nation's real wealth, so to use part of the nation's real wealth to secure cheques is to use the same real wealth as security twice over. In case these unaccustomed distinctions may prove confusing to the reader, perhaps the simplest way of looking at it is this: if the borrower defaults, the bank can, it is true, sell the security and obtain cash, which he can use to cancel the loan. But if the security was going to be sold, the owner himself might as well have sold it and obtained the money in this way. But if he had done so we should not have considered that money was being created by his action. Neither then is money created if the banker sells it. *If* he sells it. But he doesn't sell it. Therefore money *is* created.

One further point: do not be misled because the borrower repays the loan with real (*i.e.* existing) money—because nine-tenths of that money originally came into circulation through being invented by a bank in the first place.

Another argument advanced on behalf of the banker is that whereas money is an asset to you and me, to him it is a liability. If he creates £100 to lend to you, for you it is a pleasure, but for him it is a worry, since you may not repay it. But since bankers do not make loans without adequate security, the liability is not a very serious one, and since they obtain interest on this liability bankers are always very anxious to increase their liabilities.

The banker's position is highly paradoxical. He cannot possibly meet all his liabilities, if all his depositors demand cash at the same time. Every banker is, as Soddy has emphasized,

insolvent. But the thing which enables him to carry on is the general belief on the part of the public that he is not insolvent. If at any moment the public begins to doubt a banker's solvency, *i.e.* his ability to meet their demands for cash, they all rush to take out their money and thus create by their own action the very position they fear. If the public understood more about banking they would promptly *pay in* money whenever they thought their banker's solvency was threatened. The thing which the public chiefly takes as a proof of a banker's ability to meet demands is the size of his cash reserves. Thus the bigger his reserves the less he will need them, and the less cash he has the more he will need it.

THE VOLUME OF MONEY

The plain fact is that bankers have, in the past, built up their business by a device which, on close analysis, turns out to have been shady, if not actually illegal. But it would be unrealistic to waste breath or ink in assailing them for being insolvent counterfeiters. The banks are too much a part of our system now to be radically changed even by a Socialist government. We must confine ourselves to asking how this extraordinary system affects the supply of money, with a view to seeing what practical steps can be taken to mend matters.

We can see that when we want to alter the volume of money, in order to keep the price-level stable, the chief thing we shall have to do is to alter the volume of bank-credit. At present, however, joint-stock bankers do not use their power over the volume of credit in order to keep prices stable; they simply concentrate on keeping it in a 10:1 ratio to their cash reserves. This suggests the thought that if we could control the volume of cash we should be able to achieve our object. Now there is in point of fact a body which has the power to alter the volume of cash within considerable limits, and that is the Bank of England, or in the case of the United States, the Federal Reserve Bank.

The Bank of England and the Federal Reserve Bank are examples of what is usually known as a *central bank*. Among other things they hold the accounts of the joint-stock banks, and are accordingly sometimes called 'the banker's bank'. And, as already

explained, they are responsible for the issue of notes and the guarding of the gold reserve.

Now how is a Central Bank able to alter the supply of cash? For one thing, it does not put into circulation all the notes it is entitled to straight away, and it can later issue more if it wishes. Conversely, it can go through the process of withdrawing notes even when no gold has left its vaults.

The method normally used for withdrawing notes is to sell some of the securities owned by the Bank in return for cash. The buyers obtain this cash by drawing cheques on their accounts, thus reducing the cash holdings of the joint-stock banks and compelling them to restrict their loans accordingly. Conversely, by buying securities, notes can be put back into the hands of the banks, and credit expanded. (These are known as *open-market* operations.)

Viewing the money-system as a whole, then, we see that it comprises three stages—gold, cash and cheques. The amount of cash is larger than the amount of gold, thanks to the fiduciary issue. The amount of credit (*i.e.* cheque-money) is larger than the amount of cash, thanks to the 10:1 ratio. Thus if the Bank of England's gold stock were £200 million, this would enable it to issue £440 million in notes,[1] and these notes, about half of which reach the joint-stock banks, would enable them to issue £2000 million in credit. (This curious arrangement is called the *pyramid of credit.*) So in the last analysis, the volume of credit is controlled by the country's gold-stock. If gold has to be sent abroad in payment of a debt, credit must be reduced. If gold is acquired through mining or the repayment of a debt owed to us, credit can be increased. But the links of this control are not rigid. The Bank can vary the amount of cash by open market operations even if no change takes place in the gold stock, or it can seek to minimize the effect of any gold movement. Equally, the joint-stock banks

[1] Taking the fiduciary issue at the figure authorized by the Bank Act of 1928; since then it has been repeatedly enlarged.

The United States, like most other countries, does not have a fixed fiduciary issue, but arranges its gold backing on a percentage basis. Thus the Federal Reserve Bank is obliged to hold a '35 per cent. gold-cover,' *i.e.* it can issue $100 for every $35 of gold it possesses.

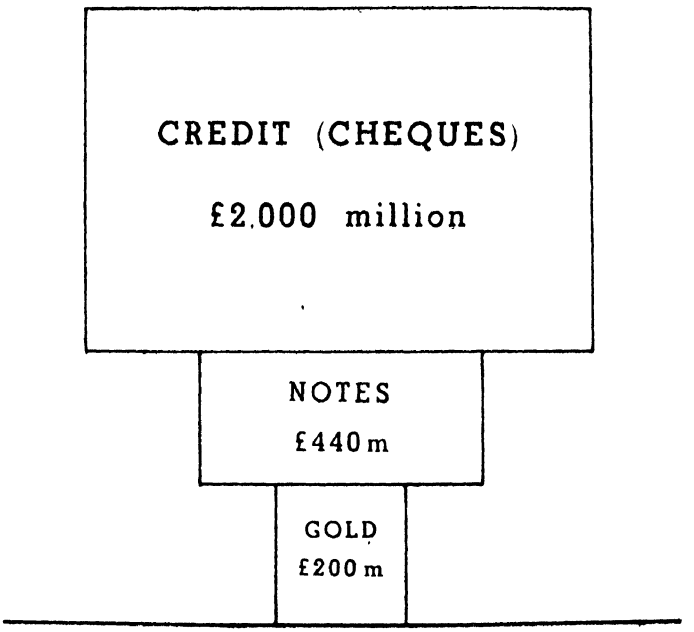


FIG. 12.—THE PYRAMID OF CREDIT.

The figure shows how a large quantity of notes is issued on the strength of a small amount of gold, while the notes in turn form the basis of an even larger volume of cheque-money. (In practice banks do not hold more than half the notes at any moment; on the other hand they have other cash assets in the form of deposits at the central bank.)

To meet the needs of war, the two upper rectangles have been increased to more than twice their normal size. The figures given above represent the approximate position in 1935.

may not always respond to an increase in their cash reserves by issuing more credit.[1]

(It should perhaps be added that the idea of having a central bank at all is a comparatively new one. Originally Britain was the only country to have one, and its obligations and functions were agreed on by trial and error methods. After the U.S. banking crisis in 1907, the Americans decided to set up a central bank roughly on the English model. In 1922 when the finances of most of the smaller European countries were being straightened out, it was decided at Geneva that they should also have central banks. France and Germany, on the other hand, have never had central banks in the sense in which we have been using the word. The Banque de France and the Reichsbank were from the start heavily involved in the direct financing of industry in competition with ordinary banks. A responsible central bank must often force on joint-stock banks a restriction of lending which they much dislike. As a result the policy of the Reichsbank and the Banque de France could never display the same detachment as that which is essential to central banking as now conceived.)

MUDDLED MONEY

Viewed as a method of regulating the volume of money, this intricate concatenation of devices can only be described as Heath Robinsonian.

To start with, the system is essentially restrictive: it can force the volume of money to contract, but it cannot be relied on to

[1] The relation between the lending policy of a joint-stock bank and its cash reserves is really more complex than appears here, for the lending policy of joint-stock banks is dominated by another consideration—*liquidity*. A joint-stock bank will divide its loans between long-term loans (*i.e.* loans to industry which will only be repaid after many years), short-term loans, 90-day loans (principally to the government through the medium of Treasury bills), loans which can be redeemed on demand (call-money) and actual cash. In times of stress, it will wish to keep a larger proportion of its money in the shorter term loans. In the technical phrase it will make its position more liquid. Thus the ease with which any particular class of borrower can obtain money will depend on a combination of (*a*) the size of the cash reserves and (*b*) the degree of liquidity aimed at.

expand it. By reducing the cash reserves of the joint-stock banks, the central bank can compel them to call in loans and so reduce the volume of money; but when it comes to the reverse process, the central bank can do no more than make it possible for the joint-stock banks to increase their loans. Whether or not they will take advantage of any increase in their cash holdings depends on whether they see profitable opportunities of investment. But it may be precisely because of the lack of adequate supplies of money that no such opportunities exist.

Many analysts stop at this point, but actually there is a far more serious flaw in the system. The joint-stock banks can only create new money *through the medium of loans to industry*. But it may well happen (and as we shall soon see, it does happen) that there is need of new money at a time when no further industrial expansion is required. And still more often, it may be desirable for entrepreneurs to start new enterprises without the volume of money being increased. Furthermore, when the central bank desires to reduce the volume of money, the joint-stock banks are obliged to call in loans; but obviously it is extremely damaging to industry to be obliged to repay money at short notice, just because the total volume of money is too great. Surely it is obvious that the financing of new enterprises and the supply of money are two entirely separate and independent propositions and must be regulated independently? It is almost incredible that we can unconcernedly link them together in this way, and thus make it impossible for more than one to be correctly adjusted at any given time.

One of the things which makes this strange habit particularly dangerous is the fact that bankers (not unnaturally) only make loans with the intention of having them repaid. But every time a loan is repaid, the volume of money contracts—unless the banker immediately makes a fresh loan of equal size.

Now during a period of industrial expansion, the demand for loans is great. When expansion ceases (as it must when all the available labour has been drawn into employment, if not before), the demand for loans falls; hence there is a contraction in the volume of money just at the time when output of goods and industrial activity are at their highest pitch.

Professor Soddy has aptly compared the financing of an economic system with the establishing of an oil pipe-line. As soon as the pipe-line is completed you start to feed oil into it—but none emerges from the other end until the pipe is full. If the pipe contains 10,000 barrels of oil, you must produce 10,000 barrels of oil at the well and pour it into the pipe, while selling none at the far end. This quantity remains permanently locked up in the pipe as long as you continue to use it as a pipe-line. Similarly, when industry expands it is necessary to create money which becomes locked up in the economic system, just as long as it maintains its new dimensions.

It is clear, then, that in the present system prosperity must inevitably lead to disaster, for it is precisely at prosperous times that firms pay back loans and provoke a monetary contraction which ends prosperity. The answer is to make the creation of money a deliberate task of a properly-constituted body (as it used to be—for this, of course, was the function of the Mint in the days when money consisted only of coins) and to cease letting it creep into existence as the by-product of the entirely distinct activity of lending.

INEFFECTIVE TECHNIQUE

These are criticisms of our whole monetary practice. It might reasonably be imagined that within the limitations of such practice our monetary methods were reasonably efficient. This is not so.

We have described how the central bank seeks to vary the cash reserves of the joint-stock banks by open-market operations. These operations are more ingenious than effective. Suppose the central bank is trying to increase the volume of money by buying securities. It may happen that the sellers simply use the proceeds to pay back loans—with the result that the joint-stock banks' cash reserves do not increase. Neither are open-market operations wholly satisfactory when it comes to decreasing credit; in the first place, the bank cannot sell more securities than it possesses, and in the second, if people steadily borrow from the bank this naturally neutralizes the effect of selling securities. It might seem that the bank could meet this difficulty by refusing to make

further loans, but in fact it is bound by law to act as 'a lender of last resort'.

The Federal Reserve Bank suffers from a further handicap in that it customarily lends to joint-stock banks when they are in need. If, at a time when it is striving to increase their cash assets, the joint-stock banks simply repay their debts, nothing will be achieved. This was demonstrated very clearly in 1932 when the Federal Reserve Bank bought more than $1000 million of securities in the hope of increasing the volume of money, and promptly received $800 million back in repayment of debts. A further $100 million was hoarded or exported, so that in the end a mere $170 million went to increase cash reserves as intended.

It is difficult to escape the feeling that if it is really in the interests of the whole country to increase the reserves of joint-stock banks, then why not just increase them, instead of going through these tortuous and chancy manœuvres?

Moreover, even if the cash reserves of joint-stock banks are successfully increased, it does not follow that they will take advantage of the fact to make more loans. Though they will normally wish to do so, no suitable borrowers may be available. Thus, between June 1932 and June 1933, when the Bank of England was trying to increase the volume of money in order to dispel the slump, the increase in the cash reserves of London clearing banks enabled them to increase deposits by £214 millions, but in the same period, so far from increasing their loans, they reduced them by £77 millions, while putting the whole of the difference (and more) into the purchase of securities.

Surely to goodness, if we want to increase the supply of money it should be possible to do so. Cannot we discard these almost mediæval indirect devices and replace them with a monetary machine designed for the task in hand? Of course we can, and there are a variety of different devices we might adopt. I will now try and indicate the main planks of such a reform, not in a spirit of dogmatic assertion, but simply in an attempt to show the sort of thing at which we need to aim.

PLANNED MONEY

1. The first step is to equip ourselves with a properly constituted body for controlling the volume of money. Without doubt, the central bank is the natural candidate for this task, which, indeed, in a hole-and-corner way it already undertakes. It is equipped with the experience, the prestige and the staff. But it also follows that the responsibility of the bank to the nation must be made clear. It cannot continue to be a private concern, operating in secrecy and tempted by the lure of private profits. Nor can we tolerate the absurdity of pretending that it is an automaton and does not really wield the powers we all know it possesses. The bank must own up to its responsibilities.

But on making the bank responsible to the nation, the nation owes a corresponding duty to the bank. It must present it with a coherent and clearly defined monetary policy, such as the maintenance of a stable price-level. It can be seen, then, that the recent nationalization of the Bank of England by the Labour Government was valuable as a preliminary step but left the central problem untouched.

2. Once the central bank's responsibility has been defined, it becomes possible to drop the antiquated restrictions on enlarging the fiduciary issue, and leave the bank free to adjust the supply of money without reference to the quantity of gold.[1] Its use of this power should be subject to debate along with all its other activities.

3. Whatever money is required, over and above that created by the joint-stock banks in the course of making loans, could be created by the fiat of the central bank. Alternatively, if the joint-stock banks were creating excessive amounts of money in this way, the central bank could destroy appropriate sums of money by fiat.

In practice this would probably mean that the Chancellor of the Exchequer would be advised, when drawing up his budget, that he could count on a specified contribution from the central

[1] The relation of such a policy to the problem of foreign trade will be discussed later in the book.

bank towards his revenues; or, if money was to be destroyed, he would be called on to make a payment to the central bank. The central bank would spread these payments over the year in instalments which would vary with seasonal needs.

4. These reforms would leave the central bank free to regulate not the volume of money but the volume of *lending* by open market operations—but if we really want to make a job of it, we shall abandon this chancy process and place the responsibility for regulating lending according to national needs squarely in the hands of the joint-stock banks themselves. This implies that these bodies, too, must be converted to a public corporation basis, or to its equivalent, becoming responsible primarily to the public and not to their stockholders.

5. If we do this, we can then supply the joint-stock banks with whatever quantities of cash they need to meet the public's demands, and thus make them solvent for the first time in more than a hundred years. No longer need there be any danger of a 'run on the bank' in which thousands of investors may lose their savings. The whole of the money circulating as cheques will be convertible into notes and coin if need be.

6. For the efficient operation of planned money, the Bank should have access to a wider range of statistics than at present and it should work in close co-operation with the joint-stock banks. The separation of identity, which we owe to the accident of their evolution, becomes meaningless, and they can be woven into as close an organization as seems desirable.

7. The main difficulty in such a programme is the need for confidence. If people are seized with unreasoning fears of inflation, if they hesitate to accept notes issued under the new arrangements, then it cannot be made to work. If the scheme is presented with the backing and approval of industry and the press, there is little likelihood of public nervousness. But all those who at present draw incomes from the present dispensation will be likely to oppose the change, and it is precisely such people who have public influence. Their opposition might well make the reforms unworkable.

Nervousness might also be caused in foreign financial circles; foreign investors might withdraw money in large quantities from

Britain, supposing the present war-time currency controls to have been removed. Some measure of control might therefore be needed in our international monetary dealings. With this side of the question we shall deal in later chapters.

CONCLUSION

Let me repeat, what I have just given is not a hard-and-fast 'programme' of monetary reconstruction. It is only an attempt to block in the main issues; a draft, not a blueprint. Banking experts, no doubt, could evolve devices more subtle than the creation of money by fiat. Perhaps there are better ways of freeing the banks from their over-riding responsibility to share-holders and making them servants of the whole nation than converting them into public corporations. Experience in operation will suggest many refinements and novelties of technique.

But at present we have not got as far as that. We have not even got a general agreement and consent to the necessity of re-designing the monetary machine at all.

The importance of a new monetary technique must be admitted even by those who do not accept the desirability of a stable price-level. For whatever changes in the volume of money we may wish to make, with whatever object, at least it is helpful to have a technique which can be relied on to produce the desired results.

We have now almost completed our survey of the machinery by which the volume of money is regulated. It will be realized that in the last analysis, the controlling factor is the supply of gold. If the supply of gold is reduced then the number of bank-notes must be reduced and thus the volume of bank-credit must also be reduced. If it is increased the number of bank-notes and quantity of bank-credit *can* be expanded—though for this to happen both bankers and public must be willing.

Gold, in short, acts as a kind of regulator. Parliament can, by passing a law changing the fiduciary issue, alter the setting of the regulator; but with this exception the system is supposed to work automatically. So the next step is to investigate how the supply of gold alters and why.

Summary

Bankers permit people to write cheques for ten times the cash they hold. In this way they have multiplied the volume of money tenfold, creating £1000 million in the century up to 1914, and more since. Every time a banker makes a loan, new money is created; every time a loan is paid off, it is destroyed. But loans are often needed when new money is not, and vice versa. This strange system is bound to play havoc with the volume of money.

The Bank of England can cause the cash-holdings of the joint-stock banks to vary, and can thus vary the volume of *bank-credit*. Since cheques are based on notes and notes are based on gold, when gold leaves the country the volume of money is drastically reduced. But when gold comes in, it does not follow that the volume of bank-credit will increase, since bankers may not be willing or able to make the corresponding volume of loans.

It is not the job of joint-stock bankers to regulate the volume of money; it is their object to issue as much as possible, since they receive interest on it. We cannot hope for a satisfactory regulation of the volume of money until it is detached from the jobs of looking after clients' savings, and making loans.

9

Gold be Damned![1]

'And what is *this on my head?' she exclaimed in a tone of dismay, as she put her hands up to something very heavy, that fitted tight round her head. 'But how* can *it have got there without my knowing it?' she said to herself as she lifted it off, and set it on her lap to make out what it could possibly be. It was a golden crown.*

THE WAY in which the supply of gold controls the volume of money in any particular country depends on two main factors: first, the rate at which fresh gold is being mined, and second, the way in which the total gold stock of the planet is distributed between the different nations.

Let us start by considering the first issue, the mining of new gold. Assuming, for the moment, that the stock of gold is satisfactorily distributed, the question that immediately springs to mind is: what reason is there to suppose that the supply of new gold is proportional to the world's requirements of new money? The answer is simple: there is no relation between them—and in point of fact the supply of new gold is far smaller than is required. The prospects for the future are even less encouraging.

Only a series of fortunate accidents and strange expedients prevented the system from breaking down much sooner than it did. During the last 100 years, the great increase in productive power among the western nations was matched, (though not very accurately), by the periodic discovery of new mines in Africa, California, Australia and Alaska, but even so the expansion

[1] The title is taken from a remark of the late Sir Henri Deterding, presiding genius of The Royal Dutch-Shell oil combine: 'If any message from me to the world is worth anything, I can give it to you in three words: "Gold be damned!" '

achieved was insufficient and the additional devices of bank-credit and the fiduciary issue were required to mend the situation. And even despite these devices—though a period of rising prices followed each new gold discovery—on the whole prices fell over the period. This was true even in Britain which, since it owned so many of the new mines, was in a more favourable position than most countries.

However, early in the twentieth century events took a new turn. Until then the output of the world's gold-mines had been steadily expanding. Since then it has been falling. Here are the production figures for the three first decades:

	Output
1899 to 1909	£990 million
1909 to 1919	£771 ,,
1919 to 1929	£500 ,,

It was estimated that by 1950 production would have shrunk to one-fifth of its 1930 volume, that is, from about £80 million a year to about £16 million! However, under the pressure of war, output has begun to climb again. The League of Nations Gold Committee has estimated that the world needs some 2–3 per cent more gold every year. And if the problem of unemployment could be solved, the output of goods—and hence the need for gold—might rise to a much higher figure than hitherto.[1]

New mines may be discovered, but geologists are not optimistic. If they are found, the most probable place is Russia, and as the USSR does not need gold for her internal currency she can hardly be relied upon to mine it for the benefit of international bankers. At the same time it is always possible that some scientist may find a method of producing gold in unheard-of quantities—say, from sea-water, in which it is present as gold chloride.[2] It is estimated that the oceans of the world contain some 10,000

[1] As a result of the gold shortage, many countries have tried to introduce 'economies' in the use of gold. For instance, Britain called in her sovereigns and added them to the central gold stock. Several small countries use dollars or pounds as a backing for their currency instead of gold. And so on.

[2] This is not a pipe-dream. See *Nature*, 148, 3745.

million tons of gold. Then we should be faced with a wild inflation instead of a slump, and would have to turn from gold to some other metal.

But the question is not simply one of supplying an adequate total quantity of gold, it is one of matching the supply to the supply of goods. But the rate at which gold is dug out of the earth has no conceivable relation with the rate at which the supply of goods is expanding (or with any other economic entity for that matter). Furthermore, the exhaustion of old mines, the discovery of new, the invention of new extraction techniques (such as cyaniding and dredging) all may, and do, combine to vary the supply of money in unpredictable fits and starts. One might as well make the supply of money depend on the potato crop. It would save a lot of useless labour and could hardly produce worse results.

In the past, the rate at which the capacity to produce goods increased, and the rate at which gold was mined, though never equivalent, were both so slow that the resulting inflations and deflations were greatly mitigated by being spread over very long periods of time. (Even so, there were periodic crises, notably the great inflation caused by the influx of gold into Europe after the discovery of the New World.) But to-day output, affected both by technical and political and economic factors, may increase as much as 25 per cent in five years, or decrease a similar amount. Can there be any doubt that the idea of regulating the world's supply of money by the supply of gold is sheer folly?

ADVANTAGES OF GOLD

Why, you may ask, was gold ever chosen for money? Because what was required in lawless times for money was some object universally coveted and so universally acceptable; in addition it should be small in relation to its value (to make it easily portable), hard-wearing, chemically stable and difficult to falsify. Of the metals then known none fulfilled these requirements. Iron and bronze were hard-wearing but not sufficiently valuable. Gold was valuable but not hard-wearing and at times not sufficiently plentiful. Silver, on the whole, seemed the best proposition. As

both became more plentiful and when means of hardening gold were found, it began to replace silver.

To-day there are many substances which fulfil all the requirements better than gold, if we really want a metallic backing of currency. Rhodium, to name just one example, is six times as valuable as gold, weight for weight, or seven times as valuable on the basis of volume. Banks would therefore need proportionately smaller safes to keep it in and would spend less when sending it from country to country. And it is much greater real value, being vital to several industrial processes, whereas the chief industrial demand for gold is for ornamental work. Even here the demand for gold is largely traditional; it is wanted because it has come to connote opulence, much more than for its intrinsic beauty. But if the world's entire gold supply were available for ornamental purposes, its price would be so low that it would no longer connote opulence. It is only the fact the world desperately needs gold to use as money which gives it its present high price. Consequently we have the Gilbertian situation that we are using gold for money because it has a high value, and it has a high value because we are using it for money.

Now let us turn our attention to the way in which gold affects the supply of money in a particular country, as distinct from its effect on the world's supply of money as a whole.

THE DISTRIBUTION OF GOLD

Gold is moved about the world, from one country to another, in payment of various kinds of debts.

First let me tell you something about how these international debts arise and how they are settled. In olden days, when a man in London wanted to buy goods from, say, Frankfort he had no alternative but to send a messenger to Frankfort with gold bars or coin to settle the deal. As trade became more extensive, it began to happen that a messenger was travelling from London to Frankfort with gold at the same time as a messenger with more gold was travelling in the reverse direction. With the development of an international banking system this waste of effort could be cut out. The buyer in London paid his gold into the bank, and

the bank sent a message to the Frankfort bank to pay out the appropriate sum. For the moment the London bank was in debt to the German one, but soon after someone in Frankfort would wish to buy from London and would pay gold into the Frankfort bank, which would instruct the London bank to pay out.

In the course of a year, payments in each direction would tend to cancel out; if they did not, the banks only had to remit the difference to one another, a relatively small sum. Finally this developed into the full-fledged modern system. Instead of merely seeking to balance the transaction between two towns, or even two countries, it was only necessary for the central bank of a country to balance its incomings from all other countries with its outgoings to all other countries, and no gold would have to be moved either to or from its vaults. Naturally the bankers' ideal was that no gold should move at all, since this reduced their costs. Such a state of affairs occurs when the *money value* of a country's exports equals the money value of its imports.

I have italicized the words 'money value', because the tendency has been to wangle prices so that money values come into balance even when the real volumes of goods were growing more and more uneven. This is typical of our habit of putting the financial cart before the industrial horse. Instead of trying to bring the volume of goods into balance, we ignore the reality and alter the price-ticket.

This monetary balance is known as *the balance of payments*, or, less accurately, as the *balance of trade*.

Now, if it happens that imports do not equal exports, that trade does not balance, then the difference has to be settled by sending gold abroad or bringing gold in. Thus, if trade is satisfactorily balanced, a very large volume of foreign trade can be carried on with a very small volume of gold.

But for a variety of reasons (some of which we shall examine in a later chapter) trade does not always balance. For example, if a country becomes prosperous and the average income of its inhabitants rises, then they will tend to buy more from abroad than formerly. Accordingly an *adverse balance of trade* (or, correctly, payments) develops. Imports begin to exceed exports. Mark what happens! Gold is sent out of the country—but we

know that the volume of money in the country depends on the gold stock. When the Bank of England sends £1000 of gold abroad, it is obliged to call in from general circulation £1000 of notes. It obtains these from the joint-stock banks by open-market operations. But the volume of bank-credit has to be kept at *ten times* the cash reserves. So the export of £1000 of gold forces the joint-stock banks to cancel £10,000 worth of bank-credit.

In short, when any appreciable quantity of gold moves abroad, it causes an internal deflation of ten times the size, forcing down incomes and strangling trade in the process. This extraordinary process, which was the unexpected progeny of the invention of bank-credit, was immediately hailed by Victorian economists and bankers as a God-sent blessing. For the deflation naturally caused people to buy less from abroad (and, by forcing down wages, it enabled manufacturers to produce more cheaply and expand exports) so that the imbalance of trade was soon rectified. Similarly a favourable balance of trade leads to an influx of gold and a corresponding degree of inflation.

PENALTIES OF THE SELF-REGULATING SYSTEM

But was this really such a satisfactory way of achieving the result? The answer is 'No'—and for two reasons. In the first place, a general depression (even a slight one) is far too high a cost to pay. It should be possible to control the balance of trade without in any way prejudicing the conditions of internal prosperity.

In Chapter 7 we established the principle that the object of monetary policy must be to maintain a stable price-level (with certain reservations which we specified). But now we see that the present money-regulating system cannot possibly make this its objective, because it is already committed to another, completely incompatible, objective: to adjust the balance of trade by manipulating the price-level. The balance of trade is adjusted by varying prosperity.

I shall not go any further at this point into the balance-of-trade side of the question—we shall come to it again in Chapters 13 and 15—all I am concerned with here is to show the

handicaps the money-regulating system works under where the question of full employment is concerned. We therefore establish the principle: the control of the internal currency should be completely detached from the system of external payments, the balance of trade to be maintained by other means.

Now we come to the second reason why this process is a disastrous one. You remember that bank-credit, which is the form of money we chiefly use, can only be issued in the form of *loans*. So it follows that when gold is exported, not only is money cancelled, but the whole of that cancelled money is in the form of loans, which have to be called in for the purpose. Needless to say, this is in the highest degree damaging to industry. This is the penalty of the extraordinary system to which we have become committed by historical accident, of only issuing new money in the form of loans. We have already pointed out that this system is illogical, since there is no close correlation between the monetary requirements of the economic machine and the need of industry for new capital.

Looked at not as a historical accident but as monetary phenomenon, the system is extraordinary enough. The visitor from Mars would unquestionably regard it as primitive beyond words. But what makes it doubly extraordinary is the volume of stuff which has been written in terms of glowing admiration of it as the last refinement of human ingenuity. I should have supposed that no one but a maniac could regard as satisfactory a system which corrects a simple inequality of purchases by the catastrophic expedient of plunging a whole nation into economic distress.

OTHER FACTORS

To be accurate, we must now make reference to the fact that the settlement of trade balances is not the only purpose for which gold moves from one country to another. An important part of gold movements is due to loans made by richer to poorer countries. These loans can be divided into two groups: long-term investments and short-term loans which are taken up (for example) by governments wishing to bridge the gap between receiving the tax-revenue and making salary payments to civil servants. These

short-term loans are another thing which exert a maleficent influence on the volume of money, for in troubled times they are transferred from capital to capital at great speed in response to the lender's fears of war or government default. As a result, the volume of money in the countries concerned is constantly being contracted and expanded without rhyme or reason.

Then again there is the special type of unbalanced trade which results when a country buys armaments without paying for them at the time, but pays by instalments after the war. And there may also be reparations imposed on the defeated country. Such payments are made in gold (if they *are* made) and they enable the creditor country to increase its imports without increasing its exports.

But what if it refuses to do so? No country can afford to maintain an adverse trade balance for long, because it will have to keep paying out gold, and will finally exhaust its supplies of the metal: just as a man who spends more than his income will finally exhaust his savings. But there is nothing to stop a country exporting more than it imports. If it fails to return the gold thus acquired to circulation in the form of loans, its own price-level will rise and that of debtor countries will fall. Alternatively, if the creditor country hoards the surplus, it will induce a slump.

For all these reasons the world's stock of gold has become most unfairly distributed. After the last war it was true to say that only five countries had appreciable stocks of gold: U.S.A., Britain, France, Holland and Switzerland. Since then the situation has grown worse and by 1940 the U.S.A held more than 80 per cent of the world's gold stock. (How this came about we shall see elsewhere.) In consequence the other countries have undergone severe periods of falling prices and many of them have been forced to detach their national money from the gold regulator.

THE OWNERSHIP OF GOLD-MINES

Lastly there is one more factor, and it is one which brings us back to the point we started from. Three-fifths of the world's supplies of new gold come from mines in the possession of the British Empire and the U.S.A. (We can ignore the U.S.S.R. in

this context, since she does not take part in the system.) Consequently these countries are in a position to import more than they export—a very valuable privilege. By so doing the gold becomes rather more evenly distributed, and so the world's stock of money is increased instead of simply increasing the money of the country owning the mines.

Alternatively, they can make use of this gold 'bonus' to make loans to less fortunate countries. This also serves to distribute the supply evenly as long as the loans continue to be made, but when they are repaid, it involves the lending country in increasing its imports. Hence the fact that gold-mines are privately owned does not cause any maldistribution of gold but it does bias the distribution of goods.

THE SUPERSESSION OF GOLD

Useless as gold is as a basis for the internal currency, it can be seen that it serves a function as a means of settling debts between countries, since it is clearly no use for importers to send pound notes to traders in foreign countries or for exporters to accumulate foreign currencies.

In a completely civilized world, of course, such payments would be made by book-entries: if England owed money to the United States it would cancel the appropriate amount of English money, while the Americans would issue a corresponding amount of dollars; the farce of shipping gold bars across the Atlantic could be dispensed with. The only prerequisite is unquestioning trust in the other country sticking to the rules. As a matter of fact Britain and America have at times progressed thus far: gold has been 'earmarked' for America by the Bank of England, but not actually transported there.

But it will, I fear, be a long time before the world as a whole develops the requisite mutual confidence, and so makes gold unnecessary. That day must wait for the establishment of an international police and judiciary capable of bringing to book any government which does not honour its obligations, in the same way that law and order in the national sphere are the precondition of a national token currency. Until then we must stick

to the use of media of real value in the international sphere, like savages.

No—not like savages. For most primitive communities use tokens (*e.g.* cowrie shells) for money and honour their debts punctiliously. It is only the buccaneering members of quasi-anarchic 'individualist' societies that sink to such ignominy.

Fortunately, however, it is not necessary to wait until every one of the world's seventy-odd countries has established a reputation for honesty; any two nations which have faith in one another's integrity can substitute book-entries for gold movements. As soon as more than two or three nations are using the system, the world will need a central accounting organization which will be to Central Banks what the Bankers' Clearing House is to joint-stock banks in Britain. The Bank of International Settlements at Basle was founded in 1930 partly with this object, though it unfortunately became involved with other issues. Economists hoped that something of the sort would emerge from the Bretton Woods discussions, but the spirit of co-operation was found to be entirely lacking. And when the world's international payments are rationally organized (if ever) no gold will be needed at all. Then at last it will be possible to detach the volume of money entirely from this erratic regulator.

CONCLUSION

In this chapter we have seen how, whenever a country tends to buy too much from abroad this brings about a deflation which puts an end to prosperity. But this is not the only, or even the main, reason why booms turn into slumps. We must now delve more deeply into the question of why prosperity breeds its own collapse. The best line of attack will be to start by seeing how prosperity is brought about in the first place. We shall find that, even if the effect of gold movements were eliminated, prosperity would tend to bring about its own decease. But the time we have spent studying the volume of money has not been wasted, for in this story of trade fluctuation, variation in the volume of money plays an intimate part.

Summary

The supply of gold is a hopeless method of controlling the total supply of money in the world, because gold output is decreasing while world trade is increasing.

Gold is used to settle debts to other countries, and this has the effect of producing deflation at home and so discourages the country from contracting any more such debts, but this result is achieved at the cost of depression; in addition it involves calling in loans, which harms industry. On top of this, gold is badly distributed between the countries of the world.

Gold also moves from country to country in the form of short-term loans and as a result of speculation, with unpredictable effects on the internal volume of money. If a country maintains an export surplus it accumulates gold and disturbs the supply of money. Gold is unnecessary at home, and equally unnecessary in international trade, once integrity is established.

10

The Birth of the Boom

Alice could never quite make out, in thinking it over afterwards, how it was that they began: all she remembers is, that they were running hand in hand, and the Queen went so fast that it was all she could do to keep up with her: and still the Queen kept crying 'Faster!' but Alice felt she could not go faster, though she had no breath to say so.
The most curious part of the thing was, that the trees and the other things round them never changed their places at all: however fast they went, they never seemed to pass anything. 'I wonder if all the things move along with us?' thought poor puzzled Alice. And the Queen seemed to guess her thoughts, for she cried: 'Faster! Don't try to talk.'

WE CAME across the clue to the origins of the trade-cycle in Chapter 2, when probing the question of basic unemployment. You remember we argued that capital industry must bear the correct relationship to consumption industry and hence that saving must bear the correct relationship to spending. We then went on to suppose that too much saving occurred, creating a shortage of spending power and precipitating a slump.

Things will develop differently, however, if the change in the ratio between saving and spending is followed by a similar change in the ratio between the sizes of capital and consumption industry: that is, if the monetary change is followed by a physical one. If capital industry remains unchanged in size, any additional saving will be unable to find an outlet in investment and will perforce be hoarded; but if those in charge of capital industry for any reason decided to increase the scale of their operations this additional saving will find an outlet. Given the existence of a reservoir of unemployed, it is easy for capital industry to increase

the scale of its activities by absorbing labour therefrom; the extra saving is soon paid out as wages to these new recruits. Result: total buying power is enlarged, for all the original wage-earners are still in work plus those absorbed from the unemployed. Originally, entrepreneurs may have been wrong in their decision to build new capital equipment, but now their judgment seems to have been justified—for the very fact of building this equipment *creates* the demand required to justify it, and more besides. Entrepreneurs now feel encouraged to start yet more works of capital construction—that is, to build more factories, garages, restaurants and to start more bus services and market-gardens—and as they do so they unwittingly create new floods of purchasing power which justify still further undertakings. A snowball process has started: a boom is under way.

Note the part played in this story by the existence of a reservoir of unemployed labour. If there were no such reservoir, capital industry would only be able to achieve its initial expansion by borrowing men from consumption industry. There would be no decline in purchasing power, because precisely the same total number of wage-earners would be at work as before. Consumption industry and capital industry would then compete for the services of these workers by raising wages and in this way profits would be lessened; thus the over-saving which started the trouble would be caused to disappear. Finally, as saving was reduced, capital industry would find it impossible to obtain such large funds and would also diminish to its proper size. It is the existence of unemployed which makes the boom possible. It follows that the more we pay unemployed in the form of a dole, the more we weaken the tendency of the boom to develop. If the unemployed were paid the same as men in work, there would be no booms—and no slumps. There would, assuredly, be basic and structural unemployment, but there would be no risk of unemployment rising above this level.

As the boom proceeds, profits are steadily piled up. Capital industry must therefore grow and grow to absorb them; but clearly there is a limit to capital industry's power to expand. If nothing else, it will finally absorb all the reserve of unemployed—or at any rate all those suited to its purposes. Thereupon over-

saving will develop, purchasing power will decline, and some parts of capital industry will prove to be redundant. As purchasing power declines, consumption industry also will be found to be too big for demand, and firms will be forced to reduce their activity. More men will be fired and the process will repeat itself. The slump is on. Once under way, it proceeds cumulatively until it has swung as far below the average as it once was above it.

In practice the down-turn occurs *before* the reserve of labour is exhausted, but before attempting to fill in the details of the story I want to examine the main plot more closely.

Such is the process by which booms are generated and turn into slumps. Some writers speak as if the practical problem were simply to prevent this occurring; but there is little satisfaction in stabilizing a state of semi-prosperity coupled with the existence of a large number of unemployed; what we want is to stabilize a state of maximum prosperity coupled with zero cyclical unemployment. It follows then that some kind of expansive process must be allowed to take place. But it does not follow that all we need do is permit the development of a boom and 'stabilize it at the peak'. The typical boom contains factors which make it inherently difficult to stabilize. At this point, therefore, I want to examine the problems of a rationally-controlled expansion, so that we can see where the boom process, as it develops in a capitalist society, departs from the desirable pattern.

As usual, we shall start by considering the physical problem first, and later will fit the monetary pattern to it.

EXPANDING THE PRODUCTIVE MACHINE

In engineering a controlled expansion, our objective will be to expand both capital and consumption industry until, together, they provide employment for all; and at the end of this process they must still bear the same ratio to one another as originally. Unfortunately this involves more than just adding a few per cent more factories and a few per cent more blast-furnaces.

In the first place we shall have to put men to constructing the additional factories required. In other words, over and above

the slight enlargement of capital industry which will be needed to replace the worn-out equipment of a somewhat enlarged consumption industry, we have to provide a much larger *temporary* expansion of capital industry in order to bring about the expansion at all.

To make sure this is quite clear, let us invent an example. We have 95 men cutting sugar-cane, and 5 men making and sharpening knives for them. We wish to absorb another 100 men who are unemployed because there are no knives for them. Clearly, after we have achieved the expansion, we shall need 10 men in all to keep the doubled number of workers supplied with knives, *i.e.* 5 of the unemployed will have to go into capital industry. But how are we to bring the expansion about? Are we to start by taking 5 men from the unemployed and setting them to making 95 knives? It is clear that this would be a slow business and would greatly delay the absorption of the other unemployed. How much better to take perhaps 20 or 30 of them and put them to making knives; in this way the necessary capital equipment will be produced in a short time and the absorption of the unemployed will be speeded up.

But this course involves us in a ticklish structural readjustment. It means that employment in capital industry (as represented by the knife-makers) expands from 5 to as much as 35 and subsequently contracts to 10; and it means that of these 30 men absorbed into capital industry, only 5 can hope to stay on in it; the others must all transfer into consumption industry as knives become available.

CAPITAL INDUSTRY IS VULNERABLE

We can put the same proposition in words which make it more applicable to current problems. Suppose consumption industry normally replaces 2½ per cent of its equipment every year. But a period of expansion sets in and it increases its demands on capital industry by another 2½ per cent. Now for consumption industry this is a very gentle rate of expansion—2½ per cent per annum. But what has happened in capital industry? Its market has *doubled*. If consumption industry increased at the rate of

5 per cent per annum, its market would have trebled, *i.e.* increased 200 per cent.

In other words, quite a small change in the habits of consumption industry means a catastrophic change in the constitution of capital industry. This is a fact of crucial importance. It shows why it is almost impossible to prevent capital industry experiencing extremes of prosperity and depression; it is constitutionally vulnerable.

But this vulnerability assumes a wider significance than being a misfortune for a particular section of industry. It is the thing which brings the boom to an end. For when capital industry contracts, men are fired and purchasing power falls. Soon the growth of consumption industry also comes to an end; then the presence of over-saving, which has been concealed until now, becomes apparent and the resultant slump can no longer be postponed.

What then are the objectives of a rationally-ordered expansion? First, we must set a limit on the maximum rate of expansion and thus restrict the increase in the size of capital industry to some prearranged figure, in order to minimize the structural changes. By so doing we should penalize the community as a whole in one way (by slowing down the rate at which the output of consumption goods could expand) in order to protect it in another, by preventing unemployment, waste of resources and a possible slump.

Secondly, we must try and taper off the rate of expansion as the end of the expansion phase approached; we could start a steady process of transferring so many thousand men a month from capital to consumption industry. The curve of employment in capital industry would then follow a smooth curve, rising steadily to a maximum and then declining to the new level of normality. This is entirely different from the way things develop in an uncontrolled boom. We permit capital industry to go on taking on more and more men right up to the last moment and then to shut down, bang! thus ensuring the maximum disruption and distress.

This problem is of particular interest just after a war. Thousands of factories are ceasing the manufacture of war goods

and are demanding different tools suitable for the production of peace-time goods. Much of the country's capital equipment has been overworked or its replacement postponed. More has been destroyed by bombing. On top of this, civilians are anxious to replace the numerous articles which they have had to go without. For all these reasons there is *temporarily* a huge market for capital goods. Thus, instead of beginning the process of contracting a heavy industry which has been bloated by arms production, the temptation is to preserve it or even enlarge it as demobilized labour becomes available. But in a year or two, these exceptional conditions begin to subside and before long heavy industry begins to find itself in the throes of a slump. The probability is that this slump then brings on a general depression in all industries. That is what occurred after the 1914–8 war.

To sum up, then, capital industry is peculiarly liable to fluctuations in prosperity at any time; but when it is proposed to expand the whole system this is bound to occur on a serious scale.

MONEY-ASPECT OF EXPANSION

Parallel with the physical process of expansion and contraction runs a monetary process. If the size of capital industry is to expand and decline—if the *rate* at which new factories are erected by capital industry is to rise and then fall—then, since these investments are financed from saving, *the rate of saving must rise and fall* in harmony. It is precisely here that the trouble lies.

If we had merely wanted to prevent the boom developing we should have had to ask investors to save less and spend more; in itself an almost impossibly difficult task. But as it is, we have to let them save more and more for a while, and then reduce their rate of saving. Now what people have never had they don't miss; but once investors have tasted the pleasures of a high rate of saving and investment, they cannot easily be persuaded to retrench. They come to regard the temporary high rate of saving as normal. They point out that when they were saving at this rate there was great prosperity; and if they reduce it there will be unemployment in capital industry—all of which is perfectly true.

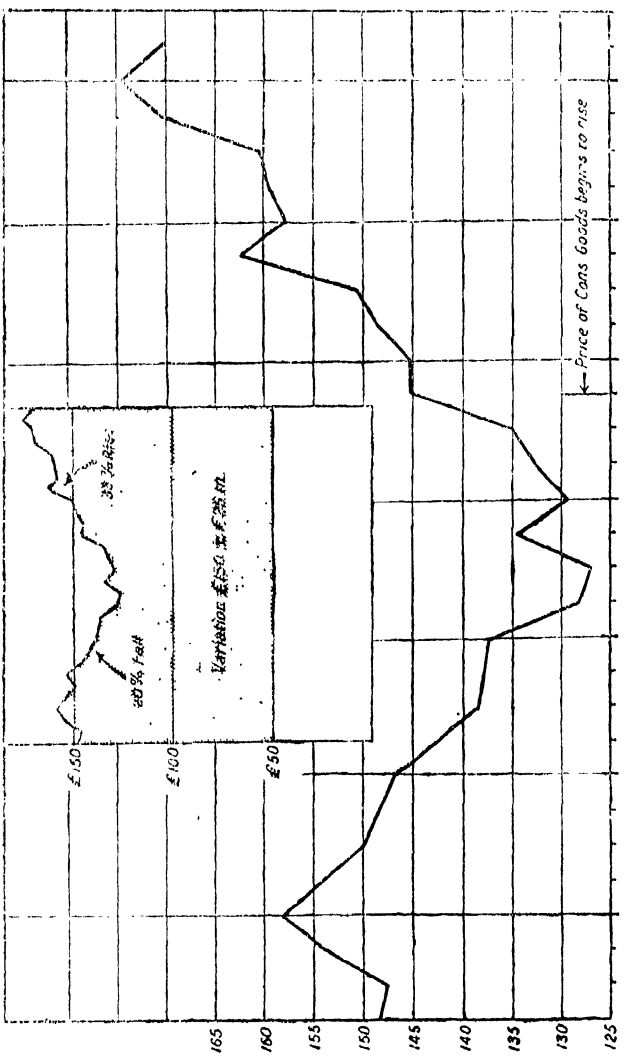


FIG. 13.—THE ERRATIC SHAPE OF INVESTMENT (1).

The curve shows the value, in millions of pounds, of capital goods consumed in the home market in Britain (seasonal variations eliminated). It includes goods which went to maintain and replace worn equipment, but excludes such capital goods as were exported.

Inset.—The same curve shown in relation to the absolute size of home investment.

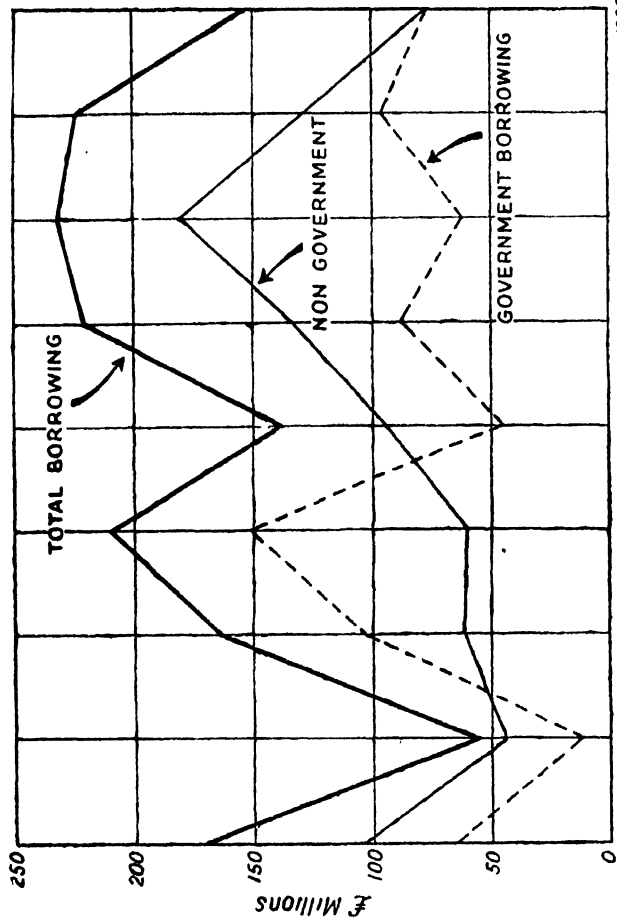


FIG. 14.—THE ERRATIC SHAPE OF INVESTMENT (2).

Here is shown British government borrowing in the London New Issue market, together with non-government borrowing, and the two together. Public borrowing is, of course, only one from among several sources of new capital, and not all the money thus raised goes into the purchase of investment goods: something like a quarter goes to repurchase existing assets. Nevertheless, the tendency of government borrowing to compensate for the variable enthusiasm of other borrowers can be seen.

So when investment opportunity declines, instead of reconciling themselves to the fact and increasing their rate of expenditure proportionately, they begin to hoard. (As noted in Chapter 2 this hoarding does not proceed very far, for the onset of the slump speedily reduces profits sharply all round and this diminishes the tendency to save.) All this hoarded money represents purchasing power withheld from the market. It is part of a stream of which a few weeks before was reaching the cash registers of retailers through the hands of workers in capital industry and now is not. Small as it is, it is enough to set off the downward snowball we call the slump.

CAN INVESTORS SPEND MORE?

It is easy enough to say that at the peak of the boom investors must decrease saving and increase expenditure, but as we have already seen in detail, investors as a group are virtually unable to do this. The bulk of saving is done by business concerns which regulate their saving in accordance with their conception of good business management; and even if they passed on a greater part of their profits to their shareholders we know from investigation of actual instances that the latter will invariably save at least a proportion of any increase in their income.

Consequently we are obliged to face the hard fact that this stream of purchasing power which can no longer be invested, and which investors are unwilling to spend, must be taken from them and given to those who can use it. The money which formerly reached the worker in capital industry through the channel of investment, must reach him (after his transfer into consumption industry) through the ordinary method of purchasing the goods he helps to make. And if investors are unwilling to purchase them, the money must be given to those who are willing.

This amounts to saying that investors must become poorer. Their income consists of a part A which they spend and a part B which they invest. In a boom B is fully absorbed, but when expansion is complete B must be reduced to B-x. If they refuse to spend x then it must be given to someone else. So their income drops by x. But naturally investors invest with the idea of

enlarging their income, not decreasing it. If they knew that their income was to be *reduced* by investment they would not invest at all. In short, we are compelled to ask investors to carry out investment without reward at all—to lend money without receiving interest. This is contrary to the whole basis of the financial system as we know it. Investors will never consent to this confiscation of their wealth (for such it is). So it is literally true to say that the system has broken down.

The reader will have noticed the similarity between what we have been saying and what we said in Chapter 2: it may now be helpful to indicate the relationship between the two processes. In Chapter 2 we were considering the relationship of purchasing power to the general long-term rise of productivity due to technical progress; in the boom we have to deal with an increase of output due to the absorption of labour from the unemployed. The first of these trends causes basic unemployment, the second, cyclical.

In Chapter 2 we described how investors are able to dispose of the unspent part of their income by financing a growing number of capital undertakings. When the supply of capital finally comes to exceed the opportunities of investment, a temporary respite can be won if capital industry is enlarged, so that it can absorb a greater volume of savings. In this way the emergence of over-saving is postponed for some five years or so, which is the time required to expand capital industry appreciably and for the resulting flood of additional production to come on the market. In short, the boom represents an eleventh-hour attempt to postpone the onset of over-saving, by the hopeless course of expanding capital industry far beyond its proper size. The difference is, that in the case of the trade-cycle we are considering increases in output which resulted from the *absorption of unemployed labour* into industry, whereas in the earlier case we were considering increases in output resulting from *technical advances*. And whereas the cyclical absorption of unemployed takes place over a period of six or seven years and is followed by their ejection, rising productivity on the other hand takes place slowly and fairly continuously over an indefinitely long period of years.

We want to try and visualize these two processes acting

simultaneously. Still keeping the outlines simple, we want to imagine a constant output of goods being produced by a steadily decreasing proportion of the working population. But within the framework of this general trend we picture periodic bouts of capital expenditure which give temporary employment to a proportion of the unemployed, only to throw them out again a few years later. Cyclic increases in employment may be likened to the repeated heavings of a system trying to burst loose from the bonds restraining it. If basic unemployment did not exist there would be far less tendency for booms to develop, because capital industry would not have access to a huge reservoir of unemployed labour; it would be compelled to provide a continuous flow of work for a constant number of employees instead of using a larger number for part of the time.

Basic unemployment, not cyclical, is the primary problem.

RELOCATION PROBLEMS

The difficulty of preventing over-saving we have already discussed. There remain two other problems of adjustment in the successful administration of an expansion:

(*a*) the *human* problem of diverting workers from one industry to another.

(*b*) the *physical* problem of scrapping redundant equipment: this is also a financial problem in that the owners of the redundant equipment suffer a loss of income.

Over and above all this, there is the general organizational problem of planning and administering the changeover as a whole. The problem of transferring men out of a contracting capital industry into other work is not dissimilar to the problem of demobilization from the army—with this great difference, that the men in the army are anxious to return to civilian work, while the steelworker is anxious to stay where he is. A new job is likely to mean loss of status, loss of pay, loss of friends. It may mean transfer to a different district, which not only costs money but may create difficult personal problems if other members of the family have jobs in the district.

There are also difficult psychological readjustments. A steel-worker will not be anxious to abandon his hardly acquired skill and become an apprentice again.

The problem cannot be solved, therefore, simply by setting up training centres and unemployment exchanges. Only the younger and more adaptable men can be successfully handled in this way. For the older men a policy of earlier superannuation seems indicated; and it hardly needs saying that the stream of new recruits into the industry must be sharply cut down the moment contraction starts. (At present, however, we do nothing of the sort: new recruits entered Britain's over-sized coal and cotton industries throughout the interwar period—which makes just one more argument against an unplanned economy).

Finally it is essential that manpower policies should be interlocked with policies for the provision of housing and public services based on a full knowledge of the population movements involved.

THE PHYSICAL PROBLEM

The great, temporary expansion of capital industry means that in the end much of the equipment used by capital industry itself will become superfluous. Blast-furnaces, steel-mills, coal-mines, drop-hammers, to say nothing of the associated buildings, railway lines and trucks, pit-head gear and the like, will cease to be of value or to have earning power. More than this, the transfer of population will mean that workers' houses will stand empty, and all the shops, cinemas and tramways which supplied those who dwelt in them will do diminished business as a result.

There will be a strong pressure to erect new consumption industries in the same locality, but since any population-planning policy will aim at—at the very least—a degree of dispersal and rehousing in our overcrowded industrial areas, these secondary effects will not be negligible.

How are we to deal with the loss of income to those who have invested in all this equipment? Laissez-faire economics would say that investors must take the rough with the smooth; it would seem fairer to find a way of balancing the declining prosperity of capital industry against the rising prosperity of consumption industries.

Complicated moral, as well as organizational, problems are involved here, and we will therefore postpone discussion of remedies until a later chapter.

It may be said that, quite apart from fairness, there is an even stronger argument for finding some way of offering compensation to the large class which must suffer from the contraction of capital industry. For at present the owners of capital investments, when they see a period of expansion coming to an end, seek by every means in their power to postpone this necessary and inevitable contraction. There is, however, only one thing which will ensure them this continued prosperity: the manufacture of armaments. To the heavy industries modern warfare comes with a double blessing, for the extensive destruction of heavy equipment caused by aerial bombing guarantees them a further spell of prosperity even when the war unfortunately comes to an end.

Having dissected out the skeleton of the boom process, let us now clothe it in flesh: let us see what happens when the boom collapses, and how the ensuing slump at last gives birth to another boom. In fact, since we have so far only shown the root-cause of collapse, neglecting many accessory factors, let us tell the whole story of the trade-cycle consecutively.

Summary

If saving is increased at the cost of spending, the ultimate effect is a slump; but matters develop differently if entrepreneurs respond to this extra saving by a higher rate of capital construction. No hoarding then occurs; instead men are absorbed from the unemployed, demand expands and a boom results.

But this expansion of capital industry cannot be carried far: soon it must contract again, and then the briefly postponed slump ensues.

In the typical boom, capital industry grows steadily in size until finally cut off with great abruptness; this contrasts with the pattern to be aimed at in a rationally-controlled expansion—a smooth expansion followed by a gradual tapering off.

This expansion of capital industry temporarily justifies a higher rate of saving. As the tapering-off starts, investors must diminish saving and increase spending. If they cannot and will

not spend more, there is no alternative but confiscation. Unfortunately investors regard the high rate of saving they have temporarily enjoyed as normality and cannot be persuaded of the impossibility of maintaining it.

The tapering-off process also creates an organizational problem, a problem of fair distribution of the monetary burden, and a problem of relocating manpower.

II

Boom into Slump

'It's really dreadful,' she muttered to herself, 'the way all the creatures argue. It's enough to drive one crazy!'

WE ARE now in a position to gather together all the facts we have learned, and trace the whole process of how booms turn into slumps, and back again, round the cycle. We will begin at the point where a boom has just started; entrepreneurs feel that there is a reasonable chance of new enterprises making a profit and are beginning to dishoard their savings and to contract loans in order to take advantage of this opening.

Phase I *: Boom*

A number of factors combine to create a mildly inflationary situation. When entrepreneurs take their savings out of the bank and spend them in capital industries, thus giving work to men formerly unemployed, they increase demand although no increase in output has yet occurred; prices rise. When entrepreneurs borrow from the banks, and the banks invent money with which to make these so-called loans, inflation occurs. It is true that when entrepreneurs raise money by appeals to the public to invest, in theory no inflation occurs, since the money thus raised and spent in capital industry is money which is *not* spent by the original owners. However, in practice, the effect may well be inflationary since it is not spent on the same type of goods as it would have been if not invested. Putting this money in the hands of men working in capital industry enlarges the demand for foodstuffs, the cheaper grades of clothing and *articles of popular consumption* generally. Prices therefore rise in these industries and entrepreneurs are naturally attracted by these high prices, which promise a good profit, into attempts to meet this demand.

A species of 'local inflation' takes place which is not in any real sense counterbalanced by local deflation in luxury industries, which do not lower prices but simply hold on to their stocks until better times.

Finally there is the effect of the *rate* at which these sums are disbursed. If money which has been saved over a period of ten years is spent over a period of two it is clear that the velocity of circulation is increased for the time being. During the slump savings have piled up in bank balances or in government loans; when the boom starts investors are anxious to get a return on their loans within as short a time as possible; so entrepreneurs build their new factories (and thus spend these savings) as fast as technical considerations permit.

Consequently, right from the start a *rising-price situation* is established. This in itself constitutes an inducement to go into business, as we pointed out in Chapter 7, since a business which would only break even when prices were stable can now make a profit.

As more enterprises are set on foot to take advantage of the rising-price situation, more money is distributed as purchasing power in capital industry, and yet more enterprises are evoked. A spiral of expansion is set up. The key factor in its creation is the *time-lag* between the distribution of purchasing power in capital industry (the result of investment) and the subsequent appearance of goods. The goods which are appearing this year do not offset the loans which are being made this year, they offset the loans which were made last year—and that only partially. The loans which are made this year are always inflationary at the time. And the loans which are made this year are always bigger than those which were made last year, thanks to the host of contributory causes which come into play.

Thus the prosperity which is reigning encourages the banks—and private investors—to make loans to the limit of their ability. It also attracts investments from abroad. When foreign investors send their money to England they send it in the form of gold. The Bank of England is thereupon able to increase the note issue. This increases the cash reserve of the joint stock banks, and thus

increases by ten times as much the amount which they are able to lend. The banks readily take the opportunity to increase their loans, to anyone who can offer the necessary security, without any attempt to consider what the total effect of their action may be. Provided they can pay a dividend they reck little of the fate of the economic system as a whole.

Prosperity also increases the velocity of circulation and so in effect the volume of money is enlarged still further. Money being plentiful, people are quicker to pay their debts. Since rainy days seem further off people feel they can permit themselves this or that long-coveted expenditure. Moreover since prices are rising people are tempted to make any purchase they have in view without delay.

Before long, labour organizations begin to agitate for higher wages to meet the higher cost of living. At first there is little result, but as skilled labour becomes harder to get their bargaining power improves and they end by obtaining wage increases which may do more than compensate for the rise in the price-level. Thus purchasing power is again increased.

You can see that all these contributory causes will manifest whenever there is a rising-price situation. The trouble is that they turn a gently rising price-level (which is rather a healthy stimulant) into a madly accelerating gallop. Under this stimulus investors initiate the construction of so much capital equipment (= factories) that capital industry becomes unduly large; that is, so large that if it continued to operate at full capacity it would create more capital goods (= factories) than are required. Heavy industries become top-heavy industries.

Phase 2: Boom into Slump

In the last chapter we pictured the boom as coming to an end because capital industry is forced to contract when full employment has been attained. It is true that the thing which precipitates the slump is the contraction of capital industry, but it generally comes about before this state has been reached, for the reason that excessive saving is taking place—which is the same as saying that insufficient money is being spent on consumption goods And by 'excessive saving' I mean not merely that saving exceed

the reasonable needs of capital expansion, but that it exceeds even the inflated needs of the boom period.

What makes the process difficult to describe in detail is that we are not dealing with a static system in which certain elements become too big or too small, but with an expanding system in which all the elements are growing—hence we have to keep substituting for the words 'too big' or 'too small' the clumsier phrases 'expanding too fast' or 'expanding insufficiently fast'. In addition, prices are all over the place: the general price-level is rising, but the price of individual articles is falling owing to greater efficiency in production. Hence we must think twice or three times before interpreting any statistics in support of our assertion. In particular we must be careful to distinguish between the money-value of wages and their purchasing power over goods. For instance, the money-value of wages may be rising, but if prices are rising still faster, the real value of wages is falling. In the following passage, it is real values rather than money-values which are meant unless otherwise specified.

As the boom proceeds the output of goods increases, but it does not increase steadily; instead the increase is slow at first and grows ever more rapid as time passes. This is called *geometrical*, as opposed to *linear*, expansion. The primary reason for this is that capital industry, at first, can build equipment only slowly; but as capital industry itself expands, it can produce equipment more and more rapidly. Apart from this, there are many forms of capital equipment which do not attain their maximum efficiency until other parts of the system have done the same. Thus if you add a new ship to your merchant-fleet, at first it may not carry a full load; similarly, roads and railways depend on the expansion of other enterprises for their full effectiveness. Factories and power-stations, too, have to work below full capacity for some years—in fact, entrepreneurs go out of their way to be prepared for future demands. Consequently, as an expansion programme approaches full development, quite large amounts of hitherto unused capital equipment come into operation without any corresponding disbursement of money in capital industries. Moreover, each new plant takes advantage of the latest technical ideas and processes and profits by the mistakes of predecessors,

so that productivity of the newer plants, pound for pound and man for man, will be higher than that of the old.

To match this geometrical increase in output, it is essential that purchasing power should also expand geometrically. But it does not. On the contrary, it expands rapidly at first and then more slowly; as a consequence the price of consumption goods rises at first, but gradually the rise grows less rapid, tails off and turns into a decline. To see why this occurs we can consider incomes as being divided into wages and profits. (Really we should add at least two other categories, salaries and rents. Rents are small, however, about 7–10 per cent of the national income and the bulk of salaries can be lumped in with wages). The total volume of wages, called the *wage-bill* or *total-wages*, depends both on wage-*levels* and the total number of men at work.

During the boom, both total-wages and total-profits expand, but in the case of wages the expansion is chiefly due to the increasing number of men at work, levels remaining unchanged, whereas in the case of profits, the expansion is due mainly to the higher levels of profits in the case of each enterprise. Owing to the comparative rigidity of wages, every rise in efficiency, every rise in prices tends to enlarge profit-levels. It is true that towards the end of the boom, the trades unions will win wage concessions, but it must be remembered that prices have been steadily rising, so that real wage-levels have actually been falling. Such concessions do little more than offset the rise in prices, and it is a reasonable simplification to regard real wage-levels as remaining constant throughout the boom. By no means can the same be said of profits. It is not unusual for total-profits to increase 300 per cent in a year, while prices rise perhaps 5 per cent in the same period, and not more than 25 per cent in the whole course of the trade-cycle.

It is interesting that profit-totals and wage-totals, expanding in their distinctive ways, preserve very nearly the same relationship to one another, profits taking 40 per cent of the national income, and wages (with salaries) 50 per cent. Consequently, persons in each group should increase their consumption of goods by the same total amount, as the national income expands.

Now, as we know from earlier chapters, when incomes increase,

the proportion saved increases too. The rapid increase in profit-levels means that entrepreneurs and their shareholders considerably increase the amount of their saving. Wage-earners, on the other hand, save the same proportion of their incomes as before, though there will be an increase in the total amount saved, of course, owing to the larger number in work. Wage-earners do indeed increase consumption by the due amount, since every extra man in work becomes a spender, but entrepreneurs and their shareholders do not—since their rate of saving has gone up, it is clear that the fraction saved out of every increment is too high.[1]

In plain words, entrepreneurs and their shareholders do not take up their full share of every increase in the community's output. If output rises 10 per cent, wage-earners take up their 10 per cent, but entrepreneurs perhaps only 6 per cent of their share. The odd 4 per cent is saved from waste by bringing men into work from the unemployed, the entrepreneurs giving the corresponding purchasing power to them through the medium of investment. As profits continue to rise, the amount of money to be got rid of in this way increases, and men have to be brought in from the unemployed in ever-larger numbers, *i.e.* employment must increase geometrically.[2] But this is impossible; factories cannot be built fast enough. Output will always rise more rapidly than consumption industry is enlarged. Only in the early stages when men are being taken into capital industry and new goods have not yet appeared on the market as a result, is it possible for employment to rise faster than output.

We can see the same thing from another angle by saying that if entrepreneurs are not taking up their full share of the extra output available, then wage-earners must do so. This means that wage-levels must be increased—and since any increase will result in some increase in working-class savings, the amount of the

[1] In real life the picture is complicated by the existence of the dole, as a result of which the consumption of men taken into employment does not rise so much as it otherwise would.

[2] We are assuming the case of a stable population. In interpreting real-life statistics allowance must be made for population changes. Figures showing the real total of unemployment must, of course, be used, and not simply those for insured workers who comprise only 60 per cent of the total.

increase must be sufficient to allow for this fact. If wage-levels are increased, profits are cut down and saving reduced. If wage-levels are not increased, then the wage-total must be enlarged by dint of increasing the number at work—this is the method we attempt to follow at present, but, as we have seen, the rate of increase can never be fast enough. Even if it could the day would come when there were no more unemployed to absorb, so we shall in any case have to fall back on raising wage-levels.

If wage-levels are raised, profits are cut down and saving reduced. The question is, will it be reduced enough? As we have argued before, entrepreneurs interested only in cautious business management may prefer to cut down dividends rather than appropriations to reserve, and consequently profits may have to be reduced very drastically before saving is cut back to the requisite figure. The larger the national income, the higher the rate of investment, the more unequal the distribution of incomes, the more drastic must this cutting-back operation be.

In the manner we have now described, purchasing power (at first excessive) slowly becomes inadequate. The rise in the price of consumption goods ceases and becomes a fall. When this occurs, or even as soon as it seems probable, entrepreneurs, taking a poor view of the prospects of investment, cease to place new orders with capital industry. The output of capital industry, which had been rising, now slumps with great abruptness and the price of capital goods is reduced. Men are fired wholesale, and buying power declines still further in consequence, causing the price of consumption goods to fall yet more. The slump is on.

Phase 3: *Slump*

Faced with declining buying power, firms in consumption industry reduce the scale of their operations, firing some of their hands, and thus intensifying the lack of purchasing power.

Soon firms which have been operating on small margins of profits go bankrupt or sell out. This naturally increases unemployment and decreases purchasing power still further. As prices are falling people postpone expenditure and the velocity of circulation falls, thus inducing further decreases in prices. The slump is much exacerbated by the action of wholesalers, who at once

refrain from replenishing their stocks. At first they merely hope to be able to replenish them more cheaply by waiting, but before long a doubt arises as to whether they will even be able to dispose of what they hold—for they accumulated big stocks in the early part of the boom. Their action does a great deal to depress the price of consumption goods still further.

By now an atmosphere of pessimism is general. The joint-stock banks who began very early in the proceedings to restrict the making of new loans, so that the volume of money was further decreased, now begin to find themselves faced with a decline in their cash deposits which forces them to call in loans—when they can do so without bankrupting the lender, which naturally is not in their interest. Similarly, business concerns, which had been lenient about debts during the boom, now begin to press debtors for what they owe and to ask for the payment of accounts. Since every unpaid bill is an addition to credit, the demand for repayment is a further restriction on it.

Naturally very early in this process foreign investors become alarmed and withdraw their money. This occurs even when things are equally bad everywhere else, since they then prefer to hold their assets as cash or in some other reasonably 'liquid' form. Their action reduces the gold stock and thus necessitates a further restriction of credit. Moreover, the general fall in values often causes the security put forward by borrowers to become inadequate for their loan, so that lenders press for repayment. (A farcical

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The diagram opposite points an accusing finger at the origin of the 1931 slump. Look at the curve marked WAGE-BILL: from 1927 onwards it begins to decline. But for two years after this date the NATIONAL INCOME continued to rise. How could people buy more goods with less money? Only if the recipients of profits were disproportionately increasing their consumption of the same type of goods: which they were not.

The lower pair of curves reveals the cause of this decline in the wage-bill: they show that from 1926 onwards wage-*rates* were steadily falling, though the fact was disguised for a couple of years by the growth in the number in work. As soon as inadequate purchasing power began to cause unemployment total-wages begin to fall.

It can also be seen that the resulting fall in the national income is more violent than the fall in wages and thus restores the balance.

The only thing which would have preserved purchasing power in 1927 would have been the inception of a steady rise in wage-rates. But even if wage-rates *had* been increased, we should still have plunged into a slump, for this would have discouraged entrepreneurs who would have reduced the scale of their investment so drastically that the wage-bill as a whole would have contracted. The paradox of purchasing power is that entrepreneurs allow themselves to be discouraged by the one thing which can prevent a slump and encouraged by the one thing which ensures it.

(NOTE.—The effects of the General Strike and the great coal strike of 1926, which depressed both wage-bill and national income in that year, have been eliminated from the diagram for the sake of greater clarity.)

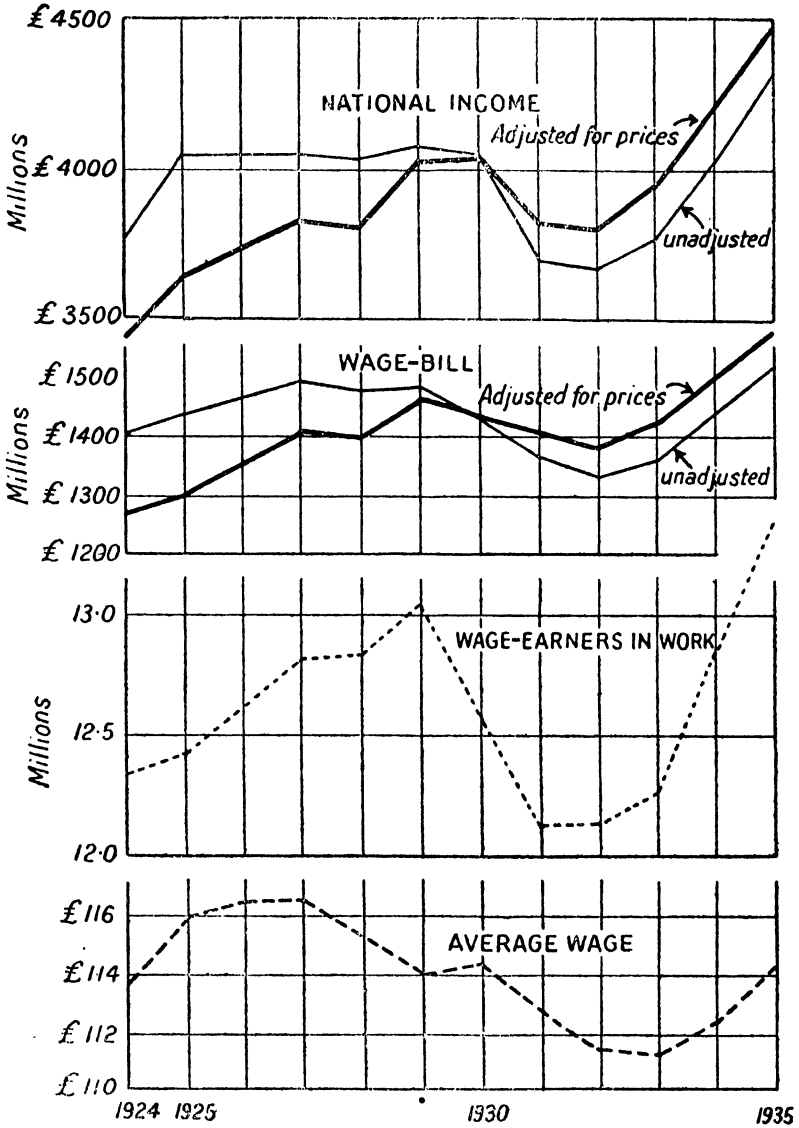


FIG. 15.—THE PARADOX OF PURCHASING POWER.

(*See opposite.*)

state of affairs: the real goods, a factory perhaps, being considered less valuable, while the loan, a mere book entry, retains its value.)

Powerful combines now start restricting the quantity of goods placed on the market in an effort to force prices up to a remunerative level—a futile gesture which may enhance profits for a few weeks but only makes things worse in the long run. For since this leaves them with a reserve of unsold goods, they greatly reduce production, discharging more men and still further reducing purchasing power, and, through it, prices. Moreover, manufacturers, in a natural effort to keep solvent, seek to impose wage-cuts on their remaining employees, once again decreasing purchasing power, to say nothing of causing class-bitterness.

The slump is thus the reverse process to a boom, but much more rapid, since the necessity of building equipment imposes a limit on the rate of expansion, whereas a firm can close down overnight.

Phase 4: Slump into Boom

As the profits of enterprise contract, entrepreneurs reduce their allocations to reserve (*i.e.* industrial savings) but they reduce dividends also, further reducing spending power. But in the end profits frequently reach zero, so that both dividends and saving become zero. Since the bulk of saving comes from industry, this means that industrial saving almost entirely ceases; dividends, on the other hand, only compose a fraction of purchasing power, so that saving is cut down faster than spending. Indeed, things may go further than this: profits may sink below zero, *i.e.* a loss may be made. In this case the loss must be met by dishoarding reserves, in which case saving becomes negative.

At the same time there is a limit to the extent to which spending can contract. Those who are thrown out of work cannot cease entirely to consume. They must draw on their savings in order to keep alive. Thus saving is reduced as expenditure is maintained. This is not only true of the poor; investigation shows that the rich, at any rate for a year or two, continue to live at the same rate, drawing on savings to do so. As a result unemployment, while it hits capital industry very heavily and also hits industries producing semi-durable goods, such as motor-cars, does not

seriously affect food, clothing and similar necessities. Nor does it greatly affect administrative and office workers, who must continue to function whether the volume of business done is large or small. Nor will the strength of the armed forces, the police, the civil service or the medical profession be reduced, nor will the number of pensioners and annuitants be affected. In fact, since prices have fallen, these sections of society may even be able to increase their consumption of goods—unless the government is so supremely silly as to institute wage-cuts, as it did in 1931–2.

These facts are illustrated by figures given by Colin Clark for the 1931 slump. Unemployment among manual labourers was 30 per cent, but among shop assistants only 7.9 per cent, among office-workers just above 5 per cent, among retail traders 2.3 per cent and among farmers only ½ per cent.

Moreover, men who have been discharged do not cease to exert any purchasing power even if they have no savings to draw on; they receive the 'dole' and though it is little enough with which to meet individual needs, it helps to provide a 'floor' through which purchasing power will not descend. Again, even in capital industry, there is a limit to the extent work can contract; some types of maintenance and replacement have to be carried out even during a slump. The railways must maintain their permanent way. For instance, in 1932, British railway companies spent £80 million on maintenance and £75 million on new works, as compared with the £105 million or so that they had spent on each in the boom years.[1] Similarly, sewers, harbours, hospitals and many other types of equipment must be maintained at all costs.

All this 'non-compressible' part of purchasing power remains; it is chiefly the manufacture of capital goods and luxuries which is shorn off. So the system begins to function at its new level. Profits have been reduced until saving is matched to existing (much reduced) needs. Employment does not decrease further; it may even increase a little as people recover from the excesses of their first pessimism. But since most of the expenditure is

[1] *Public Investment and the Trade-Cycle in Great Britain.* Bretherton, Burchardt and Rutherford. O.U.P. 1941.

going for necessities, the prices of other types of consumption goods continue to decline, as manufacturers reconcile themselves to a lower margin of profit. In the last slump this state of things continued for nearly two years.

Now we can begin to ask how recovery comes about.

Having succeeded in explaining the change from boom to slump by the theory that saving exceeded investment, economists were naturally anxious (for such is the human desire for symmetry) to explain the transition from slump to boom by the complementary process, *i.e.*, profits having been reduced, savings fall *below* the needs of investment, causing expenditure to rise correspondingly until it exceeds the supply of goods. The natural result would be a rise in prices, enlarged profits and renewal of the urge to invest. It must be admitted, alas, that the facts do not seem to support this neat explanation. Rather does it appear that the whole system settles comfortably down at the new level, the level at which total profits are held down to a figure which produces just the requisite amount of saving. This state of affairs persists for two or three years.

There are a variety of developments which would serve to break this deadlock. For instance, a shift of demand may make investment in some one particular field profitable; investors will then draw on their hoards, or obtain loans from the banks of invested money, to enter this field and will place orders with capital industry. Capital industry will take on a few more men, and so, very gradually the snowball will be started rolling again. Similarly, the existence of some unexploited invention, the discovery of some untapped natural resource, might justify a renewal of investment.

But the comparative regularity with which the trade-cycle gets under weigh again suggests that some less capricious factor must be at work. Either costs must fall or prices must rise, if profits are to expand sufficiently to encourage investment, and this must happen over a fairly wide field of goods. And since the reduction of costs is a chancy matter, it is rather to a rise of prices we must look. For prices to rise, either demand must expand or the supply of goods must decline. There seems to be no good reason why demand should suddenly expand. Is there, then,

any reason why the supply of goods should suddenly fail some two or three years after the initiation of the slump?

The answer, I suggest, is that wholesalers' stocks run out. During the downward phase, the productive machine has been reduced in size *until it is actually inadequate to supply the current needs of the population even at their reduced level.* This is the natural consequence of the action of the wholesalers in stopping making further purchases, an action which reduces the demand for goods, as it appears to the manufacturer, below the demand as it appears to the wholesaler, that is, the demand as it really is. But in time the wholesalers' stocks begin to approach exhaustion and they begin to replenish them. This causes prices to improve, and as soon as they observe prices rising they hasten to get in not merely enough to meet current needs but also a reserve while it is still cheap to do so. Prices improve sharply, and, hey presto! the cycle is off on its whirlwind career again.

Insufficient attention has been paid to the importance of wholesale stocks. This may be partly because of the absence of statistical information about them. The greatest single contribution which could be made to the understanding of the trade-cycle would be if wholesalers were made to disgorge some of the data in their account books.[1]

It will probably have occurred to the reader that the duration of the slump could certainly be reduced—and perhaps its violence diminished—if wholesalers could be induced to act in the reverse manner to what they do. That is, if during the downward phase

[1] The authors of *Public Investment and the Trade-Cycle* (*vid. sup.*) lend support to this thesis. 'Unfortunately there is a great lack of reliable information about even the total magnitude of stocks and goods in process, and still more about the degree of variation in the course of the trade-cycle. . . . On the whole, it seems probable that the reduction of stocks actually effected between the end of 1929 and the end of 1933 amounted to something between £250 and £350 millions (at 1930 prices); and there is some evidence that the recovery of investment and consumption during 1933 was accompanied at first by a sharp reduction of stocks below the level which they had reached in 1932.' They add that such a reduction was more than sufficient to neutralize the stimulating effect of all the public expenditure which took place between 1929 and 1931; in fact it could have neutralized fully much greater expenditure.

of the depression they bought heavily, this would offset the fall to some extent, while they might refrain from buying so heavily during the early part of the boom. But any such proposal is inextricably bound up with the vital question of confidence. If the entrepreneur knows that prices are being held up by the action of wholesalers, he will discount the fact, and hold his hand in anticipation of the inevitable drop when they come to the end of their resources. The whole collapse is largely a collapse of confidence and the knowledge that some small group is trying to mend matters will not restore confidence in the justifiably cynical heart of an entrepreneur. Nevertheless, the basic principle is sound, and steady buying by boards backed with all the state's resources would constitute a powerful stabilizing influence.

Having established the principle behind the emergence of recovery, it is now necessary to say that there is a strong psychological element about the whole business. People gradually readjust themselves to the new conditions and accept them as normal. They reconcile themselves to the disappearance of their former source of income and begin to look about for a new one. Simultaneously changes in fashion occur, so that opportunities of profit arise in hitherto neglected spheres, and those in whom confidence is somewhat restored venture into these fields. To

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The diagram opposite gives a general picture of the mechanism of the trade-cycle as it developed in Great Britain in the period 1924–35. As before, the effects of the strikes of 1926 have been eliminated.

THE BOOM.—At the beginning of the period, rising average wages (1) caused profits to decline (2) and discouraged investment (3). As a result, employment faltered (4) and the wage-bill ceased to rise (5). On the strength of the falling price-level wage-cuts were imposed (6), temporarily encouraging investors (7), thus creating more employment (8) and swelling the wage-bill (9). In consequence, profits rose (10). But the savings from these profits did not find an outlet in investment (11) so that employment fell sharply (12) as of course did the wage-bill (13).

THE SLUMP.—By 1931 profits had been drastically reduced (from £902 to £620 million) and over-saving was thus eliminated (14). Wages, as can be seen from Fig. 5, had fallen much less than the national income and were now adequate to purchase the diminished output. No further decline took place either in capital investment (15) or in the number of wage-earners in work (16). With average wages still falling (17) entrepreneurs began to increase the scale of their investment (18). The wage-bill responded sharply (19) and the still falling price-level made the rise in real wages even more impressive (20). Prices turned the corner and the new boom was under way.

(NOTE.—It must be stressed that the diagram does not give a complete picture, still less an explanation, of the trade-cycle. The curves show only selected variables of particular significance. Thus the curve showing the number of wage-earners is especially significant in relation to investment—but must not be confused with a general unemployment curve which would cover another seven million people. In any case, every cycle is strongly influenced by outside events such as the foreign trade position, world price-levels of the threat of war. An account of these is given in Chapters 19 and 20.)

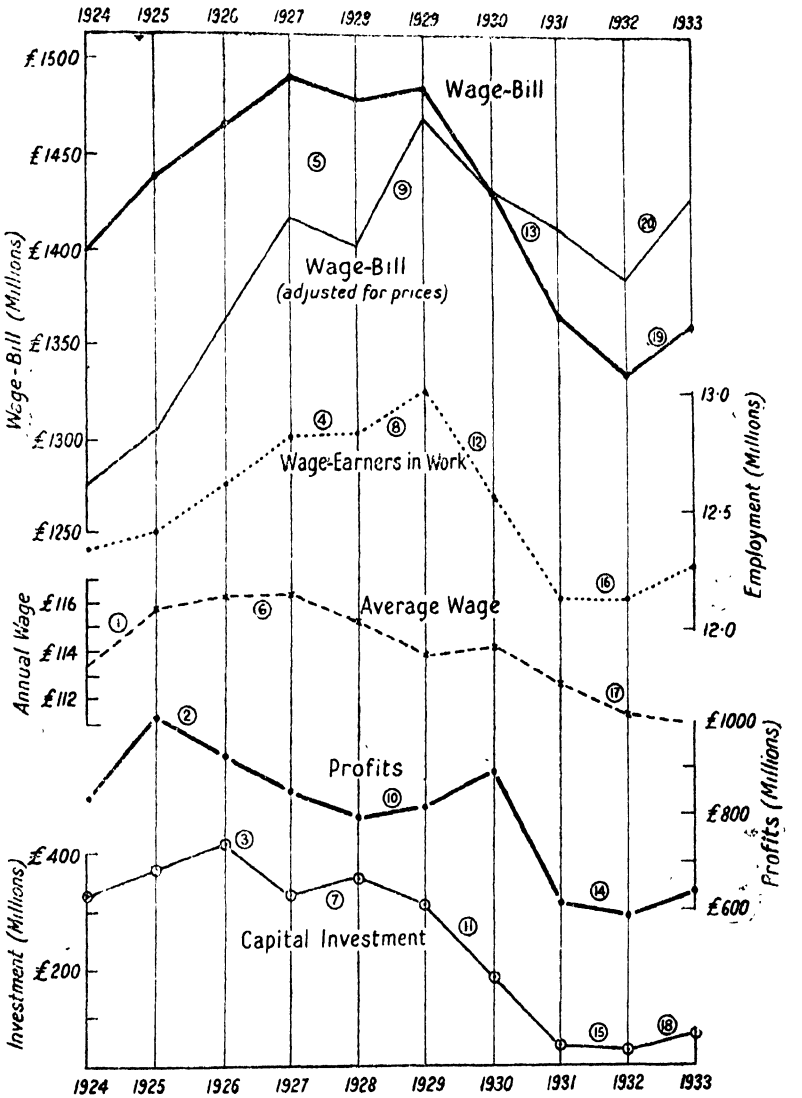


FIG. 16.—ANATOMY OF THE TRADE-CYCLE.
(*See opposite.*)

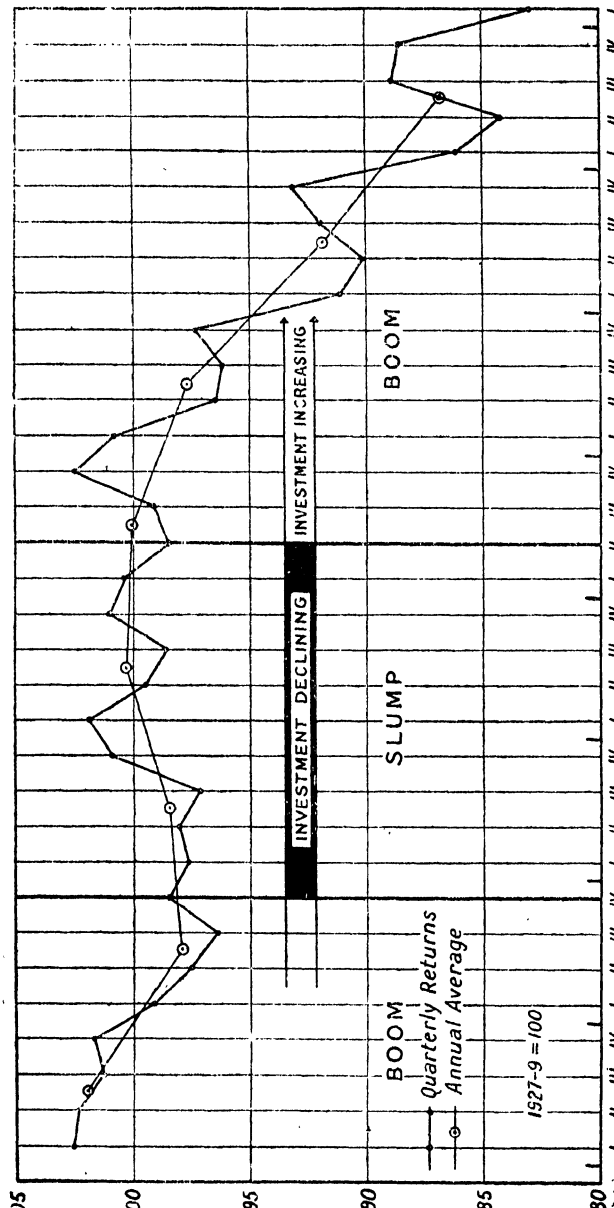


FIG. 17.—PRODUCTION COSTS IN THE TRADE-CYCLE.

Average labour costs per unit fall during a boom and rise during a slump, because overheads are spread over a bigger volume of output and because idle time on pay is reduced. This tendency enlarges the share of receipts going to profits in a boom and hence is a factor contributing to the emergency of over-saving. (Correspondingly, it helps to diminish saving in the slump.) Incidentally, it goes a long way to refute the 'under-saving' theory of the trade-cycle, which asserts (without statistical backing) that production becomes more costly during the boom.

say whether confidence precedes profits, or profits confidence is like the riddle of the chicken and the egg. Each nourishes the other. But we cannot, as some writers have, attribute the dawn of recovery to psychological causes alone, for if conditions remain obstinately bad confidence is blighted and turns to greater bitterness than before, as happened in Germany after the first world war.

It is worth noting that the effect of the trade-cycle is to cause repeated structural changes in industry: the expansion and contraction of capital industry is essentially a structural problem, the redistribution of income which takes place during the cycle creates others. In the boom people venture on the purchase of semi-durable goods (*e.g.* cars) bringing short-lived prosperity to these industries; and we have already noted how the absorption of unemployed creates a sudden spurt of demand for articles of popular consumption. In fact, cyclical unemployment in the final analysis is only a special variety of structural unemployment, the causes being monetary rather than technological, demographic, political and developmental. The definitions given in the first chapter are thus seen to be more a matter of convenience than fact.

RIVAL TRADE-CYCLE THEORIES

As some readers will know, there was a good deal of discussion of the trade-cycle by professional economists following the great 1931 slump, and a large number of theories were put forward. 'What is the good of trying to understand the cause of the trouble, if even the experts disagree?' was a commonly-heard complaint. The reader may be wondering, therefore, what claim the foregoing account has to be considered the true explanation.

In reality, the difference of opinion was not as violent as it seemed to the casual observer. The writing of books and articles is one of the few ways in which economists can supplement their incomes and so they found it agreeable and profitable to magnify small differences of detail in print, while saying little about the very large areas of general agreement. When Prof. Haberler came to review trade-cycle theory for the League of

Nations he found little difficulty in boiling the theories down into four types.

The first of these took the view that booms and slumps were due primarily to chance external events: good harvests, new inventions, the discovery of goldfields and the like. Some writers went so far as to admit that the economic system might get into an 'unstable' state, but claimed that it needed one of these chance stimuli to set the snowball rolling. In view of the extraordinary regularity of the trade-cycle in many countries over a long period, this theory can, I think, be rejected. Moreover, the brilliant 'multiple correlation' analyses of Prof. Tinbergen for the League of Nations have shown the existence of a cyclic component beyond question.

In saying this I do not imply that such external events can be disregarded. Though all trade-cycles are fundamentally similar, yet each shows specific variations from the general pattern and these variations (which may be quite marked) are undoubtedly due to the impact of external events.

The second group of theories places the main responsibility for the cycle on the volume of money. Broadly speaking, they maintain that an excess of money causes rising prices, which cause high profits and hence over-saving. Later on, failure to create sufficient money causes prices to fall and transforms the boom into a slump. A few distinguished advocates of the 'monetary school' are still fighting a gallant rearguard action in defence of the theory, but the main body of economic thought—while recognizing the important part played by the volume of money—is disinclined to give it pride of place as the basic cause. The signs of a real disequilibrium at the peak of the boom are too strong. Main cause or auxiliary—for practical purposes the dispute is irrelevant, for we must in any case undertake deliberate management of the volume of money.

The third group pinned the blame on over-saving, some of the adherents claiming that excess capacity was constructed as a result (so that a physical disequilibrium resulted), others taking the view that the excess saving was hoarded (so that a monetary disequilibrium resulted). This second theory proved promising and was refined into the form here presented—to wit, that saving

must be equated to investment, and investment matched to real needs. In its original form the 'over-saving' theory failed to explain why a boom can develop even when saving is smaller than the community's real needs (as will happen if saving is nevertheless larger than investment).

Because of this weakness, a brief burst of interest was accorded to a very startling rival theory (put forward by Prof. Hayek) that the boom (and hence the slump) resulted from people saving *too little*—an idea which was naturally most acceptable to the big institutional savers! Briefly, the argument was that, though people may be saving too little for the country's needs, the fact that the banks are ready to create quantities of new money and lend it to entrepreneurs enables them to go ahead and build equipment. But since this increase in investment activity is not compensated by any reduction in the consumption of ordinary goods (as would happen if the money were drawn from savings) the result is that the capital and consumption industries begin to *compete for raw materials*, the price of which rises until capital industry cannot operate at a profit. Capital industry contracts, the banks then refuse to make further loans, and a slump ensues.[1]

Professor Hayek's remedy would be to cut down wages and so encourage saving by entrepreneurs, and simultaneously for the banks to refrain from making any loans, so that no inflationary purchasing power develops.

On closer inspection it was realized that this was no new theory, but merely a variant of the one previously described. For if the price of raw materials is rising capital industry can always raise its prices to suit and consumption industry will

[1] Since the theory claims that capital industry, during its prosperous period, manages to build equipment which will be surplus after the collapse, it has (with typical economic ambiguity) been dubbed an 'over-investment' or over-saving theory, since economists use these words to describe the physical as well as the monetary process. It would avoid a lot of confusion if we referred to the two theories as 'under-consumption' and 'over-consumption' theories respectively.

I must apologize to Professor Hayek and the over-consumptionists if in this brief outline I have distorted their views in any way. Compression always involves a certain amount of distortion. Besides, Professor Hayek's exposition contains so many ambiguities that even professional economists are not always clear as to what he means.

follow, with the result that the excessive purchasing power of which Professor Hayek complains will be mopped up, and finally lack of purchasing power will develop. At the same time the suppliers of raw materials will be making enormous profits and will begin to save excessive amounts. Hence the Hayek theory only differs from the one here put forward in asserting that it is raw material industries, rather than industry generally, which makes the excessive profits—an assertion for which there is not the faintest support to be found in the facts.

Where Professor Hayek really departs from the orthodox line is in his remedy. He proposes to avoid the boom by perpetuating the slump. But, after all, let us be realistic. The object of monetary policy is not to prevent any boom from developing. We want the boom. We want industry to expand and absorb unemployed. The object is, having achieved the boom, to prevent employment collapsing.

In general, while economists have been lavish with their views as to the precise mode of development of the trade-cycle, they have been niggardly with practical proposals for putting things right. Yet even if there may be doubt as to the precise inter-relationships between the various factors concerned, about the factors themselves there can be no doubt: it is clear that full employment can only be achieved and the trade-cycle damped out, by the introduction of a certain degree of conscious regulation (whether direct or indirect) of the many variables—saving, investment and the volume of money—in place of the present supposedly automatic system.

Furthermore, the doubts which linger about some of the more detailed developments of the trade-cycle could be cleared up if we had access to sufficiently extensive and reliable statistics. At present we have to rely on approximations worked out by inconceivably tortuous methods years after the event.

CONCLUSION

With the end of this chapter we have reached the half-way point of the book. Let us pause for a moment to take stock. We have dealt with all the internal monetary factors which contribute

to unemployment. We showed how over-saving led to basic unemployment unless the extra savings were led off by the overflow pipe of foreign loans. Then we showed how cyclical unemployment was superimposed on basic unemployment, though we had to go rather carefully into quantity theory before we could do so.

So far we have considered the economic system as an isolated phenomenon; but actually the world comprises some seventy national economic systems in various stages of development, all interacting. We must now consider these relationships. We shall find that they affect the body of ideas just developed in various ways. The simplest is the fact that the growth of industrialism in various countries causes structural changes in the others, and hence unemployment. Another is that the attempt to bring these numerous monetary systems into harmonious relationships often clashes with internal monetary policies. This hampers the authorities in pursuing policies of full employment.

Let us start by trying to picture these evolving national systems as they stand in space and time.

12

How Nations Grow Rich

'She's grown a good deal!' was her first remark. She had indeed: when Alice first found her in the ashes, she had been only three inches high—and here she was, half a head taller than Alice herself!

WHY ARE the poor poor? Is it because the rich have too much, or is it because there is not enough to go round?

Let us look at the facts. In 1937 Britain's national income—that is, the sum of the incomes of every individual worker—amounted in round figures to £4000 million. The number of people in work or seeking work was, also in round numbers, 20 millions. So if income had been equally distributed there would have been roughly £4 a week for everybody. That is little enough—but for considerably more than half the population it would be a substantial increase. More than ten million people were earning less than £2 10s. a week, and perhaps another five million were earning between £2 10s. and £3. To a rich man, the difference between £2 10s. and £4 may seem small; both spell poverty to him. But anyone who has tried to live on £2 10s. will agree that it is the difference between poverty and affluence: £2 10s. pays for the necessities of existence, the odd 30s. provide the pleasures which make life tolerable. So it is not true (what some assert) that redistribution of incomes would make no difference. But surely the startling thing about this figure of £4 a week is that it is so small. Britain is one of the world's richer countries yet it can only support a small minority in civilized comfort at the cost of depressing the standard of living of millions to somewhere approaching starvation level. (This is no exaggeration, for Sir John Orr before the war declared that 8 million people in this country were suffering from downright malnutrition, while half the population were getting less than is desirable.)

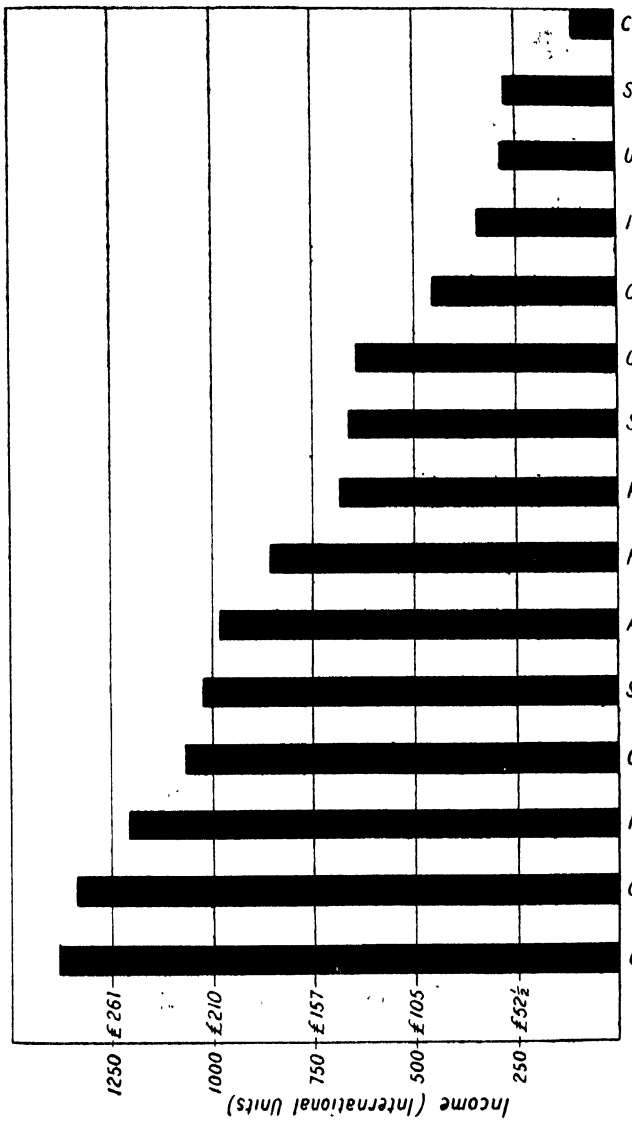


FIG. 18.—WHICH NATION EARNS MOST?
Average annual income per worker, inclusive of unemployed. Average of 1925–34.

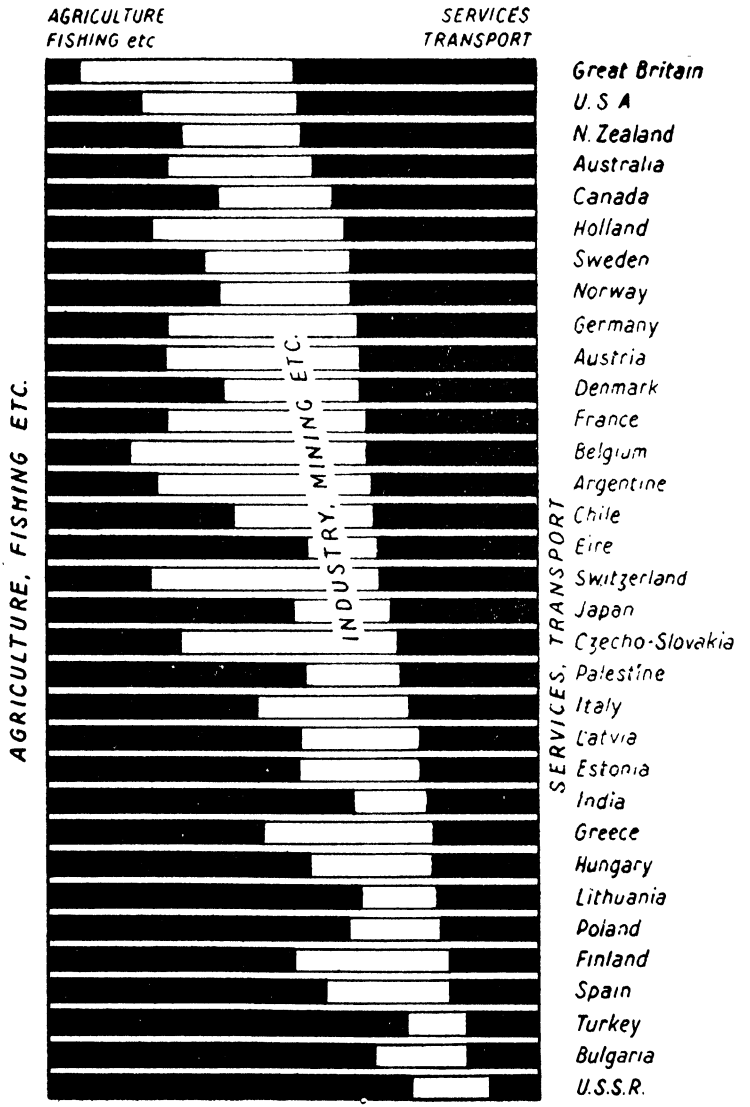


FIG. 19.—THE CHANGE FROM FARMING TO SERVICES.

The rectangles show the proportion of the population in the three main groups of activity for 1930 or nearest available year.

American figures are normally only slightly better. There the average income per worker in 1937 was 1700 dollars (say £340) per year. (It is true that during the war the American national income doubled, most of the increase going to purchase armaments and other war supplies. It remains to be seen how much of this increase America can retain for peace-time consumption.) It is clear that we could afford to double or treble our productive capacity without achieving any disgusting degree of luxury for the ordinary man.

If this is the case in rich countries like Britain and America, how much more so in poorer and less developed lands! The truth is, the world is still mouse-poor. Economic progress is desperately necessary.

To find out how economic progress is achieved it is first necessary to have a scale by which to measure it. The comparison of incomes at different times and in different countries is a tricky business, thanks to changes in prices and to other more technical difficulties. However, we can get an approximate idea by taking figures of income per head of occupied population (the figures we made use of in Chapter 2) and converting them, with due allowance for price movements, into a single currency. Professor Colin Clark has undertaken this laborious task, converting the various average incomes into an international unit defined as the amount of goods and services which one dollar would purchase, on the average, over the period 1925–34.

On this scale, then, we find New Zealand, Australia and the United States as the richest countries in the world, with real incomes of some 1400 I.U. a head; Britain, Canada and Switzerland come next with just over 1000 I.U. a head; the next group includes countries like France, Sweden and Denmark with about 750 I.U. These are the lucky ones; most of eastern Europe, Russia, Japan, India and other countries are below 400 I.U., working down to China which has only 100 I.U. a head. In round terms, this means:

New Zealanders, Australians, Americans	£280 p.a.
Britons, Canadians, Swiss	£200 ,,
Swedes, Frenchmen, Danes	£150 ,,
E. Europeans, Russians, Indians, Japanese	£80 ,,
Chinese	£20 ,,

We must, of course, be a little careful what conclusions we draw from these figures about the pleasantness of life in each country because they are only averages. They make no allowance for the degree of income dispersion and other more recondite factors.

Though we know from experience that there can be wide difference in the incomes of individuals, it is, I think, surprising to find such wide differences in the averages for entire nations, the richest being as much as fourteen times wealthier than the poorest. What is even more surprising is that a similar contrast exists within the borders of the United States. The average income of the state of North Carolina is about the same as that of the Balkans.

Considering the planet as a whole, the fact is that 80 per cent of the population of the world gets the equivalent of £2 a week or less. So, despite the fact that wealth does not always connote happiness, it cannot be disputed that raising the standard of living is an objective of the greatest importance.

How, then, does a country increase its productive capacity and therewith its national income? There are, broadly speaking, two courses by which a country can raise its productive capacity, and both of them create very serious problems of readjustment. It is these problems of readjustment which are at the bottom of most of our political and economic problems to-day.

TOWARDS INDUSTRIALIZATION

Let us take first the familiar process by which primitive countries, devoted almost exclusively to agriculture and related activities such as forestry and hunting, raise their national income by gradually becoming industrialized.

As Colin Clark has pointed out, the process should really be depicted in three stages. To start with, the vast majority of the population is engaged in agriculture, forestry, hunting and allied pursuits—what economists call *primary* production. The next stage is the initiation of more complex activities—mining, road-building, manufacture and so on—called *secondary* production. Finally a third field of activity emerges, the supply of public

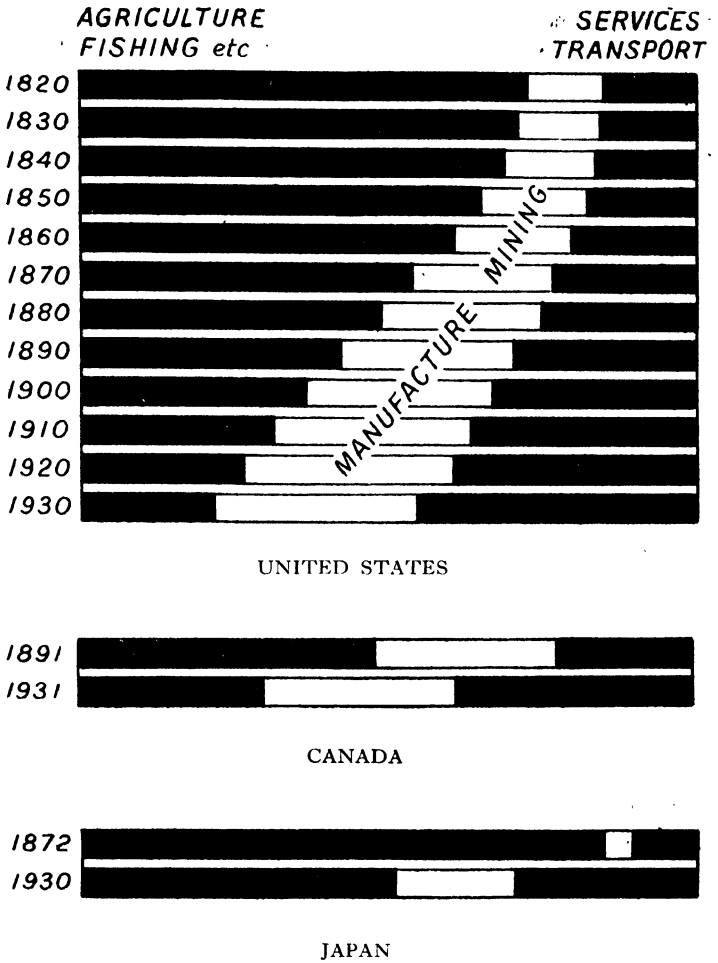


FIG. 20.—THE RATE OF INDUSTRIALIZATION.

The upper figure shows how the United States has gradually changed from a largely agricultural to an industrialized country. The rectangles show the proportion of the population in the three main occupation groups.

A consistent series of figures is not available for any other country, even Britain, but the beginning and the current stage of the process are shown for two other countries, for comparison.

services, such as transport, administration and entertainment. This *tertiary* industry is defined as all those things which cannot be exported. For this reason, and because tertiary activity provides most of the things which contribute to what we inaccurately call civilization, it is the size of this group which gives us the best clue to a country's standard of living. No similar conclusions can be drawn from the relative sizes of secondary and primary industry, since a country may prefer to export some of its primary output in exchange for manufactures, or vice versa.

If we look at the different countries of the world at this moment, we see that some of them have developed large tertiary industries (Britain being head of the list, followed by the U.S.A., New Zealand, etc.). Others have only just begun to leave the primary stage (Bulgaria, Lithuania, Turkey) while the majority are at various stages in between. Countries like Britain, New Zealand and the U.S.A. cannot expect to push the process much further except when technical improvements raise the productivity of primary or secondary activity and make it possible to release labour to tertiary industry, but for most of the countries of the world there is an excess of labour in primary industry and progress is pre-eminently a matter of acquiring the necessary industrial equipment. Accordingly, the question of greatest practical interest to most of the world's countries to-day is: what are the factors which limit the pace of this process of industrialization?

CONDITIONS OF PROGRESS

Many people will tell you still that the limiting factor in economic progress is the rate at which capital can be accumulated. This is the classic theory but it has since been formally disproved.

In the nineteenth century, perhaps, it may have contained a certain amount of truth. For a country seeking industrialization in an unindustrialized world, as was the case with Britain, it was indeed necessary to save in order to finance the construction of capital equipment. But to-day the world is full of capital-sated countries willing and even anxious to do the saving on behalf of the capital-hungry ones. Hence the rate at which a backward country can progress is governed less by its own ability to save

than by its power to make effective use of the capital which is being pressed upon it.

If saving is not a limiting factor for backward countries, how much less so for capital-sated ones! Despite this, we regularly see letters in the Conservative papers appealing to us to 'tighten our belts'—a course which in reality will only increase unemployment. This urge for self-immolation is difficult to exorcise, for it goes back to the ascetic element in the Christian religion—the teaching that to gain something you must first give up something. The teaching is profoundly true, but it is the entrepreneurs to whom it applies on this occasion and it is their profits which must be given up.

To tell the truth, capital accumulation was never more than one of a group of factors limiting progress. Important among them is density of population, density mattering more than total size. If the population is scattered widely, the construction of roads, railways and telegraphs will proceed but slowly, if at all, for long mileages will be necessary to handle the traffic and thus the capital cost will be high compared with the available returns. But if transport is inadequate, mass production cannot be undertaken; potential consumers cannot be reached. At the same time, high transport charges will discourage trade. On the other hand, if the population is too dense, over-crowding takes place. Rents are driven abnormally high, and costly delays occur.

There is no need to try and list all the factors affecting the rate of advance, for there are two which are paramount.

THE LIMITING FACTORS

The real limiting factors in economic progress are the intelligence, drive and education of the inhabitants and the efficiency and honesty of the administrative system.

We can see, by comparing the Orkneys with the West Highlands, how the character of the inhabitants affects economic growth. This is a factor which cannot readily be altered; but the remainder can. Industrialization is impossible without education. Efficient local and national administration and an uncorrupt police are necessary for industry to flourish. No country can run

ahead of its general social growth. Attempts to start industries in backward countries are discouraged if the mails are unreliable, the trains late, the judges corrupt, the banking system inadequate, the people diseased and illiterate, the government venal. The joke is that business men usually resent paying their rates and taxes, and regard education and administration as luxuries.

Tradition, too, is often a powerful force obstructing progress. Farming cannot become efficient as long as peasants cling to dividing the land into tiny hereditary strips too small for mechanized farming. The practice of dividing land between sons on the death of the father is an example of a purely social tradition producing economic results.

For most of the world's countries, then, the path to economic advance is social advance. For the mature countries the problem is different only in degree. While the task of the immature country is to erect machinery where none stood before, the task of the mature country is to erect better machinery where obsolete machinery now stands. In this task, as we have seen in Chap. 3, the great obstacles are the desire of entrepreneurs to protect existing investments, the decline of competition (at present the main force acting to stimulate the introduction of better machinery) the ill-framed patent laws which make it possible to shelve useful inventions, inadequate expenditure on research, and like factors. To the factors limiting technical progress, we may add the unsatisfactory layout and organization of the productive machine as a whole.

The problems of the highly industrialized country differ from those of the backward country only in degree since both are handicapped by the reluctance of human material to subject themselves to unfamiliar regulations, and to pay for the administrative machinery required.

Let us turn now from the conditions of progress to its consequences.

CONSEQUENCES OF ECONOMIC PROGRESS

Let us start again from the picture we have outlined, and illustrated in the diagrams: a world composed of nearly seventy economic systems, more than half of them struggling blindly

towards industrialization. Some are far along the road, others have barely begun; some are travelling slowly, others faster; some have already built up a big secondary industry, others have developed tertiary industry on the strength of an efficient agriculture.

The existence of all this spasmodic, unco-ordinated development on the part of thirty or forty nations is to cause huge and unpredictable fluctuations in the demand for the manufactured goods supplied by the senior industrialized countries. For a long time Britain supplied Australia with locomotives and other heavy machinery. To-day Australia makes much of her own, and British producers must seek an outlet elsewhere. Once British mills supplied the east with cotton goods; to-day Japan has usurped her place. These changes are a potent cause of unemployment.

It must be obvious, even at this early stage of the argument, that unemployment thus caused cannot be effectively solved by any nation acting in isolation; world-wide co-operation and agreement is needed if structural change caused by national development is to be minimized. As long as any large nation or group of nations remains devoted to nationalism or isolationism, unemployment cannot be defeated.

The disruption caused by all this unco-ordinated development is intensified by another factor, widely neglected but of the deepest importance. This is the discrepancy between wage-levels in different countries. In a country only recently emerged from the pre-industrial stage, such as Japan, the workers are unorganized and used to a low standard of living; it is therefore possible to pay relatively much lower wages than would be feasible in an advanced country like Britain. In these circumstances it will be possible for Japan to under-sell Britain, even in cases when, mechanically, her industry is no more efficient than Britain's. (As a matter of fact, some of Japan's industry is highly efficient, more so than Britain's, but that is not the point.)

We may restate this by saying that a country with a low degree of dispersion of income obtains an unfair disadvantage over a country with a fairer income distribution. Socially backward countries gain an advantage over more advanced and liberal ones, countries where employers are powerful an advantage over those where labour is strong.

It will be realized that the question at issue is not one of the absolute height of wages, but of the height of wages relative to efficiency. Compared with other countries, wages in America are high—but they are not high relative to efficiency—America's income dispersion is highly unequal. American goods therefore compete in the world market at an unfair disadvantage with, say, Australian goods. High as they are, American wages should be higher in fairness to those who earn them, and in fairness to foreign competitors.

It is not usually realized that if wage-dispersion is equal, (and other factors are absent) an efficient country has no advantage in world trade over an inefficient one. The higher efficiency is exactly offset by the higher wages.[1]

Different degrees of income dispersion, then, are to blame for intensifying structural changes and consequently unemployment. It should therefore be a matter of urgent interest for countries to agree on a common degree of income dispersion—quite a different thing from trying to get equal wage rates in different countries, which is totally impracticable.

The story is complicated by the fact that the various monetary systems in the world are often incorrectly related to one another—in other words, the exchange rates between the various currencies are wrongly fixed. (Why this occurs is the subject of one of the coming chapters; here we need only note the fact as an important factor in causing this kind of structural unemployment.)

THE AGRICULTURAL COUNTRIES

This picture we have drawn of countries evolving as fast as they can towards the tertiary stage of industrialization stands in sharp contrast with another and more popular picture which

[1] This rather general statement needs qualification. The efficiency of a whole country is an average of the efficiencies of its several industries. It may well happen that wages in a highly efficient industry have not been raised in proportion to its degree of efficiency, while in some other industry wages are relatively too high. In such a case the first industry will have an advantage in international trade, while the second will be handicapped. If the first is an exporting industry and the second is not, the country is, in effect, subsidizing its export industry.

shows some of the world's countries, favoured with raw materials, specializing in manufacture and others, favoured by soil and climate, devoting themselves to agriculture.

Which is right? It is an important question, because the future trend of foreign trade depends upon it. If specialization is the thing, we shall expect to see the world become divided into two camps, farmers and manufacturers, between whom a massive exchange of food for goods is continually taking place; if every country is developing towards industrialization, then to a considerable extent they will each make what they want at home and the total volume of foreign trade will be much smaller. Furthermore, the countries which are at present industrialized, such as ourselves, must expect their exports to diminish and must modify their industrial structure to produce what is needed at home, whereas on the other analysis they might expect their exports to increase.

The truth, as usual, lies somewhere between the two extremes, but it lies nearer the first picture than the second: for two reasons.

Though it is true that some countries are favoured by climate and soil for agriculture, while others are handicapped, it is far less the case that any country is naturally unfitted for manufacture. Of course, some countries are seriously handicapped for either activity—Greenland to take an extreme example, or Tibet—but that is not the point in question. The point is that there are very few countries which, while fitted for farming are not fitted for manufacture. No one can say that Canada or Australia, South Africa or the Argentine, India or China are inherently unsuited to support an industry.

In the last century industry depended on a rather limited number of assets—chiefly coal, iron and access to water-transport. Britain owed her head-start to the fact that she possessed these and still more to the fact that she had for long been in the habit of working them. A fourth essential asset is the existence of sufficient skilful and adaptable craftsmen to do the technical jobs. To-day many countries are discovering that they have hardly suspected mineral resources and are beginning to produce the technicians required.

To-day the classic minerals are, in any case, of dwindling importance. Coal is no longer a *sine qua non*. Oil and water-power are just as satisfactory. Iron is still essential for structural purposes, but for smaller articles is being displaced by the light metals and by plastics. No country need be deficient in these, for aluminium can be made wherever there is clay, magnesium wherever there is sea-water.

Still more conclusive is the fact that any country which is deficient in certain raw materials can obtain them from other countries in exchange for the materials it does possess. Switzerland, with relatively few natural resources, is one of the most highly industrialized countries in the world.

The second reason why the attempt to classify the world into agricultural and industrial countries won't wash is that the productivity of agriculture is rising rapidly. As a result the agricultural countries are beginning to find that they can supply the world's needs in foodstuffs by the labour of only a fraction of their population. To put it slightly differently, they can farm all the soil they have got with a fraction of their manpower. The others they must employ in industry, *even if that industry is handicapped* by isolation from markets or lack of resources.

JAM TO-MORROW AGAIN

It is this pressing need for industrialization which causes the familiar customers of the industrial countries to fail them and imposes on the latter the necessity either to convert their export industries to industries working for home consumption, or to seek new customers by opening up backward territories for commercial development. Only by fostering the development of backward areas towards modern industrialism can the great manufacturing nations preserve themselves—for the moment—from the costs of structural change: another paradox.

In the course of this process the exporting nations naturally lend great sums of capital to the backward ones. Thus the policy of jam to-morrow comes with a double blessing to the great export industries. At the same time as it enhances their profits it prolongs their tenure of their favoured position.

But there are limits. There are no longer a great many countries still in a condition to be exploited and most of these—observing the fate of those that have gone before—have become very shy of such overwhelming assistance. As the years go by, an ever greater number of wealthy nations is seeking to lend to and develop an export surplus to an ever smaller number of backward countries. Thus commercial warfare must become ever more bitter (unless, indeed, it is wholly regulated by supranational cartels). Finally the day must come when the policy can be pursued no further. When that day arrives the exporting countries, above all Britain, must face up to a huge and costly structural re-organization—one which grows more gigantic the longer it is postponed—accompanied by a massive redistribution of wealth.

And when that day arrives the classic industries will be sorely tempted to save themselves from extinction by the one remaining means, the one activity which provides an insatiable market for the products of heavy industry—war.

Summary

Eighty per cent of the world's population earns £2 a week or less; even in a wealthy country like Britain the average income per head of working population is only £4. For the rich countries, and still more the poor, increased productivity is of first importance.

Economic progress depends chiefly on social progress, however, and not on the rate at which capital is accumulated, as is so often alleged. In advanced countries the refusal of vested interests to modernize their equipment is the main obstacle to further progress.

The struggle of the world's nations to industrialize themselves, in pursuit of a higher standard of living, has the effect of imposing costly structural changes on the industry of the older countries—changes which they try to resist by finding new countries to whom to export. This persistent attempt to export is the counterpart of the monetary policy of jam to-morrow. It cannot be carried much further, so, unless we can face the difficulties of a huge structural re-organization, we are condemned to an increasingly bitter commercial war, culminating in real war.

13

Exporting Unemployment

And the moral of that is—'The more there is of mine, the less there is of yours.'

I SUPPOSE the ordinary man thinks of international trade as a mutually convenient exchange of unwanted surpluses; and he also takes it for granted that the amounts exchanged will be equal in value, for if they are unequal some country must be suffering a loss, and that they will naturally dislike. That is certainly what international trade would be like in a sane world, but it by no means describes how it functions to-day. Instead, each country is frantically trying to give away as many goods as it can and to accept as few as possible in return.

This macabre state of affairs comes about primarily because foreign trade is not conducted between one country, collectively, and another, collectively, each considering their whole range of interests as they make each transaction, but consists instead of millions of transactions between individual firms made quite without regard to the total effect. The individual manufacturer wishes only to sell as many goods as possible. If foreign countries are minded to buy his goods in quantity, so much the better. He does not ask himself whether a corresponding amount of foreign goods is coming in to offset his sales; he neither knows nor cares. Similarly, the importer does not know whether exports are going out to balance his imports, and feels quite indifferent about it.

As a result, the country as a whole may export more than it imports ('have an *export-surplus*') or import more than it exports ('have an *import-surplus*'). It it has an export-surplus it will be piling up money—just as an individual trader who sells more than he buys piles up money. But if it has an import-surplus, it will be drained of money and finally will be unable to pay

its debts. Consequently, every government must take steps to avoid an import-surplus—though it has not the slightest objection to an export-surplus.

If you think back to the subject of the volume of money, you will perceive that as the country is drained of money there will be a general decline of prices which will depress trade, while an export surplus would, in the absence of other factors, tend to produce rising prices in the exporting country. But in point of fact the extra money piled up as a result of the export-surplus rarely goes into the purchase of consumption goods. The exporters to whom it accrues are most likely to invest it and, since the amount of home investment is limited, the piling up of money in this way simply goes to enlarge investment overseas. Meanwhile prices at home remain unchanged.

In short, every country is busily trying to export more goods than it imports, in order to acquire a 'profit' in money which it can invest overseas. This, as you will have realized, is no more than the policy we have already described under the name 'jam to-morrow', seen as it were, from the other side. In the first part of the book 'jam to-morrow' was presented as the only means of disposing of the surplus savings of the domestic economic machine. The counterpart of this process is that the goods corresponding to this purchasing power shall be exported. In both cases it is the natural result of the desire of the individual trader so to conduct his affairs as to obtain sums for investment.

Moreover, while exporters have a motive for maximizing foreign sales, they also have a motive for minimizing home ones. For the more goods they seek to sell at home, the higher must home wages be, so that people can buy them. But high domestic wages, by raising costs, reduce their ability to compete in the world market. Hence the ideal of the exporter is to have the lowest possible internal wage-level and to sell the *whole* of his output in the world market.[1]

[1] Of course, I am not suggesting, here or elsewhere, that every individual manufacturer works out the economics of the situation. But the handful of powerful men who represent industry to the Cabinet, to the Treasury and to the Bank are naturally fully advised, and so are the financial organizations, which have large sums invested in basic industries.

There is yet another reason why manufacturers find it more attractive to export than to sell in the home market. If home consumption is allowed to rise in step with increasing national output, as technical efficiency increases, the nature of production must become increasingly diverse. As income-levels rise people do not buy more of the same thing, they turn to new forms of expenditure. Seen from the viewpoint of the individual manufacturer, this means that the market for his particular product is limited. The market for his goods will not expand indefinitely as purchasing power expands, it will tail off and become stable, or even decline to the figure required to replace the stuff as it wears out. The additional purchasing power will provide opportunities for manufacturers selling new and different goods; but the maker of cars is not consoled by the fact that the public is beginning to demand more refrigerators and television sets. He wants to sell more cars. Hence, from the viewpoint of the established car manufacturer, it is better to be supplying the Chinese and the Indians with cars, than for the same amount of labour to be employed (by someone else) in making refrigerators for Britons. In short, existing industrial interests—'vested' interests—prefer an expansion of foreign trade to a rise in the domestic standard of living.

The government also has a stake in the creation of an export-surplus. For such a surplus enlarges the volume of employment: the more you manufacture to send abroad, the more people you will employ. However, an increase in employment obtained in this way is very different from an increase based on enlarged consuming power at home, because it is only possible to have an export-surplus if elsewhere there are countries with an import-surplus; such countries naturally suffer a decrease in their volume of employment since they are accepting goods from abroad which (if their trade were balanced) they would be making at home.

The policy of maintaining an export-surplus is accordingly sometimes described as 'exporting unemployment'. Countries which pursue this policy must be prepared for resentment and political repercussions in the countries to which the unemployment is exported.

Employment achieved by virtue of an export-surplus has the

additional drawback that it does nothing to raise the standard of living; in fact, it lowers it for anyone who was not on the dole before. The supply of goods is spread over a larger number of workers, and though this brings benefit to those who were unemployed before, it lowers the standard of those who were not.

It is for these reasons that foreign trade, instead of being an exchange of surpluses, has far more the character of a hectic attempt to get rid of as much of one's own output as possible, while accepting as little as possible in return.

So firmly is this attitude to exports ingrained in producers, that an export-surplus is referred to as a 'favourable balance of trade' and an import-surplus as an 'unfavourable' one, though what there can be that is favourable in giving away more than you receive it takes a financier to see.

THE BALANCE OF TRADE

With these facts in our possession we are in a position to define the terms 'balance of payments' and 'balance of trade'.

The object of every trading country is to export more than it imports and to devote the profit on the deal to investment abroad. If it does this its payments outward will equal its payments inward. It will have achieved a *balance of payments*. It does not wish to be left with money in hand, which will be a waste of money that might be earning interest; still less does it wish to run short of money which will provoke a slump. But this, of course, is a very different thing from wishing to *balance its trade*. So far from wishing to balance its trade, it is keen as mustard to give away more than it gets, to achieve an export-surplus. The only time that both trade and payments are balanced simultaneously, is when no overseas lending is taking place.

Unfortunately economists, who seem to have a positive gift for confusing their terminology, constantly use the words 'balance of trade' when what they really mean is 'balance of payments', a thing which is most confusing for the unwary reader.

While we are on the subject, we may as well mention that the balance of payments contains not only a record of imports and exports and of foreign loans, but also a number of so-called

invisible items. For instance, if you go abroad and spend money in foreign hotels the effect is the same as if you had sat in Britain and ordered the food, drink and so on, to be sent to you. Britain is deprived of money to the full extent of the hotel bills and other expenses you contract. Conversely, any expenditure by a visitor to this country is equivalent to an addition to our exports.

Similarly, if a foreigner pays a British shipping firm to transport goods from one place to another, or if a charitable organization sends a donation to this country, this in-payment has the same effect (so far as the balance sheet is concerned) as if we had sold additional exports. For Britain in particular these invisible items are of considerable importance, amounting in favourable years to well over £100 million.

The balance sheet, when drawn up, will also show the sums paid to Britain (and by Britain) in the form of interest. If, as in the British case, you are, on balance, receiving interest you can obviously afford to import a correspondingly larger amount of goods. In saying that we must aim at a balance of payments, therefore, we include all these invisible items among the quantities to be balanced.

Let us take an example. In order to simplify things, we will only write the difference between in-payments and out-payments, using a + sign when the former exceed the latter. In 1928 our imports of merchandise exceeded our exports by £353 million. If these had been the only items on the balance sheet we should have had to send £353 million of gold abroad to pay for this import-surplus. But, fortunately, invisible exports exceeded invisible imports by £225 million, besides which we received as much as £250 million in interest on our foreign loans. Therefore, so far from sending gold abroad, when all was settled we were due to receive £122 million. Thus:

Net Balance of Invisible Trade .	+£225 million
Net Interest	+£250 ,,
	+£475 ,,
Net Balance of Visible Trade .	−£353 ,,
Gold due to Great Britain . .	+£122 ,,

However, we did not rest content with receiving the £122 million of gold; we also made fresh loans abroad to the tune of £117 million, so that in the end our gold stock was only increased by £5 million—a negligible amount compared with the sums involved. Since 1929, however, Britain's foreign trade has only once yielded a gold surplus.

The reader will grasp that the above instance reveals an import-surplus of £353 million as far as merchandise alone is concerned, but an *export-surplus* of £122 million if we include invisible items. We could have imported additional consumption goods to that value and raised our standard of living accordingly.

In the case of the United States, however, the 'visibles' always show a substantial export-surplus but not so the 'invisibles', and on five occasions during the 'thirties the U.S. found itself with a net import surplus. The U.S. authorities recently pointed to this fact in justification of their high tariffs. But what matters is the movement of gold. And when we take interest-payments into the reckoning we find that during the period America received gold to the tune of $2792 millions on current account. This would not have mattered had she re-lent it, but from 1930 on she steadily lent less than she borrowed.

A balance sheet drawn up in the same way as the one just given will illustrate the point. I take the year 1938:

Net Balance of Invisible Trade .	−$551 million	
Net Interest	+$384	,,
	−$167	,,
Net Balance of Visible Trade .	+$1136	,,
Gold due to United States . .	+$969	,,

But whereas Britain lent almost all her surplus, bringing about a balance of payments, the United States actually borrowed from abroad to the tune of $97 million, increasing her total gold intake to $1064 million (say, £266 million). As Europe was at this time in the grip of war fears, a considerable amount of short-term loans (not included above) also flowed into America, and in 1939 the flow increased into a torrent (from $344 to $1470 million), adding, if only temporarily, to the maldistribution of the metal.

REAL MEANING OF BALANCE OF PAYMENTS

The object, then, of national policy must be to see that imports plus loans do not exceed the total of exports by more than the amount of any interest which may be due on previous loans. In the narrow sense, this necessity arises because the country does not wish to get into debt; but let us forget the money for a moment and try and see what this condition means in real terms.

Assuming that exports remain unchanged, the less you import the more you can lend abroad. In real terms then, the lending country is cutting down its standard of living, abstaining from consuming certain imports and at the same time is lending the money which would have served to buy them to foreigners. These foreigners can then consume the goods instead. So viewed, the process is seen to be the exact counterpart of saving and investment performed by the individual. But—and this is what the exponents of the theory usually forget to mention—the picture is too simple. It treats each country as if it were a single person, and assumes that any benefit it receives truly offsets any abstinence it undergoes. In reality, however, a country consists of millions of people, some of them paid by salaries and wages and some through profits. The first group bear the bulk of the abstinence, the benefit all accrues to the second. If wages are lowered to enable exporters to enlarge their sales, it is wage-earners who economize, but it is entrepreneurs who make the profits and who come to own the investments in foreign countries into which these profits are put.

Those who are concerned to defend the system sometimes produce a most insidious argument in reply. They point out that if a country—let us say Britain—is receiving interest from abroad, this makes it possible for her to import a corresponding amount without having to dispose of any corresponding exports. In the case of the balance sheet printed two pages back, they would point triumphantly to the £250 millions of interest as having turned a deficit of £128 million into a surplus of £122 million. This looks curiously like an advantage to the ordinary British citizen.

It is an illusion. The British people have, at any given moment, a certain amount of purchasing power. They can spend it all at home, or they may spend part abroad. If they spend it all abroad, they will unbalance the payments. What the existence of interest does, as you can see, is to permit the British people to spend a larger fraction of their purchasing power abroad than they otherwise could. It does nothing to enlarge the total. It does not make them richer. The only people it makes richer are the investors to whom the interest is owed.

The point then is what advantage does the British people get from the privilege of being able to buy more foreign and fewer home-produced goods? It permits them to buy such goods as are beyond the power of Britain to produce, *e.g.* tropical fruit, and it permits them to buy any goods which foreigners make better or more cheaply than Britain. Accordingly, being able to import more is an advantage to any country where the productive machine is inefficient, whether this be due to natural handicaps or to bad management.

Clearly this is a very limited type of advantage indeed. Certainly every country will want to buy from abroad the things which foreigners are best at producing—but normally it will be able to pay for them by exporting the goods which *it* is best at producing. Only if the things which it wants outnumber the things which it is able to supply, will it be an advantage to derive from interest payments the right to import more. For a country which, like the U.S.A. or Russia, can manufacture nearly everything it wants at home, and which can dispose of a considerable volume of exports besides, there is no advantage whatever to be reaped from the presence of interest in the balance of payments.

The irony is that it is only countries which can thus export which are able to obtain surpluses and, by investing them, acquire the right to interest. The countries which could make use of interest have no means of acquiring it. Only for a country like Britain, which once was strong in the exporting field but is so no longer, does the interest built up in the past offer benefit in the present.

Britain is a country which, before the war, was choosing to buy large quantities of goods from abroad, but was failing to

sell a corresponding amount of exports. The crucial question is: was this because she had little to offer that the world wanted, while the world had much that she wanted? In other words, was she handicapped by natural disadvantages from paying for her imports by exports? Or was it simply that her exporting industries were inefficiently run? And with the words 'inefficiently run' we must include the possibility that they were unwisely chosen: perhaps Britain was trying to sell the world coal and shipping when what the world really wanted was office machinery and refrigerators.

We need not attempt to answer this question here because I am only using the case of Britain to illuminate the general problem. Instead I want to carry on the argument by asking what Britain should have done, supposing she really was unable to dispose of sufficient exports. Should she have forced down the wages of her workers so as to be able to undersell other countries (and so as to discourage the said workers from buying so many foreign goods) or should she have *changed her industrial structure*? Should she have stopped trying to sell the world coal and ships and devoted the manpower instead to making the equipment and growing the food which her people wanted, and were having to buy from abroad?

To do so might have meant a loss of efficiency, in the sense that it might take more man-hours to produce a ton of food in Britain than it would take to grow it in Canada and transport it to Britain. But which is worse, to suffer a slight rise in prices or a heavy cut in wages? For the wage-earner there can be no question that the former is infinitely better; and there can also be no question that the latter is better for the manufacturer and the financier, while for the manufacturer who happens to be in an exporting industry it is essential.

Thanks to the dual system of payment, and the unequal distribution of wealth, the interests of wage and salary earner are directly opposed to those of the employer and rentier in the matter of export policy.

The discussion of Britain's position, intended as an illustration of problems created by the need to maintain a balance of payments, has turned into something of a digression on export

policy. I have made no attempt to answer the questions raised, for there are still many other aspects of foreign trade with which we must make acquaintance before we are in a position to deliver judgments on the subject. The discussion serves to bring us up against that fact that there is no inherent tendency for trade to balance. It is a thing you have to arrange.

Even if countries could forget their frantic desire to export more goods than they receive, inequalities would surely develop because of the widely overlooked fact that there is no natural balance between the economic assets and advantages of the various nations.

LACK OF NATURAL BALANCE

There are some countries which need to import very little, because they can supply practically all their own needs at home; and at the same time these countries may be favourably equipped to produce many kinds of goods which less fortunate nations desire. The United States is a case in point. Clearly such a country will tend to export more than it imports. Conversely, there are nations which have almost no natural advantages and require numerous types of goods which they cannot possibly produce at home and who, by the same token, have practically nothing to offer in exchange: for example, the Eskimos. Such a country will, if allowed to, import more than it exports. In addition to these physical factors there are also such economic influences as the dispersion of incomes, social factors affecting efficiency, such as tradition, the handicaps imposed by the need for extensive structural changes, and many more; many of them have already been mentioned at various places in the book.

Even if we take a group of more-or-less equally favoured countries, there isn't the slightest reason to suppose that the surplus output of one will be exactly what the others are deficient in. On the contrary, the likelihood is that all of them will have a surplus of certain types of goods, and all will have a shortage of others. Hence all will be competing to get rid of their surpluses.

Of course, things aren't always as bad as this. In many cases a country can cut down on one type of production and can expand

another. Advantages and disadvantages are often relative rather than absolute. But I want to start by stressing the fact that there is no God-given harmony in the distribution of economic assets because it is so frequently assumed that foreign trade could, with care, be reduced to a perfectly balanced system of mutual exchanges, whereas the fact is otherwise.

It is this circumstance which provides the reason why we have trade balances at all. For, after all, we make no attempt to balance trade between Middlesex and the other British counties, or between Michigan and the rest of the United States; why, then, should we find it necessary in the case of other units of government?

The trade balance system is a means of keeping for each national area the benefit of its natural advantages, just as an individual seeks to avoid loss in his trading activities and to make the most of his natural advantages. If no attempt was made to balance the transactions between different areas, as is the case between American states and between British counties, production would take place exclusively in the areas where it could be performed most efficiently. Populations would move freely in pursuit of jobs and under the influence of other factors, such as climate. If Britain and the United States pooled their activities in this way large numbers of Britons would go to America and the great bulk of production would be concentrated there. Much of Britain would remain a holiday resort, for just the same reason that Florida and the Adirondacks remain resorts to-day.

Economically the change would be advantageous. Production would be more efficient. And if the whole world became a free-trade area, it would become more efficient still. But the price of the change is a complete abandonment of the attempt to retain advantages within national boundaries. Whether the economic gain would be offset by social losses raises problems beyond the scope of this book.

This seems the proper moment, even at the cost of digressing further from the problems of balancing payments, for a quick look at the much-disputed doctrine known as 'free trade'.

Summary

Foreign trade is not an exchange of surpluses but a hectic attempt to get rid of more goods than you receive—thanks to the policy of 'jam to-morrow' and the distinction between the interests of the individual exporter and of the nation as a whole.

Yet every country must seek to balance its trade. The achievement of an export-surplus forces on some other country an import-surplus and enables you to export to it your unemployment. But it holds down your standard of living. The argument that more exports enable you to import more is deceptive, because it conceals the fact that you only import more at the cost of buying less at home. For a country with an import-surplus, it is often a better plan to change the industrial structure and supply its own needs than to engage in a struggle for exports.

Economists usually overlook the fact that some countries are much better placed than others in the possession of advantages for production, and such countries will always tend to develop an export-surplus, while handicapped countries will tend to develop an import-surplus. The trade balance system is no more than an attempt to preserve for each area the benefit of its own advantages.

14

Not-so-free Trade

An obstacle that came between
Him, and ourselves, and it.

'I wish you wouldn't squeeze so,' said the Dormouse, who was sitting next to her. 'I can hardly breathe.'
'I can't help it,' said Alice very meekly; 'I'm growing.'
'You've no right to grow here,' *said the Dormouse.*
'Don't talk nonsense,' said Alice more boldly: 'you know you're growing too.'
'Yes, but I *grow at a reasonable pace,' said the Dormouse. 'Not in that ridiculous fashion.'*

WHAT IS meant by the term 'free trade'? Free trade represents the application in the international sphere of just the same process of industrial adjustment through free competition to which the classical economists pinned their faith in the domestic sphere—the process we examined in Chapter 6. The argument was that (other things being equal) people would always buy the cheapest product. Competing manufacturers would gradually lower prices until the less efficient manufacturers dropped out. If the process went too far, the supply of goods would be insufficient, and prices would rise, attracting more enterprise into that particular industrial field. In this way, by the elimination of inefficient firms, goods would be produced as efficiently as possible.

Now apply this principle in the international sphere. When a country possesses natural advantages and can therefore produce a line of goods more cheaply than any other country, it will be able to lower prices until other countries are forced out of business in the same field. Consequently, every country will tend to concentrate on the type of production for which it is best fitted; prices will be minimized, output will be maximized and everybody will be happy. In short, the great advantage of free trade, in the

view of the classical economists, was that it would lead to the most efficient possible mode of production.

(If this is not clear, an example may help. Suppose that in England 100 man-hours of labour will grow one ton of potatoes or make three bicycles; while in Australia, the same amount of labour will grow three tons of potatoes or make one bicycle. Then, if each country specializes in what it can do best and exchanges the products, it will pay England better to make three bicycles and exchange them for *three* tons of potatoes instead of using the same amount of labour to grow only *one* ton at home: Australia will benefit equally by getting three bicycles instead of making one at home.)

In principle, therefore, free trade is unquestionably the most sensible course to pursue. The *international division of labour*, as it is sometimes called, benefits all parties concerned. Yet, as the reader knows, free trade (insofar as it ever existed) has gradually broken down until to-day no industrialized country still adheres to it. On the contrary, every nation employs elaborate systems of tariffs, quotas and so forth to regulate the import and export of goods and many nations also control the import and export of money. Even Britain, for so long the apostle of free trade, has finally turned her back on it. Why then, has this obviously sensible and much-lauded system been abandoned?

RELATIVE WAGES

The first thing which the free-traders overlooked was that 'most cheaply' and 'most efficiently' are not always the same thing. A country with high wages—or, more accurately, a high degree of income-dispersion—will be unable to compete with an equally efficient country paying low wages; it may even be unable to compete with a less efficient country.[1] This is a fact of crucial

[1] The reason was explained in Chap. 12, but as the point is so important, I recapitulate it here. A country with a small national income must necessarily pay lower wages than one with a big national income, since there is less to divide up among the population. This gives the poorer country no advantage in international trade, since the lower wages are exactly offset by the larger number of people required to make a given quantity of goods. It is precisely because more people are required

interest to capital-sated countries, for if they raise wage-levels so as to prevent under-consumption at home, they automatically handicap themselves in the world market as against countries with a more backward policy such as the U.S.A., and countries still in the capital-hungry stage, such as Japan or India. Trade tends to go not to the most efficient, but to the most socially-backward countries. Accordingly there is intense pressure on the progressive countries to lower costs (*i.e.* wages) in order to retain their share of world trade. If they do not, they are liable to find themselves buying more than they can sell, and thus getting into debt. The first requisite for the successful functioning of free trade is a world agreement on income dispersion. There is, I fear, little hope of such an agreement at present.

The free-traders lamely argued that labour would emigrate from low-wage countries to high-wage countries (just as it tends to move from low-wage to high-wage districts within a country) and this would continue until a labour shortage in the first country forced wages up, and a surplus in the other countries forced their wages down, to a common level. This is, of course, pure fantasy. Japanese coolies do not emigrate to work in Lancashire textile factories, for a thousand obvious reasons, quite apart from immigration restrictions. Nor is it generally desirable that they should do so. (This is a good example of the fatal error economists continually make of treating 'labour' as homogeneous substance instead of as a complex association of persons bound by social relationships.)

If labour were completely mobile, as the free-trade economists pretended, immigration would not stop at the point when income-dispersion was equal. People would prefer to live in countries with high wages and high national incomes, and would emigrate to them. So you would get, in the end, a world distribution of population completely unaffected by natural boundaries—just

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that the national income is low. The thing which does influence international trade is the *dispersion* of income. If we consider two countries of equal efficiency, one of which is paying high wages, while being content with small profits, and another of which is keeping wages low and devoting a large part of the national income to saving, then the latter country will be able to make goods more cheaply than the former.

as you get a distribution unaffected by county boundaries inside a country.

People would be concentrated in the most favourable areas for production and would leave less fortunate lands. This is reasonable enough, and would be done if the world were run as a single state—but it is totally and irrevocably incompatible with nationalism. No government wishes to see its lands drained of people. Other governments do not wish to assimilate great masses of immigrants. The individual citizen generally dislikes to live and inter-marry with persons of another colour.

We shall never have free trade while we have nationalism.

Since completely mobile 'labour' is totally impractical socially, politically and humanly, we need not dwell on the economic objections to pure free trade; we need only observe that anyone who advocates free trade commits himself to the abolishment of all restriction on emigration and immigration by *every* country in the world. Free trade cannot be practised unilaterally—at least, not without sacrificing the desired objective, maximum efficiency. This is a fact few free-traders seem to appreciate.

Apart from this factor, there is a still more serious and far reaching consequence of free trade to which its proponents turn a blind eye: this is the effect which it has, in a changing world, on the structure of industry.

THE STRUCTURE OF INDUSTRY

In the last chapter we saw how western countries, such as Britain, were able to build up vast engineering, shipbuilding and textile industries in the last century chiefly by virtue of the fact that they got into the game before anyone else; and we pointed out that the slower-starting countries are now seeking to redress the balance by starting their own industries. Even if they can only do the job with equal efficiency, the fact that they do not have to pay transport charges halfway round the world may justify their action. In some cases they can do it more efficiently. In this case they begin to export to the very country they formerly bought from.

When these new competitors enter the field, they force the

original country to make a *costly change in her industrial structure.* She must scrap perfectly good equipment and spend time and money building up fresh equipment in some other field and in transferring labour to it. This is equally disagreeable to employers, to employees, to investors and to the government which is faced with a growth in unemployment and so in the dole. In the circumstances, all parties are ready to welcome the imposition of a tariff. They cannot get back their exports, perhaps, but they can at least continue to supply the home market.

The fact that this course means failure to take advantage of an increase in efficiency strikes them as of little interest, and not without reason. For if a country is subjected to repeated changes, decade after decade, so that it is repeatedly scrapping machinery, and maintaining an army of unemployed, its standard of living may remain lower than if it protected itself by tariffs. The fact is, it is bearing all the costs of the change, while younger countries are reaping all the advantages.

It is for this reason that the arrival of cheaper foreign goods on the market is usually regarded as a calamity and not a blessing. The point considered in the previous section is also relative here. When a backward country wakes up and begins to undertake industrial development the fact that its population is accustomed to low wages enables it to compete on unduly favourable terms with established countries. Thus, quite apart from its effect on the ability of older countries to export, the existence of low-wage countries causes unduly violent *structural dislocation* in the older lands.

The classic example, of course, is the collapse of the Lancashire cotton industry in face of Japanese competition. A more recent instance, in which protection *was* imposed, is the threatened invasion of the British motor-car industry by American competition.

For this reason a capitalist economy is strongly opposed to change, and when such changes are forced on it only absorbs them after nightmares of misery and waste.

But, the rate at which changes are occurring is constantly growing faster due both to technical progress and the opening up of huge undeveloped areas in the world. If we do nothing about

it we can expect a continuously increasing volume of disorganization, unemployment and waste or else an increase in world tariffs and a consequent failure to take advantage of rising efficiency coupled with a decline in world trade. In the end, attempts to maintain the status quo in a changing world will always fail. It is essential to face up to the problem of revising the industrial structure.

What makes the whole thing especially absurd is that while our industrialists are desperately trying to maintain the status quo, investors (who are frequently the same people) are busy lending money to other countries to develop industries which will threaten our own. The sale of cotton-machinery to Japan is again the classic example. Now one cannot prevent Japan (or any other immature country) from industrializing herself—in fact, it is proper to help them to do so. *But*, if we had a conscious economic policy instead of leaving everything to haphazard individual decisions, we should face the fact that we had better start making the requisite changes at home. We should say to ourselves: 'The Japanese can produce cotton goods more cheaply than we can. We wish to take advantage of that fact, which will enable us ultimately to raise the standard of living of our people. Therefore we will lend Japan money to develop her cotton industry, clearly realizing that to do so means the collapse of our own and the relocation of the workers in it in some other field.' Treated in this way the loan becomes part of a conscious reorganization of industry designed ultimately to benefit the lending country. But when lending is carried out by non-responsible groups of individuals it means that they are able, for their private profit, to inflict on a country almost without warning all the burdens of a reorganization it may or may not desire. The country affected is frequently not their own. In any case, reorganizations of this character cause repercussions on the trade of every country. (This provides yet another reason for an international commission.)

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SOCIAL REASONS

The second group of reasons for abandoning free trade may be described as social ones. Economic efficiency is not the only

criterion of conduct. It can be attained sometimes only by the sacrifice of equally important non-economic requirements. The commonest example of this is the fact that if a nation specializes in the exploitation of the kinds of production for which it is best fitted its production structure becomes completely unbalanced. For, under capitalism, the owners of a profitable line press their sales to the limit, without regard to such issues as maintaining a balance between town and country, between industry and agriculture. That is why we have in England mile upon mile of 'black country' with mean houses, sooty atmosphere and blighted vegetation, while the counterpart of our bloated heavy industries is undersized service industries and semi-bankrupt agriculture.

This over-exploitation of natural advantages becomes particularly absurd in a country which has only a narrow channel of natural opportunities, which it is consequently forced to exploit with exceptional intensity. Such a country has to sell not merely the surplus after meeting its own needs, but actually the whole of its output in the favoured field in order to obtain necessities. So we have the fantastic spectacle of the Danes, in order to obtain tea and oranges, concentrating so hard on the sale of butter that most of the Danish population has to live on margarine.

No one can deny that such over-specialization is, from the viewpoint of health and happiness, ridiculous. On the one hand you have the population of countries which nature has equipped with coal and iron concentrated in huge towns, deprived of their requirements of sun and fresh air (as the relative death-rates show) and eating most of their food 'in a state of arrested decay'. On the other hand you have countries so exclusively agricultural that the inhabitants live isolated existences without the medical services and the cultural and civic conveniences which denser populations take for granted: Canada, Australia and New Zealand are examples of this.

It is hardly surprising that the latter group of countries take steps to restrict the import of industrial goods in order to aid the development of their own industries. This is why we find that the Dominions impose tariffs keeping out British goods: an action which sometimes seems to the unitiated both unfriendly and uneconomic.

POLITICAL REASONS

A third reason why countries encourage the development of their own industries, although it would be cheaper to import from areas where the product can be made more efficiently, is the need for *self-sufficiency* in time of war. This works two ways: firstly, a country which expects to be, or actually becomes, a belligerent develops its own sources of supply, as Britain did with beet-sugar and Germany with synthetic rubber. Secondly, neutral countries which in peace-time were accustomed to obtain certain supplies from belligerents, find that in time of war the belligerent is unable to supply their needs, and so are driven to developing their own means of doing so. When the war is over, they will not willingly scrap the now superfluous industry, thus involving themselves in costly re-adjustments, so they erect tariffs to keep out the goods the belligerent now wishes to resume supplying. This happened, for example, with Belgium in the first world war. In the present war, the change of industrial structure wrought by Germany in conquered countries has created difficulties many times as great.

An example which falls into both the last categories is the protection of the sugar industry in Queensland, Australia. The motive here was partly social, since the government wished to prevent the standard of living of the white labour employed being forced down to that of the black labour used in all other sugar-growing areas; partly political, since it was feared that if the sugar industry was allowed to collapse, Queensland would become depopulated and the Japanese would move in.

BALANCE OF TRADE

The fourth and last big reason why many countries have resorted to protection is the need to restrict the tendency of its nationals to import too much—in other words, the need to achieve a balance of payments. Normally, as we shall see in the next chapter, this balance is achieved without recourse to protection, but in the inter-war years the device used proved increasingly

unsatisfactory (we shall see why in the next chapter), and so tariff-walls became more and more numerous and extensive.

'HAVE-NOT' COUNTRIES

Perhaps mention should be made, finally, of the case of countries which, though possessed of an efficient productive system and a high standard of living, are completely lacking in certain indispensable raw materials—the so-called 'have-not' countries. They must purchase their lack raw materials in the world market, and to compensate for these imports they must be able to dispose of an equal quantity of exports. But what if they have no field of activity in which they are specially favoured? There is then nothing which they can be sure of selling, and if other countries have protected themselves against change by the erection of tariffs, they cannot hope to get rid of their surpluses to such countries even if they can contrive to produce them slightly more cheaply.

In such an impasse a country may think it worth reducing the price of certain lines of goods until they *do* undersell a similar product in some other country, even though this means selling at less than cost. In such cases the goods may be priced exceptionally highly in the domestic market so as to offset the loss on exports, or the state may subsidize the price (*i.e.* reimburse manufacturers for their loss on exports) with money raised by taxation. This process is known as *dumping*. The citizens of the country buying the dumped goods benefit by the low price and the citizens of the exporting country suffer to the extent that the others gain.

Once again costly changes of industrial structure are forced on the country absorbing the dumped goods, and unemployment is inflicted on it. Naturally it tends to resist the process by still more stringent protective measures.

PERILS OF PROTECTION

For all these many reasons, the leading countries of the world have instituted devices for controlling the volume and nature of their foreign trade. Unhappily, this has taken us to the other

extreme. Because violent, unexpected changes are destructive, we try to prevent any change happening at all. If a country which found one of its industries threatened by cheap foreign competition were to impose trade-barriers in order to gain time to bring about the necessary adaptation of its industrial structure, contracting the superseded trade and expanding in other directions, there could be no objection at all. Such a course simply postpones the raising of the standard of living in order to reduce the problems of transition.

But what happens in practice is that the protection becomes a permanency; the now relatively inefficient industry is given an indefinite extension of life. Protection may also be granted when an industry fails to keep pace with technical progress, and thus becomes inefficient relatively to other countries, as in the British steel and coal industries. Such protection simply protects inefficiency. It becomes an attempt to freeze the status quo. It enlarges the profits of favoured industries by saving them from the necessity of spending money on modernization.

To-day the world is beset in every direction by protective networks which must represent in the aggregate an enormous loss of efficiency, and so in the possible standard of living. Criticisms on these lines by free-traders are amply justified.

But the answer is not, of course, an unqualified abandonment of protection and a return to free trade, which would simply create huge losses in efficiency and widespread misery as a result of structural dislocation. Free trade versus protection is a meaningless issue. Like most issues, the answer turns out to be neither one thing nor the other, but a complex and flexible combination of both. Instead of leaving the trade-structure to the mercies of a struggle between antagonistic units, we must apply conscious, intelligent regulation to the planet's productive structure, steering a middle course between the demands of efficiency and of stability.

Incidentally it would be a mistake to suppose that anything so simple as the abolition of protection would restore free trade. For behind the official system of controls lies a network of private agreements between the major industries in each country on a scale much vaster than is usually imagined. Plummer's

eye-opening book, *International Combines in Modern Industry* will give the reader some idea of the extent and ramifications of these arrangements. And in some cases a single firm (such as Unilever, which boasts that it controls virtually all the soap supplies of the planet) is in a position to control the nature of production, and the quantities of output available, through its subsidiaries in many countries.

Through these private agreements industry arranges the quantity of foreign-produced goods which will come into the home territory and the price at which they will be sold. Usually they take the form of an agreement that each concern will monopolize its home market, while the rest of the world is divided into sales areas appropriate to each. In such a case, the cheaper producer does not attempt to sell his goods in the country of the dearer producer and the classic concept again breaks down.

It is only when industries are unable to set up such agreements that they join the clamour for 'protection'.

PLANNING WORLD TRADE

At present the industries of the industrial countries of the world spend their energies scrambling to obtain the biggest share of world trade they can. Those that win inflict dislocation and unemployment on those that lose. The trade structure which results is not the one which best serves the interests of the human race, but reflects many chance factors, such as the degree of government help afforded to industry and the extent to which workers have been able to improve their wage levels.

It is impossible to avoid the conclusion that the world needs a mutually agreed trade-plan by which each nation would agree to provide a specified quota of every kind of article entering into world trade; a plan which would pay attention to the social needs of the countries as well as to technical efficiency. The plan, of course, should not be rigid. It would be designed to expand industries in one country and contract them in another according to circumstances. In this way national industries which had become due for contraction would be able to take steps in good time to relocate their employees. They would discourage the

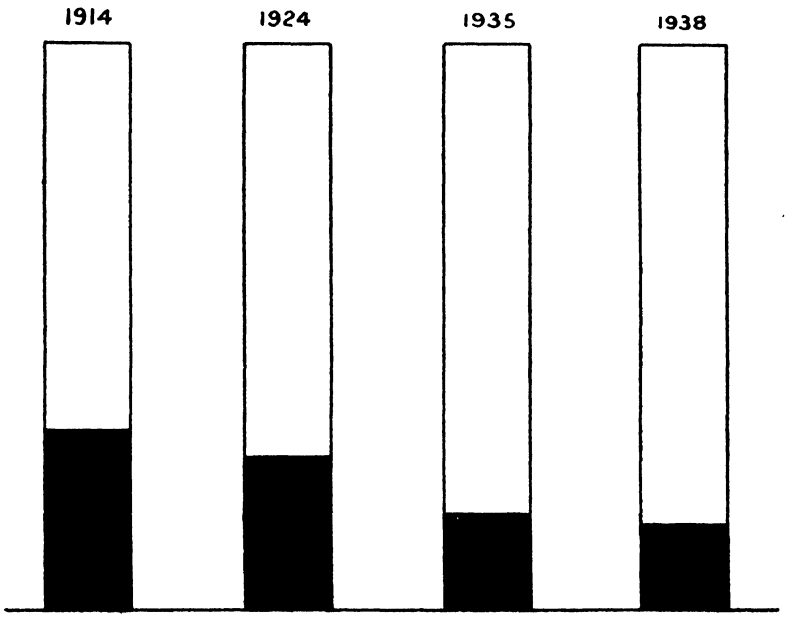


FIG. 21.—DECLINE OF BRITISH FOREIGN TRADE.
Black areas show production for export as a percentage of total industrial production.

entry of new apprentices, institute earlier retirement for older men, and provide training courses for younger employees. Similarly they would avoid the installation of new machinery or the raising of capital for modernization.

Such a proposal seems completely utopian at present, yet it is difficult to see any less drastic measures which would be any good. As a step towards it, we could at any rate set up an international organization to chart the development of world trade. (The League of Nations did something on this line, but on an inadequate scale; it lacked funds, and still more the co-operation of the world's producers.) This at least would give the public better warning of impending changes and enable governments and industries to take suitable measures in good time. It could not, of course, do anything to minimize changes and make sure they occurred smoothly; nor would it be capable of securing that the industrial structure served the widest social interests, but at least it could help by drawing attention to serious instances of disproportion.

The precondition of such a world production order (and this cannot be stressed enough) is the introduction of uniform income dispersion, all over the planet. No production planning board could hope to induce a country (or firms within it) to buy at a high price what they could get cheaper elsewhere, except on the most insignificant scale. And even if they could, this would create difficulties in payment, as will be seen from the next chapter.

But we cannot hope to induce the industrialists of India or Japan to raise wages until a very much greater degree of political unity has been achieved. And there are also social difficulties to be considered. Sudden and violent changes in the wage structure of a country produce numerous secondary effects, which the reader can deduce for himself. Nor, at present, do we possess sufficient statistical data.

In short, the defeat of structural employment is a problem which is closely interlocked with the whole task of changing over from a national to a world-wide political and economic organization—the task in which we are, whether we realize it or not, at present engaged.

SECTIONAL INTEREST AND FLEXIBILITY

Neglecting the political and nationalist forces which make such a scheme difficult of realization, there is also a major economic problem which stands in the way of its achievement. This is the lack of any technique for dealing with the financial side of obsolescence. Even within the limits of a single national economy there is great resistance to structural change; those with vested interests in dying industries naturally try and keep them alive. As we shall see in detail later, such resistance can only be overcome by some device for offsetting the losses on outmoded industries against the profits on new and thriving ones. Here we are up against the same problem not merely on a national but on a world scale. If it is hard to imagine the Aluminium Company of America recompensing the shareholders of U.S. Steel, it is yet harder to visualize Japanese cotton exporters recompensing the Lancashire industrialists. If all industry were owned by the state (not that I advocate it) there would be slightly more hope of making such an arrangement, since the government servants making the arrangement would not stand to lose personally and would be steeped in a tradition of impartiality. But it is 'against human nature' to expect a group of industrialists to sit down and sign away what they have been brought up to regard as their legitimate profits.

Here, as in so many instances, good intentions founder on the rock of private ownership. The private owner accepts misfortune when it comes from the hazards of necessity—he has no choice in the matter—but when his misfortune results from someone's deliberate policy he organizes resistance. So we have the ridiculous situation that undesirable fortuitous changes come about without a fight while wise changes in the general good are bitterly opposed.

Summary

At first sight, free trade is the most sensible policy to pursue in the field of foreign trade, since it leads to maximum efficiency in production. But owing to variations in wage levels and the

unequal development of different countries a policy of free trade repeatedly inflicts drastic structural changes on individual national economies. This causes so much unemployment and waste of capital resources that the countries concerned prefer to ignore greater productive efficiency obtainable with free trade. There are also social, political and martial reasons for controlling the structure of foreign trade. Lastly, a country may resort to protection to prevent its people from importing more than they export.

The objection to control of foreign trade is that, once introduced, it tends to stabilize the industrial structure too completely and thus it permanently obstructs advances in efficiency. And it is difficult to avoid it becoming a screen for ineptitude.

But abandonment of protection would not restore free trade, because private enterprise is rapidly evolving its own controls through secret international agreements. Hence the real issue is: 'Who is to exert control?' and not: 'Are we to have control?'

The only rational solution is: (*a*) an international body to plan the world trade-structure, weighing efficiency against the other desiderata and introducing desired changes smoothly and regularly, so that unemployment and waste of capital goods are both minimized; and (*b*) measures for preventing changes from penalizing one minority-group while benefiting another.

15

Fair Exchange

'But I was thinking of a plan
To dye one's whiskers green,
And always use so large a fan
That they could not be seen.'

PAYMENTS MUST be balanced. The balance sheet, as we saw in Chapter 13, was a somewhat complicated one including invisible items, loans and interest as well as goods. To simplify the exposition we shall speak in this chapter as if the balance sheet contained only merchandise. We shall speak of exchanging equal quantities of goods as the object of government policy, instead of saying clumsily, as we ought: 'exporting such a quantity of goods and invisibles as will, when interest and loans are taken into account, bring about a balance of payments'.

In a sane world we should try to arrange things so that the quantity of goods imported truly equalled the quantity of goods exported. This would involve us in estimating the labour involved in the production of each, and in making allowances for relative efficiency and other modifying factors. Our present custom is to measure the value of imports and exports in money but, as we have seen, money is a highly unreliable measure of value. It is a yardstick which alters in size.

So there is an enormous temptation to 'wangle' the prices of the goods concerned in foreign trade instead of adjusting the quantities. To this temptation the capitalist economic system cheerfully succumbs. If we are importing too much it arranges for foreign goods to cost more and this has the effect of reducing our willingness to purchase them. If we are exporting too little, it makes our goods appear cheap to the foreigner. In this way a balance of payments is brought about at the cost of making the bargain completely unfair in terms of real values.

Let us see how this tampering with prices is performed. The most obvious method is to adjust the *exchange-rate*—that is, the amount of foreign money you receive in exchange for a given amount of your own national money.

To take a simple example: if the exchange rate between the dollar and the pound is such that $\$5 = £1$, an American refrigerator costing $\$100$ will sell (if we ignore the cost of transport) for £20 in England. If we change the exchange rate to $£1 = \$4$, the Englishman will have to put up £25 to get it; this change may bring the price above that of the English-produced equivalent. Even if there is none the exchange rate can obviously be altered more and more until foreign goods become so dear that Englishmen cut down their purchases of them. In this way a balance, a monetary balance, can be achieved.

Alternatively, we can tamper with prices by altering the volume of money. We can force down British price-levels until thay are below foreign equivalents—to be more precise, below the figure at which foreign prices work out in English money, when translated at the current rate of exchange. This will also have the effect of making Englishmen cut down their foreign purchases.

To see how this is brought about let us go into the question of exchange rates a little more fully.

PURCHASING POWER PARITY

When you go abroad, you want to obtain francs or dollars, or whatever it may be, for your pounds. You naturally expect that the quantity of foreign money you are given will buy just as much in the country you are visiting as the British money given up would have bought at home. However, it is a matter of common experience that sometimes the rate of exchange is 'favourable'—as was the case with France before the war—while with other countries one loses on the deal—Holland was formerly an example.

The idea of a given sum of money purchasing the same volume of goods in two or more countries is called *purchasing power parity*. The rate of exchange which brings about purchasing power parity with a country I shall call the *fair rate of exchange*.

The idea of purchasing power parity is simple enough, but in practice it is far from easy to calculate. One of the main difficulties is that the world's countries are all a long way from having purchasing power parity with one another at present. The task of any single country which decides to try and do its duty in this respect is not to attain exact parity with any single country, which would be comparatively easy, but to strike some kind of average with the world as a whole. Apart from the difficulty of knowing where the average lies, there is a natural temptation to prefer to achieve real parity with the countries it is trading with even if this must be at the cost of non-parity with remoter countries with which it has few economic relations.

It should be added that elaborate calculations based on prices and wage-rates are made by economists in an attempt to determine fair exchange rates, but the results are far from satisfactory. One of the world's pressing needs is for further research on this subject.

If the exchange rate is not to be fixed at the fair rate, at what rate is it to be fixed? It is fixed at whatever level will cause the country's international payments to balance. The rate which produces this result is called the *equilibrium rate of exchange.* Let us see how it is determined.

EQUILIBRIUM EXCHANGE RATE

In settling debts owed by traders in one country to traders in another, it is of course useless for the debtor to send the creditor the currency of his own country, since the creditor cannot spend it. If you sell something to a Frenchman, it is no good his sending you francs, since you cannot spend them. Either you or he must go to the bank and ask them to exchange them for pounds. The reason the bank (to simplify the discussion we shall lump the whole banking system together under the title of 'the bank') is in a position to give the creditor pounds is that simultaneously it is being asked to make exchanges in the reverse direction. On any given day a considerable number of Frenchmen come to it and offer it francs asking it to make payments in pounds, while a considerable number of Englishmen offer it pounds and ask it to make payments in francs. And so on for other countries.

If the payments being made *to* British traders exactly equal the payments being made *by* British traders, British banks will have no difficulty in arranging the transactions, since the number of pounds offered to them by Britons who want to pay debts abroad will exactly equal the number of pounds required by foreigners to pay debts in Britain. And similarly the amount of foreign currency they are offered will equal the amount they are expected to pay out.

If, then, you leave matters to the bankers they will be strongly inclined to adjust the exchange rate in such a way that these in-payments and out-payments balance. If they find themselves with too many francs and too few pounds, they will increase the number of francs given for a pound, or—what is the same thing—decrease the number of pounds supplied for a given number of francs, until their books are balanced again.

Exchanges regulated in this way are called 'free' exchanges. When you have free exchanges you cannot possibly have an adverse trade-balance (in terms of money: it might be most inequitable in terms of goods). For as soon as out-payments exceed in-payments, bankers alter the exchange rate, which makes foreign goods dearer and the tendency to buy them is reduced. Thus the number of pounds on offer is reduced. Conversely, British goods become cheaper to foreigners, and the amounts of foreign money offered to the banks therefore increase.

The objection to this system—and it is a powerful one—is that the resulting exchange rate is not stable. This is a considerable handicap to all those engaged in foreign trade, who wish to know, when they sign contracts, what they will ultimately be called upon to pay. The existence of a fluctuating exchange rate which may double their profit or may turn it into a loss introduces a speculative element which may discourage them from trading altogether. At best it will force exporters to raise prices as 'insurance' against loss. (It also has other irritating effects, such as making price catalogues out of date.)

The exchange rate will fluctuate, in the first place, because on any given day payments will probably not balance, even though they may do so when averaged over a longer period. But it is not these minor fluctuations which damn the system. What

does matter is that if the price-level of the country changes, it necessitates a corresponding change in the exchange rate. The dependence of exchange rates on price-levels is fairly self-evident. Looking at the question in an abstract way, we can see that if the quantity of money in a country is expanding, (while the supply of goods remains constant) the buying power of any fixed amount (say Fr. 100) gets less and less, and so this sum is equivalent to a smaller and smaller amount of any stable currency. Correspondingly, if the exchange rate is fixed and the British price-level is rising, then British goods are becoming dearer and dearer in the eyes of foreigners, while foreign goods are becoming cheaper and cheaper in Britain. Hence exports will fall off and imports increase; a tendency will develop to import more than is exported. The banker has to correct this by a gradual *devaluation* of the British currency, *i.e.* by offering smaller and smaller amounts of foreign money for £1, a process which corresponds to the fact that smaller quantities of home-produced goods are now being exchanged for £1. The trouble is that the fault may not be in your own country. If the price-level of another country falls for any reason, your own nationals will tend to buy more from that country. So you may be forced to adjust *your* price-level simply because the other fellow refuses to adjust his, or else to adjust your exchange rate.[1]

Now the price-levels of the different countries are always fluctuating, so that if we relied on free exchanges we should have constantly fluctating exchange rates—although foreign trade would always balance perfectly. This naturally suggests the thought that if we could pin price-levels down we could then enjoy stable exchange rates. And this, indeed, is what bankers seek to achieve. They fix exchange rates, once and for all (they hope), and then seek to keep price-levels at the appropriate level.

[1] Some more definitions: If the buying power of the pound is so high that an import-surplus develops, the pound is said to be *over-valued*; in the reverse case it is *under-valued*. (These are the customary meanings; but the terms can also be used, more accurately, to mean that the exchange rate is above or below the fair rate.) If the pound loses value as a result of a price-rise it is said to *depreciate*; the government should then put things right by *devaluing* it, *i.e.* altering the exchange rate. The opposite of this is *appreciating*.

To ensure that all countries shall co-operate in the scheme, they devised the following ingenious set of rules, designed to achieve the necessary adjustment of the price-level 'automatically'.

THE 'SELF-REGULATING SYSTEM'

As a matter of fact, we have, in the course of the book, become familiar with the machinery involved. When an import-surplus develops, the central bank pays the balance in gold; and correspondingly countries with an export-surplus receive payment in gold. The enlargement of their gold stock obliges them to issue more notes, bank credit increases accordingly, prices rise and as a consequence the export trade is handicapped and the import trade assisted. If this does not restore the balance, a further loss of gold in the following year will carry the readjustment of prices still further. Conversely, in the countries with an import-surplus, the loss of gold causes the central bank to call in notes; this reduces the volume of bank-credit; prices fall; and the export trade is assisted while the import trade is hindered.

What the bankers fondly imagine they are achieving by this device is the adjustment of the price-level so as to make the current exchange rate correspond to the equilibrium rate. Unhappily there is a huge array of drawbacks to this clumsy system.

OBJECTIONS TO THE 'SELF-REGULATING SYSTEM'

1. Perhaps the most serious objection to the self-regulating system is that it ignores the effects of any other factors except prices and exchange rates in affecting a country's disposition to import. As we have seen such things as changes in income dispersion, the growth or decline of natural advantages, or the raising of efficiency either by firms at home or rivals abroad, will cause countries to vary their demand for imports and their ability to export.

Under the 'self-regulating' system, every one of these changes must be met by a change in price-level. This is completely contrary to the country's need for a stable internal price-level. The situation is at its most pernicious in the case where a country

is importing too much—for the prescribed cure is a price fall, and this, as we have seen, is depressing to trade.

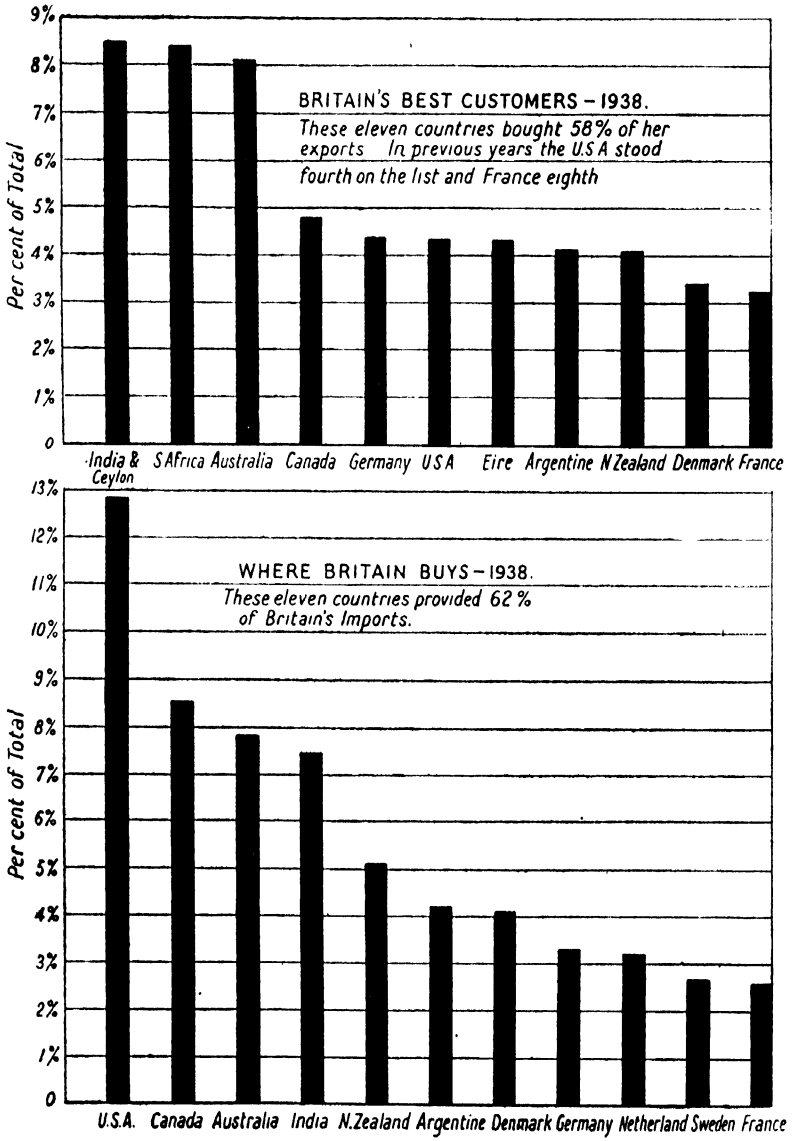
2. This brings us to the second objection, which is that there is no guarantee that the price alteration will not go too far. The self-regulating system totally ignores the elementary economic fact that the velocity of circulation is a factor in price making. Its object is merely to adjust prices downward until trade balances itself; but as we saw in Chapter 3 a falling price-level breeds a spiral of depression. So the 'self-regulating system' is liable to plunge the country into a slump in which prices are carried far lower than is necessary. Trade becomes unbalanced in the other direction.

As in due course gold flows in to correct the balance, inflation is created—in short, the mechanism contributes to the creation of the trade-cycle.

3. Furthermore, the device is easily thrown out of gear by gold movements due to speculation and political fears. In stable times, such as ruled early in the century, these movements were small. But in the 'thirties speculators transferred their loans from one country to another in rapid succession (the full story is told in Chapter 20) causing the price-level to rise in one and fall in another, and so unbalancing trade.

The bankers' answer to both these criticisms would probably be that the central bank is not obliged to issue new money for every pound of gold it receives, and by drawing on its reserves it need not always cancel money when gold goes abroad. Furthermore, they would add, it has the option of altering the bank rate and discouraging foreign money when it is unwelcome. The bank can also engage in open-market operations at its discretion. The immediate answer to these objections is that they are only effective in controlling small movements. If people fear that a country is going to be occupied by an aggressor, they will move their money out of it, and into safer countries; and those safer countries will be unable to prevent the influx of gold however much they lower the bank rate.

The second and more fundamental reply is that the bankers' objection reveals that the system is not a self-regulating one. It is a system of managed money with control vested in the central



FIGS. 22 and 23.—BRITAIN'S FOREIGN TRADE.

bank. Certainly, the whole argument of this book has been that money should be managed—but if it is to be, then let us recognize the fact, provide the managers with all the weapons they need and make them responsible to the nation. At present we leave control in the hands of a secret caucus, equipped with obsolete and inadequate machinery, and when things go wrong console ourselves with the belief that the process is automatic and inevitable.

4. Yet another drawback to the system is that its functioning depends on all the countries of the world abiding by the rules. If anywhere in the world a country receives gold and does not let her price-level rise, then she will be able to maintain an export-surplus and gradually drain the other countries of gold. (In this case the cap fits the Americans.) Equally, if any country fixes her exchange rate artificially in such a way as to favour imports, and checks the outflow of gold by devices such as Germany discovered before the war, then the whole system breaks down.

5. The system is not always effective in altering prices. It sometimes happens that an inflation develops despite the government's efforts to prevent it. (How this may happen will be seen in Chapter 17, which deals with balancing the budget.) As a result prices will rise, trade becomes increasingly unbalanced and in the end the government will be obliged to alter the exchange rate after all, or to take more drastic measures to restore the balance.

PENALTIES ON PROGRESS

Perhaps the greatest of all objections to this Heath Robinsonian system is that it is essentially restrictive. It attempts to restrict imports by the sadistic method of making the purchase of foreign goods such a bad bargain in value received that the citizens baulk at it. A handicapped nation must fix prices (or exchanges) in such a way that the real value of its exports is always greater than the real value of its imports. The more the country wants foreign goods, the less of them it is allowed to have; if it wanted them more than anything else in the world, it would not be allowed any at all. Conversely, a favourably placed nation permanently gets an advantage in its foreign trade. The system penalizes the

weak, presents a bonus to the strong. This is, of course, contrary to both justice and sense. In fact, it is crazy.

Seventhly, and lastly, of the counts for which I have space, it penalizes progress. A wise and progressive country which raises wages above subsistence levels cannot easily compete in the world market with countries employing sweated labour. When a country is pursuing the 'jam to-morrow' policy and is not attempting to distribute adequate buying power at home, it undoubtedly can compete more favourably in the world market. It is postponing the day when wages will have to be raised, and this gives it an advantage over countries which have begun to realize some part of their accumulated 'jam'. In return for its progressive policy, such a country is compelled to handicap itself by instituting penal exchanges.

A country with a high standard of living will inevitably import, because its people will take pleasure in owning unusual foreign-produced specialities, even when home-produced equivalents are available; they will also travel abroad, which is equivalent to importation. In short, a rich country will tend to develop an import-surplus. (This is especially true of Britain, where a rise in wages causes increased importation of food.) But the self-regulating mechanism says no, they mustn't do this—rightly enough—but instead of merely limiting their purchases from abroad and letting their prosperity remain, it restores the balance by depriving them of their prosperity.

To sum the whole matter up, the fact is that the system is a restrictive one. It attempts to achieve a balance between countries which are basically not in equilibrium by inflicting depression on any country which seems to be rising above the level of the lowest. It is just one more example of scarcity economics.

TOWARDS A SOLUTION

This then is the problem. We have three objectives. We wish:

1. To preserve the balance of trade.
2. To ensure stable exchange rates.
3. To maintain a stable price-level.

The only circumstances in which you can have both a stable exchange rate *and* a stable price-level is when *every* country in the world has a stable price-level. Or, to be more exact, if any country which has an unstable price-level *immediately* and continuously adjusts its exchange rate so that its money remains in equilibrium with the rest of the world. These two objectives can only be achieved on the basis of world co-operation, plus a fully developed monetary technique.

There is also a second requirement: that we shall abandon the system of using the price-level to correct the trade balance. The strength of the tendencies encouraging countries to import are always varying, and therefore we are inevitably committed to a varying price-level if we use it to offset them. This leaves us with no option but to control the balance of trade by direct means —quotas, tariffs, import boards, exchange control or whatever seems best. If we agree to do this, we can abandon the absurd system of fixing the exchange rate in the position we think most likely to bring about a balance of trade. We can, instead, fix it in the fair position.

It cannot be denied that the methods of directly controlling foreign trade known to us at present have their disadvantages. Tariffs, besides tending to act as a screen for inefficiency, as mentioned earlier, also have the drawback that being imposed on specific classes of goods they necessarily hit certain exporting countries harder than others. They therefore discriminate unfairly between the various countries trading with the nation imposing the tariff, and breed ill-will and retaliatory measures.

This might be avoided to a considerable extent by employing, instead, a system of quotas; but quotas can only be administered fairly (in a capitalist system) if each purchase is considered on its merits. This involves an enormous administrative staff with inevitable bureaucratic error and delay. The allocation of a limited number of quotas among a large number of would-be purchasers is likely to produce unfair and even ludicrous results.

The third alternative is to limit not the goods but the money, by imposing restrictions on the availability of foreign exchange. The usual method is to make the issue of foreign money subject to license; this suffers from the same bureaucratic handicaps as

when the quota system is applied to goods. In addition it evokes strong opposition from those who speculate in foreign currencies, and from all the supporters of the 'jam to-morrow' system, since they fear the restrictions might be used to prevent the export of capital, as indeed they often have been.

There is, however, an alternative, hitherto unused but apparently free from objection. This is that the government (through the banks) should raise the cost of obtaining foreign money until the demand for it is cut down to the desired level. In other words, as far as the individual is concerned, the exchange rate is what it would be with free exchanges. Having thus obtained the money, the government settles with the foreign supplier at the equilibrium rate, or any other desired rate. Any country tending to develop an import-surplus would thus leave the government with money in hand, which can be returned to the public by reducing taxes. Of course, this system will not serve to correct a tendency to export too much, because the government would soon run out of money. There is, however, no need for the government to attempt to stop an export-surplus provided that the surplus money it brings can be smoothly returned to circulation through the channel of loans. In any case the problem only arises, even in this modified form, in an irrationally run capitalist economy; for, as we have argued earlier, in a rationally run economy no one will want to have an export-surplus. It will be preferable to sell one's goods at home in known markets rather than pay the cost of sending them abroad, insuring them, waiting for the cash to come in and running the risk of one's market disappearing. In a sanely run country the only danger will be that people will be more anxious to receive than to give.

WORLD PLAN NEEDED

At present countries with an export-surplus resent the efforts of countries with an import-surplus to protect themselves by imposing tariffs or other measures. They frequently react with 'retaliatory' tariffs which restore the old imbalance, forcing the first nation to heighten its tariff walls. Thus a 'tariff race' is engendered which only serves to impede world trade. It is essential

for the countries of the world to realize that no country can tolerate an import-surplus for long and that measures taken to restore the balance are not aggressive but perfectly right and natural.

The world's nations must realize that *no country can be permitted to export more than it imports*, since such a thing is only possible if somewhere else in the world there are countries importing more than they export, and any country which does this for long must drain itself of gold.

The one circumstance in which an export-surplus can be permitted is if the gold acquired is smoothly and equitably returned to circulation through loans. Such a thing is not possible while international lending is run on the catch-as-catch-can principle which obtains to-day. There are two great dangers. The first is that political unrest or ill-judged economic policy may discourage investors from lending. This is what happened during the nineteen-thirties, when the heavy defaults of the slump followed by the expropriation of loans by dictators and then by the fear of war discouraged all further lending. As a consequence, the United States, already a great creditor nation and the holder of more than half the world's gold, so far from being able to return the gold to circulation, was actually the recipient of still further supplies. In contrast, the second danger is that a country with an export-surplus may force its loans down other countries' throats.

The logical, sensible, civilized course would be for all the countries to meet and to draw up a flexible world-trade and world-lending plan under which each country would supply the goods it was best fitted to produce, with due consideration to its need for maintaining a balanced industrial structure and so on, while the needs of borrowers would be calculated and the corresponding lending rationed out. Creditor countries would be allocated the right to have export-surpluses of appropriate size.

Really, when you come to think of it, the present situation is farcical. Here are a lot of countries each trying *to get rid of* more goods than they accept—to impoverish themselves. *And* simultaneously all these countries are desperately trying to resist the efforts of the others to supply them with more than they can pay for.

And all because the persons who conduct foreign trade—exporters—attach more value to gold than to goods. For a nation considered as a whole it is obviously preferable to have goods rather than gold. But for individuals it is preferable to have gold. Thus this absurd paradox results from leaving international trade in the hands of individuals.

Summary

We seek to achieve a balance of payments, not by controlling the volume of imports directly, but by tampering with the price of imports and of exports so as to discourage the importer by twisting the bargain more and more against him.

Instead of fixing the exchange rate at the figure which will ensure purchasing power parity, we either keep adjusting it so as to cause payments to balance ('free exchanges') or else fix the exchanges as near this point as possible (the equilibrium rate) and try and compensate for any failure of payments to balance by adjusting price-levels. As a result we get rid of fluctuating exchanges at the cost of fluctuating price-levels, a thing which clashes with our earlier conclusion that the price-level should be stable.

The classical economists overlooked the many forces acting on the balance of payments and did not realize how much adjustment of the price-level would be necessary. But the real objection to the system is that it achieves its end by penalizing the weakly situated countries and those with a progressive wage-policy, for it is just these countries which tend to develop an import-surplus.

The government can do something to restrict imports by interposing itself between the buyer and the seller, so that the penalty on the seller is at least kept in the country for redistribution; but a comprehensive solution can only be achieved on a planetary basis.

16

Buying Money

'I don't think they play at all fairly,' Alice began,
in rather a complaining tone . . .

So far we have discussed the relationship between different currencies on the assumption that the authorities would try to attain a balance, as far as they could—but in reality many governments are busily engaged in holding their exchange rate deliberately above or below the money equilibrium rate. Once we remove the necessity of maintaining a trade balance by substituting direct methods of controlling it, we make it much easier for the authorities deliberately to misvalue their currencies. It is therefore worth inspecting the motives for misvaluation.

First let us take the case of over-valuation; that is, of making an unduly small number of pounds (or whatever it is) equivalent to a fixed amount of gold. Over-valuation is helpful to a country with debts to pay abroad—for instance, war debts—since a given amount of foreign money can be obtained for a smaller amount of one's own money. By the same token, over-valuation pleases financiers who deal in gold and the currencies of other countries. Furthermore, if the quantity of pounds which is equivalent to a fixed amount of gold is small, it follows that the whole volume of money in the country is small: prices are low and those who live on fixed incomes (rentiers) find that their money goes further.

The disadvantages, on the other hand, are that exporters are handicapped since British goods cost more abroad and so an 'adverse' trade balance is likely to develop; the burden of internal debt is increased;[1] while the actual process of bringing the currency up to a high value is deflationary and therefore oppressive to trade. In brief, over-valuation suits financiers and those with private incomes, but harms manufacturers and the ordinary

[1] See next chapter.

wage-earner. It is possible that there are other forces at work, not yet understood, which add to the depression when a currency is over-valued. Certain it is that every country which has over-valued its currency in the past has found itself in the grip of economic troubles. Over-valuation was the policy pursued by Britain after 1925, and it was a contributory cause of the slump.

UNDER-VALUATION

Why then does not every country go to the other extreme and under-value? The United States has actually pursued this policy. Her exporters have been assisted, unemployment has been exported, gold has come in to raise the internal price-level and create prosperity; and when foreign goods have tried to flow in, as foreseen by the self-regulating mechanism, a prodigiously high tariff wall has been used to exclude them.

The answer is that in the Old World bankers and financiers exert a greater influence than industrialists. The financiers, who, as we have just seen, gain by over-valuation, have kept up a loud propaganda about the horrors of devaluation (with sinister threats that the currency will become worthless) with such success that the man in the street has been fooled into believing that devaluation would be a disaster. A second reason put forward is that if such a policy were tried and found successful, a 'devaluation race' might begin in which each country would endeavour to outdo the others until these reciprocal devaluations made each currency worthless. The experience of British devaluation in 1931 goes to show that this is only a bankers' bogey man.

There is a third reason which has more substance. When a country devalues, the effect may merely be to depress the world price-level instead of raising its own price-level. Thus when Britain devalued in 1931 her exporters were assisted, but her importers had to pay more. But for many sorts of goods Britain was the only market, and she simply refused to pay more: she paid the same amount in pounds, and the countries supplying her were forced to take less in their own money. Thus, while Britain gained some benefit, other countries were depressed and were not able to buy so much from Britain. In the end, therefore, Britain

gained nothing, and the world trade position was worsened to the ultimate loss of everyone.

Germany used misvaluation of the exchanges even more ingeniously in order to build up her war potential. Her main object was to acquire essential raw materials. She therefore over-valued her currency so as to make imports cheap in terms of marks. This naturally handicapped her exporters, whom she then proceeded to assist by devious devices, among them the use of special types of marks (Handelsmark, 'Aski' mark, Wechselmark) which exchanged at a different rate. Thus with countries with whom her trade was mostly inward she maintained a rate favourable to imports, while with countries to whom she acted as a big exporter, she used a rate favourable to exports. The latter were the smaller European nations; bribes and threats were used to stifle their protests at such discrimination.

Finally, there is yet one more reason why a stable price-level is difficult of attainment; it is the most important reason of all.

CURRENCY SPECULATION

Gold forms a convenient common denominator for the currencies of the world. It serves as a yardstick against which each can be measured. But unfortunately it is a yardstick which itself alters in length.

Like anything else, gold becomes more or less valuable according as the demand for it, and the supply of it, alter. But whereas with goods you can adjust supply to demand by means of the price-mechanism, this method is not available in the case of gold. For if you have fixed the exchange rate by saying that 117 grains of fine gold exchange for £1, then £1 is the *price* of that quantity of gold. If you wish to raise the price in order to discourage private individuals from buying gold, you can only do so at the cost of altering the exchange rate.

It is obviously hopeless to expect exchange rates and price-levels to remain constant if the banking authorities have to use them to compensate for the fluctuations in supply and demand for the metal. In point of fact, bankers do not, except in the last resort, meet a heavy drain of gold by altering the price. If their

stocks get dangerously low they may prefer, instead, simply to refuse to sell any more. This is what is meant by 'going off the gold standard'.

The gold standard consists of nothing more than the undertaking to sell or buy gold on demand at the official price. It does *not* mean the practice of quoting exchange rates against gold, nor does it mean the practice of settling adverse balances by gold payments. Countries which are off the gold standard frequently continue both of these practices.

It should perhaps be added that the words 'gold standard' are often used to refer to two different things. The foregoing description covers what we may call the *international gold standard*, which is what is properly meant by the term 'gold standard'. What we may call the *domestic gold standard* is the practice of regulating the issue of credit by the gold holding of the central bank. It is perfectly possible for a country to be simultaneously on the international gold standard and off the domestic one, or vice versa.

As long as the central bank has a fixed price for gold, private dealers in the metal are bound to buy and sell at the same price, for if they offer to sell at less people will immediately buy from them and sell at a profit to the central bank, while if they charge more people will not buy from them at all. But immediately the central bank goes off gold, dealers are free to fix the price according to the laws of supply and demand. The price of gold thus fixed becomes the exchange rate and the country has to endure the penalties of a fluctuating exchange rate.

The reader may wonder why the central bank cannot ignore the price of gold and continue to fix the exchange rate where it wishes. An example will show what would happen. Let us suppose that the Bank of England (being off gold) fixes the exchange rate with the franc at £1 = 100 francs. Now if the Banque de France, being on gold, has fixed a rate of 700 francs to one ounce of gold, clearly English dealers can buy one ounce of gold for £7, by dint of changing their money for francs first. In other words, the moment that the Bank of England sets up an exchange rate with any single country on the gold standard it automatically and unavoidably establishes a sterling price for gold. If that price is different from the price in the free market, it will pay dealers to

buy at whichever is cheaper and sell at the dearer, and this will go on until one of the parties gets tired of losing (or acquiring) gold and adjusts his price to that of the other.

For instance, if the dealers are offering the higher price people will go with their pounds to the Bank of England and will ask for francs; with the francs they will ask the Banque de France for gold; and with the gold they will go to the dealers and get pounds. (These roundabout operations designed to take advantage of slight price differences in two markets are known as *arbitrage*.) The Bank of England will have to send gold to the Banque de France to pay for the extra francs it needs,[1] so that the net result is that the Bank of England loses gold and acquires pounds while the dealers acquire gold and lose pounds. This is just the same as if the dealers bought the gold direct from the bank, and naturally the price will be fixed by mutual concession, according to the state of the market.

TECHNIQUE OF SPECULATION

Why, you may be wondering, should anyone want to buy gold at all? What good is it? The answer is that if a country is about to alter its exchange rate so that a larger amount of its currency is equivalent to a specific amount of gold (*i.e.* to devalue) it is profitable to swap your money temporarily for gold and switch back after the change. Thus if 117 grains of gold = £1 before the change and 117 grains = 25s. after it, you can turn your £1 into 25s. by buying gold while the change takes place. This does not necessarily give you any more purchasing power, because the central bank may take advantage of the devaluation to issue more notes, so that price-increases will absorb all the profit, but at least it saves you from the loss which everyone else suffers from the price-rise.

The sinister thing about such speculation is that the very act of buying gold tends to bring on the devaluation which the speculator is hoping for. The more gold is bought, the lower the

[1] Alternatively, it could leave the exchange rate free, so that, as pounds come on offer, the price of gold rises, until it is the Banque de France which is losing gold.

stocks of the central bank become; the more credit contracts, the greater becomes the over-valuation of the currency and the greater the need for devaluation. As a consequence, whenever a currency becomes misvalued and the central bank finds itself in a precarious position, hordes of speculators begin a campaign of buying with the deliberate intention of precipitating the catastrophe.

The converse process is also profitable. If you own a lot of gold, and think that a certain currency is going to be revalued upwards, then you change your gold for the currency and switch back after the revaluation. Even better, for the speculator, is to combine both processes: by selling an expanding currency and buying a contracting one, he can take both profits simultaneously.

It hardly needs saying that as long as a group of irresponsible dealers, concerned solely with their private profit, are free to buy and sell huge quantities of gold it is quite out of the question to hope for stable price-levels, either on a world basis or a national one. As Dr. Einzig has said: 'There is nothing to be said in excuse for their activities. Undoubtedly speculators in foreign exchanges are the dregs of humanity, who deserve individually every contempt.' Contempt, however, is hardly enough.

'HOT' MONEY

As a result of these and other still more ingenious operations, considerable quantities of gold may move from one country to another. Hence our balance sheet in the last chapter, showing gold movements resulting from the trading account, has little relationship with the actual facts. The justification for ignoring these movements in the balance sheet is that speculation is a *self-reversing* item. A speculator only buys a currency in order to sell it again. In the long run, therefore, any gold leaving the country on this score will eventually come back again. In a period of great stability, when revaluation of currencies is unlikely, such movements are negligible; but in unsettled times, such as those following a war or a world slump, they may be so great as to swamp the operation of the self-regulating mechanism. It is thus revealed

as an even more ineffective device than we have already seen it to be.

On top of this, there is another class of self-reversing items which affect the flow of gold and through it the price-level. These are loans, for a loan must ultimately be repaid. We included in our balance sheet long-term loans, made for periods in excess of a year, but we said nothing about the mass of short-term loans, most of them made for periods of three months or less. Some of them can be recalled on demand (call-money). These loans reverse themselves, but their very mobility conceals a danger. The lenders transfer them from country to country, wherever the highest rate of interest is to be found.

The theory is that any central bank which is temporarily short of gold can fill the gap by raising the bank rate and attracting short-term loans.[1] This is all very well in stable times, but if several central banks are short of gold at the same time, the gold will fly from one to the other in turn; while if devaluation threatens all the loans will be hastily removed. Just as in the case of speculation, this will tend to bring on the very thing which is feared.

Thus the outflow of gold caused by the withdrawal of loans or by financial speculation differs in an important respect from the outflow which is caused by an adverse trade balance, in that devaluation has not the slightest effect in checking it. Loans are normally made on the understanding that they will be repaid in the lender's currency. Devaluation therefore simply increases the cost of repaying the loan, it in no way penalizes the lender. In the case of speculation as we have just seen, it actually stimulates the outflow. It is for this reason rather than from a desire to control the trade balance that many countries have resorted to *exchange restrictions*, that is, refusal to let foreign countries withdraw sums due to them, and have taken other measures to stabilize their exchanges.

[1] The *Bank Rate* is the rate of interest offered on certain types of loans. It naturally sets a limit to the rate offered by private concerns—if you can borrow from the central bank for 5 per cent you will not be prepared to pay 6 per cent elsewhere. Alteration of the bank rate tends to shift all interest rates in the country, even on quite different types of loan.

EXCHANGE EQUALIZATION FUND

The most interesting of such steps was the establishment of the Exchange Equalization Account by Britain in 1932, an idea which was later copied by several other countries. This Account was equipped with a large sum borrowed from the British public and also with a considerable amount of foreign currencies. By buying when the public was selling and selling when it is buying it was able to maintain the exchange rate against the fluctuations which this traffic would normally cause. The danger is that the authorities may mistake the business resulting from a permanent change in the equilibrium rate for a temporary fluctuation (or may wrongly estimate how much of the business is due to one and how much to the other) and so be led into trying to maintain the currency at an unnatural value, in which case they will end by losing all their resources.

It will be clear that this principle can also be used by a government in order deliberately to maintain the exchange rate at an artificial level over a prolonged period, provided it has the necessary resources. This is known as *pegging* the exchange rate. Probably the biggest such operation ever carried out was during the Great War when the British government pegged the pound at $4.76\frac{1}{2}$. The extent of this operation can be judged from the fact that when the peg was withdrawn the pound fell to $3.40. The government was able to maintain the pound at such a high value for so long only because it was using compulsory powers to realize assets held in America, which provided it with an enormous supply of dollars to operate with. A similar course was followed in the second world war, on a scale which (as I write) is not yet known.

While the word 'pegging' is normally used to indicate the maintenance of a currency at an abnormal value, whereas an exchange equalization account is concerned simply to iron out fluctuations, it is clear that the difference between them is simply one of degree. The smoothing-out of fluctuations entails maintaining the currency sometimes above, sometimes below its equilibrium value; conversely a government which has no equalization account may engage in pegging to neutralize what it believes

to be a temporary depreciation of its currency. Its guess may prove wrong and it may find itself pegging in the proper sense. The dividing line is vague, and it is quite usual to speak of an equalization account as pegging the exchange.

Operations of this sort are limited by the available resources, consequently many nations have had to fall back on the use of exchange restrictions.

EXCHANGE RESTRICTIONS

The exchange rate is the resultant of supply and demand. Pegging is a method of increasing demand when the supply increases. The alternative is to prevent the increase in supply. This is done by making it a criminal offence for the citizens of your country to exchange their money for foreign currencies without permission.

Exchange restrictions were invented by the Balkan countries to counteract the sweeping demand for the repayment of loans which occurred in the 1931 crisis. But they were speedily adapted by Germany for the different purpose of gaining economic control of neighbouring countries. The method, briefly, was this. If Germany owed considerable sums to a foreign country, she would refuse to repay them in cash, but would make the creditor country take out their value in goods. In this way, creditor countries were forced to buy from Germany at prices fixed by Germany goods which they would have preferred to buy elsewhere, probably cheaper, and even to take goods they did not want at all.

The variations played on this theme were numerous and complicated. The reader should see Paul Einzig's *Bloodless Invasion* for a fascinating account of Nazi ingenuity in this field.

CONCLUSION

One thing sticks out a mile. It is lunacy to leave the volume of money and the exchange rate to the mercies of these erratic movements of gold. There is no need to. If only we could free ourselves from the domination of this idea of a self-regulating system, we could immediately introduce deliberate control of the

variables. At present if any one factor becomes unbalanced it tends to promote imbalance in all the others too. If we controlled all the variables, then a failure to adjust one of them correctly would remain no more than that. Suppose exchanges are stable, the volume of money stable and trade balanced; suddenly lenders withdraw a huge quantity of gold. Let them do so! There is no reason why the volume of money should immediately decrease. It is true that the movement of these loans may, after many months, by shifting purchasing power from one country to another, have the effect of changing, let us say, the trade balance. But if the volume of exports and imports is under control we can easily check this tendency when it emerges. It is much easier to hold a lot of isolated variables to predetermined magnitudes, than to keep a lot of interconnected variables in equilibrium, especially when the time lag with which changes are transmitted through the system is unpredictable.

Such a policy of conscious control would largely nullify the destructive effects of speculation. Nevertheless, there is not the slightest reason why people performing no useful service to the community should be able to enrich themselves by a technical manipulation whenever monetary adjustments are necessary. Currency speculation might well be made a criminal offence. (Financiers will object that it is impossible to discriminate between genuine purchases of foreign currency by traders and travellers, and speculative purchases by dealers. But while there may be marginal cases, to which the benefit of the doubt can be given, no jury would have difficulty in identifying fully-fledged speculation, given the facts; and a few exemplary prosecutions would reduce speculation to a negligible fringe.)

The foregoing are measures which any one country can adopt, regardless of the methods of others. It remains to be added that if *all* countries were to adopt control, and to exercise it conscientiously, then no further changes in the exchange rates need ever take place—except, conceivably, when control measures had been incompetently applied. In the absence of a consistent world policy it may happen that difficulties arise between two countries trading with one another because one of them undervalues and refuses to correct the valuation. In such a case the correctly

valued country may be tempted to devalue in order to restore equilibrium with its rival, even though this means disequilibrium with the rest of the world. Such a course is obviously disruptive. We therefore need a world monetary authority with power to force countries which deliberately misvalue to resume their proper level. Once again we see that the attainment of a sane and satisfactory economics cannot be attempted on less than the world scale.

This is true in a wider sense, too. One day we may learn to regard the people who live on the earth as the joint inheritors of its benefits. They will be free to live in whatever areas appeal to them most, and their standard of living will depend on the average technical efficiency of world production, and their own merits, irrespective of the geographical accident of where they happened to be born. Then there will be a world monetary system, and the footling problems of exchanging national monies will be dissolved for ever. In the meantime, for goodness' sake let us balance our national monies intelligently.

We have now concluded the section of the book which deals with international relationships, and are about to enter on the final chapters which seek to draw our many conclusions together into a unified organic picture. But before we can attempt this there are two matters arising in a general way out of all we have been saying which must be briefly dealt with. These are the balancing of the budget and the position of the stock exchanges.

Summary

Financiers and rentier favour over-valuation; manufacturers and consumers stand to gain from under-valuation. Britain has tended to over-value, America to under-value.

Gold is the yardstick against which currencies are measured, but it is a yardstick which alters in length. When the demand for gold varies, bankers are reluctant to vary the price, as this is tantamount to varying the exchange rate, so they may refuse to deal at all; this is called 'going off the gold standard'.

The demand for gold alters because speculators wish to acquire it in anticipation of an expected devaluation. Their action brings such devaluation much nearer.

The movement of short-term loans is another disturbing factor in the gold situation. Unfortunately devaluation has no effect in checking gold movements caused either by speculation or lending; hence countries are driven to impose restrictions on exchange movements. To some extent these fluctuations can be ironed out by use of an *exchange equalization fund*, the operators of which throw their weight in the opposite direction to that of speculators and lenders. In a sane world, we should control the volume of money, the balance of trade and exchange rates deliberately, without reference to the movement of gold, thus preventing these financial storms; and we should make currency speculation a crime.

17

How to Balance the Budget

'The great art of riding, as I was saying, is—to keep your balance, like this, you know——'
He let go the bridle, and stretched out both his arms to show Alice what he meant, and this time he fell flat on his back.

. . . Alice soon came to the conclusion it was a very difficult game indeed.

BALANCING ONE'S personal budget is a question of making sure that one's income does not exceed one's expenditure. In principle, balancing the nation's budget is much the same, but in practice it involves some quite unexpected difficulties—difficulties which have often led to the fall of governments and which play a prominent part in the troubles of the years between the two wars.

To expose these difficulties we will start by considering the constitution of the budget itself. In the main, it is simple enough. There are three major sources from which the Chancellor of the Exchequer is receiving revenue and there are three major groups of expenditure for which he has to budget. The sources of income are:

1. Income Tax ;
2. Surtax, Super-tax and Death-duties ;
3. Excise and Customs receipts ;

and the three main heads of expenditure are:

1. Public services ;
2. Armed forces ;
3. Interest on National Debt.

(The words 'public services' include pensions, the dole, cost of government, upkeep of roads, public health expenditure, etc., while the phrase 'excise and customs' includes the income yielded by taxes on excisable articles such as spirits.)

The nigger in this particular woodpile is the item called National Debt.

In Britain, even before the second world war, the national debt amounted to some £8000 million, or about £160 for every man, woman and child in the country, and called for the annual payment of some £360 millions in interest. (Compare this with the 1913–14 figure of £866 million for the whole national debt.)

The payment of this huge toll of interest absorbed more than one-third of the state's revenue, until it was reduced by the default on war debts to America. In fact, it demanded an amount equal in size to the whole amount raised by income tax—so that if the debt item could have been wiped out it would have been possible to run the country on the money received from surtax, super-tax, death-duties, customs and excise and cancel ordinary income-tax altogether. (I say this only for purposes of illustration. Obviously everyone should contribute to the cost of running the country according to their means; any saving realized by a reduction in the cost of the national debt should be spread proportionately over all types of taxation.)

Just consider! One-third of all the money raised every year by taxation of every kind has to be paid over to a minority of individuals to whom the nation has somehow got itself into debt. Who are these individuals, and how has this enormous obligation arisen?

THE NATIONAL DEBT

The national debt consists partly of money owed externally, to other countries, and partly of internal obligations to private individuals and concerns.

The external debt of most partially industrialized countries consists chiefly of money borrowed from more advanced countries, such as Britain, in order to build roads, railways, telegraph services and the like and thus hasten on their industrialization. We have seen in earlier chapters how this takes place and what it means to both borrower and lender so no more need be said about it here. In Britain, however, the external debt consists chiefly of the money owed to America for armaments supplied in the last war, and in this. It must be added that Britain suspended

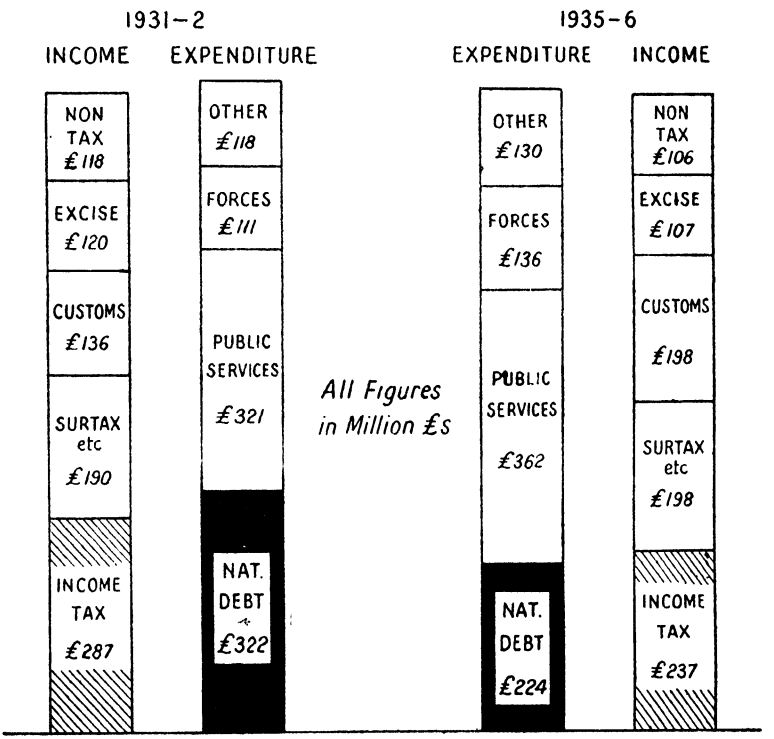


FIG. 24.—TWO BRITISH BUDGETS.

Note how the interest on the national debt absorbed, even before the second world war, an amount of revenue equal to the whole sum raised by income taxes.

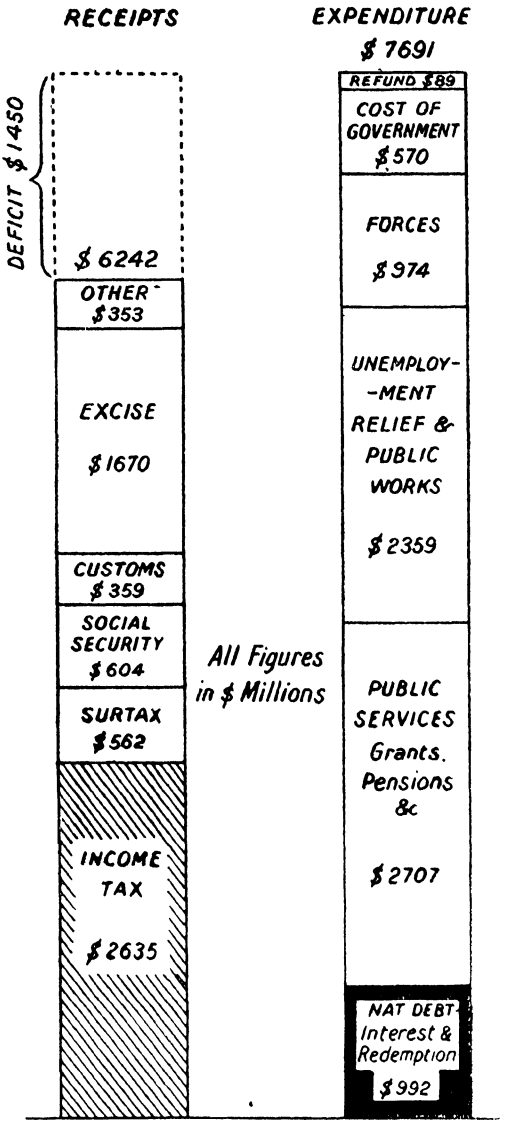


FIG. 25.—A TYPICAL U.S. BUDGET (1938).

This budget is not strictly comparable with the British budgets shown in the previous diagram, since in the United States each state also raises taxes and makes expenditures. The national debt, however, is comparable: at the end of 1938 (fiscal year) it amounted to $37,000 million (about £9000 million).

payment of her war debts after the 1931 slump; why she did this is a story in itself and we shall tell it in the next chapter but one; for the present we will just accept it that these debts exist.

Internal debt, in contrast, has been incurred chiefly through the government borrowing from the individuals and firms in order to balance an unbalanced budget. That is to say, at the end of the financial year the Chancellor of the Exchequer has found that his incomings are less than his outgoings and has therefore had to borrow to meet the deficiency, just as any of us have to when such a thing occurs. There are two main reasons why a Chancellor of the Exchequer may fail to balance his budget: slumps and wars. In times of depression taxes yield less revenue than usual because profits are smaller and fewer people are in work, while the cost of public relief increases. While in war-time the Chancellor hesitates to impose taxes sufficiently heavy to raise the whole of the colossal expenditure for which he has to provide.

So much for the way the national debt comes into being. Now I want you to consider the effect on this debt of a rising or a falling price situation: of inflation and deflation.

EFFECT OF INFLATION ON DEBT

First let us consider what happens in an inflation of the classical type in which all the variables—prices, wages, profits, rents—swell in sympathy with the expansion in the volume of money. Obviously the Chancellor's receipts will swell equally, for as incomes rise, so will tax receipts. As a matter of fact, they will rise a little faster, because people who were formerly below the taxable level will rise into it, and all the way up the scale people will be sliding into higher tax groups. Turning to outgoings, on the other hand, we see that while expenditure on public services and the armed forces will swell in unison with revenue, debt will remain unchanged, for it is fixed in terms of money. Thus inflation reduces the proportion which the debt-interest bears to the whole budget. Clearly, inflation makes it easier to balance the budget—not only while it is going on, but

for ever after, since the proportion of income which has to be set aside for the debt item is permanently reduced.

When we turn to inflations of the kind that actually occur, in which wages do not rise so fast as prices, and rents are even more 'sticky', we see that the situation is yet more favourable, for the wages of the army and navy and of civil servants will not rise, while profits, and therefore taxes, will. Moreover a rising price situation is a prosperous situation. In a prosperous year not only do taxes bring in more, for more people are in employment and more firms are earning profits, but the cost of the dole is less; and if prosperity continues the cost of health services decreases.

Inflation, therefore, makes it markedly easier to balance the budget. So much for monetary effects, but what has happened in terms of goods?

Owners of debt can buy less with the interest they receive since prices have risen. So inflation has lightened the burden of debt by actually reducing the debt when we reckon it in terms of buying power. Owners of debt therefore regard inflation as an equivalent to a partial default on their debt. Simultaneously all those whose incomes are fixed in terms of money, civil servants and pensionnaires, find their buying power reduced too.

DEFLATION AND DEBT

For exactly contrary reasons, deflation makes it harder to cope with the national debt. Indeed it is obvious that if deflation is pushed far enough it will cause debt to absorb the whole of the government's income.

Suppose the national revenue is £800 million, the interest on the national debt £200 million and the cost of public services including the armed forces £600 million. Then a 50 per cent deflation will cut the national revenue at least to £400 million; so that there will only be £200 million for public expenditure, instead of £600 million. A 50 per cent deflation has necessitated a two-thirds cut in the sum available for public services.

Now if we suppose a 75 per cent deflation, revenue will drop to £200 million, the same as the national debt, and there

will be nothing whatever left for maintaining the government or anything else. In other words, as you deflate, the interest on the national debt, which is incompressible, assumes a larger and larger proportion of the whole income. Deflationary policies therefore always make it extremely hard to balance the budget and if pushed sufficiently far they make it literally impossible.

In the effort to achieve a balance, the government has to make savage cuts in public expenditure, thus reducing purchasing power and generating depression. It is this fact, above all, which makes deflation so depressing to trade—reinforcing, as it does, the already discouraging effect of a falling price situation.

And it is this fact, above all, which makes deflation such a suicidal weapon with which to remedy an import-surplus. This is the fact which the old-fashioned economists overlooked, (and which the Treasury advisers still overlook) as they chant their panegyrics of that Heath Robinson contrivance, the international gold standard.

BALANCING THE BUDGET

With these preliminaries, we can now consider the problems of the Chancellor of the Exchequer when he finds himself with an unbalanced budget. In making out his estimates for the next year he must somehow contrive to raise enough money or to make enough economies to prevent this happening again and also to pay off the deficit in the past year. In all, there are four things he can do: increase taxes, reduce expenditure, borrow or inflate. But each of these conceals a catch. The ordinary man, when his expenditure exceeds his income, can earn more or spend less and therewith settle the matter, but the Chancellor's problem is less simple.

1. *Raising Taxes:* Tax increases cannot be placed to any great extent on the poor, whose incomes are small enough already, and therefore fall most heavily on business and the rich. If they are heavy they may so discourage business that the volume of trade declines—with the result that revenue declines too. Thus the effect of raising tax levels may actually be to bring in a smaller total amount of revenue than before!

The amount that people can be induced to pay in taxes varies

widely according to circumstances. The income tax at 6d. in the pound imposed to pay for the Napoleonic wars was so unpopular it had to be removed. In the 'thirties we would have regarded 3s. 6d. as a very reasonable rate of tax, and after a war in which taxes have gone to 10s. business men will no doubt regard a reduction to 7s. 6d. as a cause for optimism, a figure which before the war would have caused something near a breakdown.

2. *Reducing Expenditure:* Since the interest on the national debt cannot be reduced, when the Chancellor of the Exchequer wishes to economize he turns either to the armed forces or to the social services. But if he reduces the pay of soldiers, civil servants, pensions or the dole, he is cutting purchasing power and this will react on the business of the country as a whole. Prices will fall and this will evoke a clamour for the cutting of 'costs', by which is meant wage levels. But if wages are cut, purchasing power declines still further. In consequence, revenue will fall off. So once again his remedy may defeat its own object.

During the years following the great slump, the government first made economies in salaries; when it dared go no further, it starved the armed forces. But if economy is the proper solution for the nation's ills, then all should economize. If civil servants salaries are to be cut down, so should the interest on the national debt. Yet this would be regarded as a default, and the government would find it very difficult to raise fresh loans thereafter, so that this course is rarely resorted to. I do not know why it is not considered a default to cut pensions or the salaries of soldiers and civil servants.

The interest on national debt payments is occasionally reduced, but never arbitrarily. The procedure is to invite owners of national debt to be so kind as to express their willingness to accept a smaller rate of interest, with perhaps a fat bonus to sugar the pill. In this way the national government in 1932 'converted' a large block of war loan from 5 per cent to $3\frac{1}{2}$ per cent.

3. *Borrowing:* The disadvantage of this solution is that it adds to the national debt. We have already said enough to show the objection to this. In addition, the government loses face if it has to float a public loan for such a purpose. To do so would

cause such a loss of confidence that the government would probably find itself unable to find lenders willing to take its bonds.

4. *Inflation:* The Chancellor's fourth and least respectable alternative is to inflate. In the crudest case, he can simply order the printing of sufficient notes to meet the expenses for which he has no revenue. This is what the German government did in 1923.

Let us see what this resort amounts to in real terms. It causes prices to rise. Therefore the buying-power of fixed incomes (wages, pensions, certain dividends) declines. Thus the Chancellor has virtually inflicted a tax on the possessors of fixed incomes. On the other hand, those who live by profits will benefit because prices will rise while wages (the principal element in costs) will not. Thus inflation is merely a particularly unfair form of taxation, which inflicts all the burden on one section of the population and even takes from them a bit more and gives it to the remainder.

We may sum up the Chancellor's difficulties by saying that it is very difficult to increase taxes, very dangerous to reduce expenditure and most unfair to inflate.

There is, however, a form of inflation less crude than that described. The government may meet its deficit by borrowing temporarily from the central bank, which puts new notes into circulation for the purpose. Hence this borrowing is inflationary. But it differs from crude inflation in that it leaves the government under the obligation to repay the loan, *i.e.* to deflate to the original level, while the fact that the government has to pay interest on the loan ensures that it will restrict it to the minimum possible. Such borrowing from the central bank is sometimes called *disguised inflation.*

This fact, taken in conjunction with those which have gone before, leads to a result which would be somewhat comic if it were not for the scale of the disaster involved. Let us suppose a country which is importing more than it exports. According to the thrice-blessed theory of the gold standard it must deflate; that is, it must force down the price of goods until its exports compete more successfully in the world market. Very well, the

country obediently deflates—but this increases the burden of the national debt, and unbalances the budget. The government at first tries economizing, but this merely reduces purchasing power and depresses trade, causing revenue to fall and making the budget more unbalanced than ever. Finally the government is forced to resort to borrowing from the central bank. Result: inflation. Prices rise, the trade balance becomes more adverse, and so on *ad infinitum*.

The attempt to balance trade by deflation defeats itself. It does so because of the incompressibility of debt. Yet it is quite impossible to drive this fact into the heads of Treasury officials. France's economic history during the 1930's is of one abortive deflation after another, as we shall see in the following chapters.

And in a more general sense the moral (once again) is that the international gold standard is a snare and a delusion.

THE DANGER OF DEBT

One further moral may also be drawn from the contents of this chapter: countries should stay out of debt. If they cannot avoid external debt (as in war they cannot) yet at all costs let them avoid internal debt. A big internal debt is a permanent millstone round the neck of any country.[1] It is (to vary the metaphor) a channel down which money is continually flowing into the mill-wheel marked Investment at the cost of the channel marked Consumption Goods.

How then are we to explain the fact that there is a whole school of thought which brands as reactionary the orthodox theory that one must at all costs balance the budget? Lord Beveridge gives qualified approval to such a course and even the government White Paper on full employment tentatively mentioned it.

The proponents of the unbalanced budget start by pointing out that it is folly for governments to cut down expenditure in times of slump, thus adding to the general depression. Far better

[1] To illustrate how such debts persist, it is worth recalling that the people of Britain still pay an average of 10s. a head per year on account of money borrowed for the Napoleonic Wars.

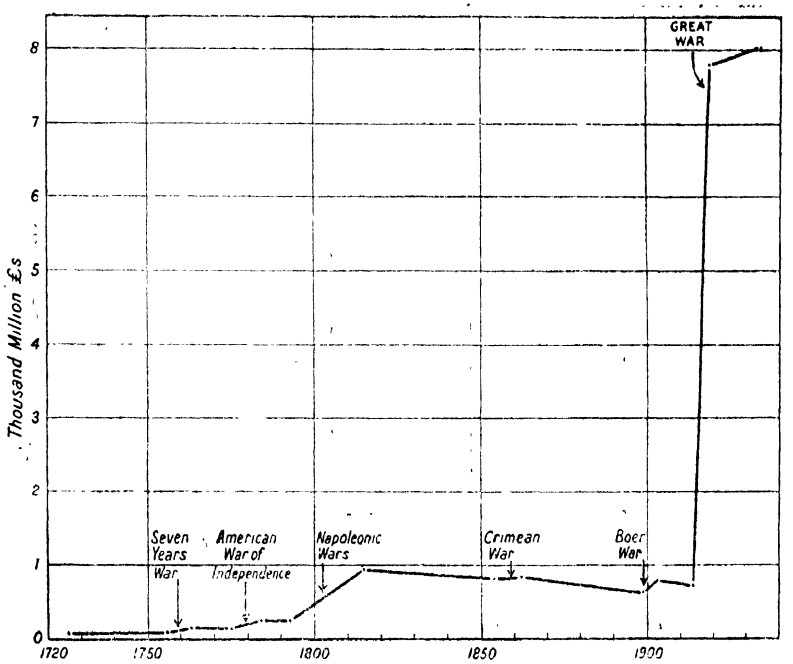


FIG. 26.—GROWTH OF BRITAIN'S NATIONAL DEBT (1).

While the gross amount of the debt grew from £52 million on the accession of George II in 1727 to £8301 million in 1934, the interest due grew from £2·4 million p.a. to £224 million p.a. in 1934. The second world war raised the total debt to £22,400 million in 1945—nearly three times as large again. (See next diagram.)

For comparison: the American national debt was $1,200 millions in 1915 ($11·83 a head); $28,700 millions in 1935 ($225 per head).

FIG. 27.—GREAT BRITAIN—INTEREST ON NATIONAL DEBT.

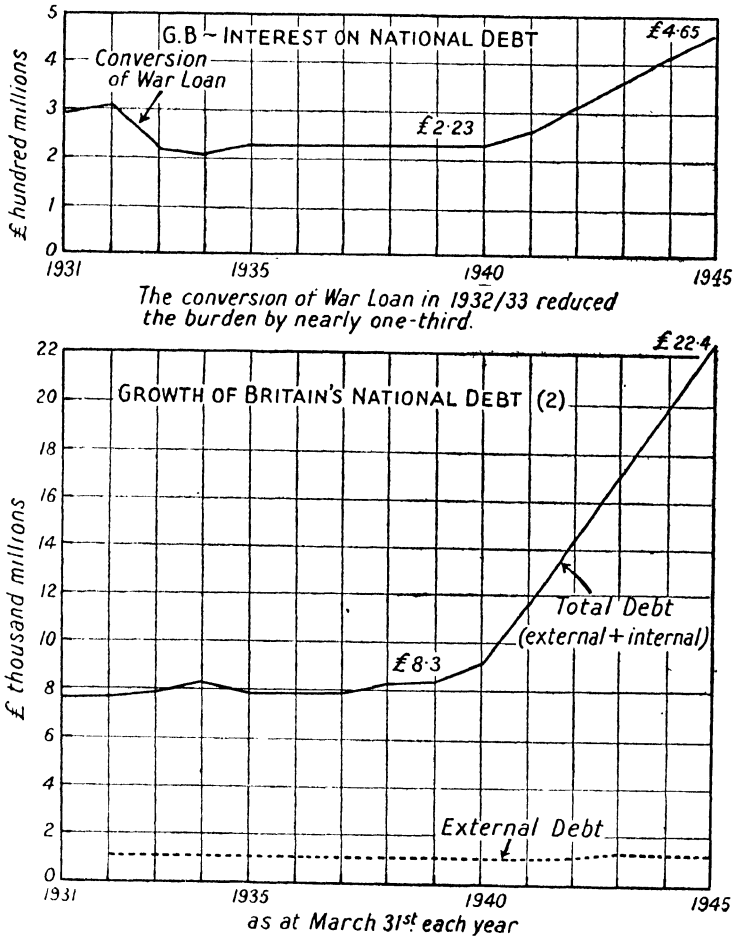


FIG. 28.—GROWTH OF BRITAIN'S NATIONAL DEBT (2).

Britain's National Debt has trebled in the course of the war; the interest due has about doubled. It represents about £500 a head for every man, woman and child in the kingdom. For comparison, the American National Debt (1944) was $201,003 millions ($1457 a head). External debt has increased but little, thanks to Lend-Lease and the sale of £1000 million of overseas investments.

if they actually increased expenditure, thus mitigating its effects. This is undoubtedly true. We must therefore modify our sweeping conclusion that the government shall not get into debt and say that it may get into debt in the slump, provided it gets out again in the boom.

But some writers go much further. They argue that there is no harm in a growing national debt, provided it does not grow at a greater rate than the national income. If this condition is observed, it can be serviced without any increase in taxation. Indeed they go further. They argue that if the effect of an unbalanced budget is to bring about a higher level of employment, revenue will increase and the government will be able to afford to pay the charges on a larger debt.

This seems to me to be entering on to dangerous ground. As a short-term policy it may be all right, particularly for a country in which the national debt is still small and where the danger of over-saving has not yet arisen. But we must not forget that national debts are liable to staggering increases in time of war, and so far no country has ever managed to pay its national debt off, or even reduce it by any substantial amount (except by the desperate device of inflation). In practice it seems that national debts tend to grow and grow until they become an incubus. It is therefore most unwise to add to them deliberately. To do so brings nearer the danger of over-saving. The case is altered, however, when the government spends money on capital goods of a sort which will subsequently bring in profits, such as on new building. The expenditure is then a form of investment and the profits will make it easier to balance the budget in future years. Hence there can be no more objection to the government getting into debt to put through such an undertaking than can be to an entrepreneur borrowing for a similar purpose.

It has therefore repeatedly been proposed that the government should not include such expenditure in the normal budget. It should have a second budget, a *capital budget* in which all capital expenditure on revenue-producing enterprises is accounted separately. It should be obliged to balance the *current budget* as before; on the capital budget it would have to show a reasonable 'dividend' in the same way as a private firm.

Besides being inexpedient, borrowing to balance a budget is morally wrong—in the sense that it does not conduce to a fair distribution of the available income. For what is really occurring, when we borrow, in terms of goods? Certain people, the lenders, are reducing their consumption of goods. If the government had raised the money by taxation this reduction would have been spread over the whole community, including the lenders themselves. In return for shouldering the whole of the economy, the lenders receive right to a larger share of the national income for ever after. Now even if we admit the justice of such an arrangement as long as it applies to the lender, we can hardly agree that his heirs and his heirs' heirs should receive benefit for an abstinence they never suffered. The ridiculousness of the proposition is seen when we take the extreme case. If a given group of lenders economize enough they can lay claim to the entire national income. The whole thing, is, of course, merely a particular instance of the inherent error in our whole system of investment.

This consideration enables us to see the sophistry of the claim that government borrowing is justified in war-time because it 'makes future generations pay for the war'. For in any sense of the words that has a real meaning the war must be paid for at the time, while it is being fought. Manpower is taken away from the manufacture of consumption goods, and devoted to the manufacture of armaments, the repair or damage of the expansion of the armed forces. The citizens of the country must in consequence do without many of the consumption goods they are used to and this sacrifice is the real cost (as far as the economics is concerned) of the war. It can only be borne at the time.

All that borrowing enables us to do is to shift the burden of the sacrifice off some shoulders on to others. Those who lend take on a heavier burden than they need: we reward them by preferential treatment after the war. The fallacy of the claim that future generations are being made to pay can be seen if we suppose that every person in the community lends equally to the government. Then, after the war, the government must take away from them in taxation and return to them in dividends precisely the same amounts.

Borrowing is a permissible device as long as incomes are equal. But in a country where incomes are unequal it merely enables those who are richest and who can therefore economize most easily to acquire a bigger income in perpetuity.

Summary

Britain's national debt, even before the second world war, absorbed one-third of all the money raised by the government from taxation and customs receipts; if it did not exist the income tax could be abolished. Part of it consists of external debt, owed for military equipment bought in the 1914–18 war; part of internal debt, that is money borrowed from British citizens by Chancellors unwilling to pay the costs of war or depression by taxation.

Since the debt item is incompressible, deflation increases the weight of the debt, and the debt sets a limit to the extent to which deflation can be pushed. This is why deflationary policies are always disastrous.

To meet the budget deficit, the Chancellor of the Exchequer can increase taxes, reduce expenditure, borrow or inflate. There is a limit to the extent taxes can be increased or expenditure reduced because to do so depresses business and reduces the tax yield. Inflation is virtually equivalent to raising taxation, but necessitates a painful deflation afterwards.

When Chancellors cannot borrow in the ordinary way they may be reduced to inflationary borrowing. Thus it often happens that an attempt to deflate unbalances the budget and brings an inflation, thus defeating its object. Thus deflation is not only a painful but may be an ineffectual means of balancing trade—a fact overlooked by the supporters of the gold standard.

18

Margin for Error

'How cheerfully he seems to grin
How neatly spreads his claws,
And welcomes little fishes in
With gently smiling jaws!'

THE PRICE-MECHANISM is supposed to bring about the matching of supply and demand, but even when circumstances are favourable this takes time. Hence there is need for a group of persons who specialize in *foreseeing* the trend of demand. The man who fills this rôle in a laissez faire economy is the *dealer*. When he anticipates an expansion of demand he begins to increase his stocks. The dealer usually purchases at something resembling an auction, so that when dealers in general are increasing their purchases, prices rise and encourage producers to enlarge output. Similarly when dealers anticipate a decline they begin to let their stocks run out and prices fall.

The dealer is also particularly useful in smoothing out fluctuations in supply, such as are apt to occur in agricultural production. If good weather causes an exceptionally abundant wheat harvest, wheat dealers take advantage of the low prices to stock up and thus provide a demand greater than would otherwise have existed. Similarly when harvests are poor, they dispose of their accumulated stocks.

Thus the dealer serves a valuable social function. He provides the farmer with a market when over-production occurs, and so prevents a disastrous fall in prices. He provides the public with goods when otherwise a shortage might have existed. It is true that he deprives the farmer of the large profits he might have made in a famine, but then he saves the farmer from a loss in time of plenty. Conversely, he prevents the price paid by the public from rising absurdly high or sinking absurdly low. In

short, the honest dealer acts as a kind of flywheel or balancing agent.

Nevertheless, the dealer has always presented an acute social problem. To begin with he represents a danger unless he is both honest and efficient. If the dealer guesses incorrectly and buys when he ought to be selling and sells when he ought to be buying, he will exaggerate price movements instead of minimizing them. (Of course, by so doing he will finally bankrupt himself.) Hence dealing should be confined to specialists. The entry of amateurs into the market causes widespread trouble. Equally the dealer must not attempt to distort prices, for instance by spreading rumours of a shortage when really a glut is expected.

Because of the useful social function of the dealer people have generally turned a blind eye to the very large profits to be made in successful dealing. The dealer is always buying cheap and selling dear, and the most skilful will make profits of many hundred per cent. When one looks at the number of dealers who have retired with fortunes, one wonders whether the service rendered could not have been obtained more economically. There is, above all, the danger that the dealer will become a parasite performing no useful work and taking the bulk of the profits. With the decline of competition, in many industries the wholesaler has become a useless link in the chain between producer and consumer. He makes assured profits in return for the negligible service of putting the goods on to the train to their destination.

For these and other reasons the Russians have made dealing a crime in Soviet Russia. This they are well able to do because they have other methods of estimating probable demand and controlling the volume of production. Even so, this is rather drastic, since some types of dealer also perform a useful task in searching out in one district goods which are wanted in another—the antique dealer is an example and so is the importer of foreign goods.

This brief description of the functions of the genuine dealer provides us with the background against which to consider two types of dealer for whom there is very little social justification: the speculator in land and the stock exchange operator.

SPECULATION

The function of the dealer is to foresee changes in supply and demand—so there can be little justification for the existence of the dealer in cases where the supply is invariable. If demand grows, the dealer makes a profit—but what service to society has he performed? It is true that if demand declines he may lose—but then nobody asked him to intervene. Dealing in such cases is not dealing at all. It is speculation. The true dealer minimizes price fluctuations. The speculator exaggerates them.

In no case is the unjustifiability of speculation more outrageous than in that of land, particularly in a country with a rising population. For as a country grows richer its land values rise bringing undeserved profit to the owners. The story is complicated by the fact that all land is not equivalent. One ton of wheat is much like another, but one acre of land cannot always be substituted for another.

Population movements may make one particular bit of land more valuable, another less so, hence it is possible for the speculator to miss his guess. This does not alter the fact that a speculator who succeeds in buying land which is going to be needed for building, the construction of a new road or railway or some other social purpose, holds the community up to ransom and performs no useful service.

The reader will perceive that these objections apply equally to the original owner of the land, who may not be a speculator at all. The honest farmer, whose land is wanted for building, is equally able to hold the community up to ransom. The trouble is that *in the last analysis* we still regard the land as the property of the community as a whole, despite the fact that we have been so foolish as to bestow it on private individuals. We do not admit the unlimited right of landowners to prevent the community living on the land or to prevent the construction of social services. But having made the mistake of giving the land over into the hands of a minority, when the community wants the land it has thus so thoughtlessly given away, it has to buy it back. The final solution of the problem of land speculation lies in the restoration of

communal ownership of the land. Since some people will take this remark to mean wholesale 'nationalization' of the land and will add thereto associated ideas (such as state farms) I hasten to add that communal ownership need only mean the leasing of land at nominal rents to its present owners, by bodies with a sense of public responsibility (cf. the stewardship of the National Trust). Such a change would have no effect, other than to preserve for the community the benefit of an increase in land values, and to make land available to planning purposes without such complicated questions of compensation as arise to-day.

The subject of land nationalization is a digression as far as this book is concerned, for it does not bear directly on the main subject, which is unemployment, and I shall not discuss it further. Indeed, the whole subject of speculation in land interests us here only because it helps to clarify the issues involved in speculation on the stock exchange.

THE STOCK EXCHANGE

Speculation in stocks and shares resembles speculation in land to the extent that the supply is invariable and also in that stocks and shares are not all equivalent.[1] An increased demand for one particular stock is not alleviated by the issue of stock in some new company. The dealer who correctly anticipates what stock the public is going to want does not thereby enable the public to get it any cheaper than they would without his existence. On the contrary.

The stock exchange does provide a useful service in enabling those who hold shares and are in need of cash to obtain it without delay, because naturally it often occurs that no one is willing to buy a certain stock on the precise day that the owner wishes to sell. The stockbroker fulfils a useful function in purchasing such stock and holding it until a customer appears. In the same way he makes it possible for a man to buy stock at will, instead of waiting until someone wishes to sell.

But just how useful is this service? Just how often is a man in

[1] There is no difference between stocks and shares except that shares are numbered and thus possess a kind of individual identity.

such a hurry to raise cash that he cannot afford to wait until a purchaser can be found? The truth is that only a minority of stock exchange transactions are concluded by people genuinely desirous of investing savings or in converting investments into cash. The great majority are purchases by people who hope that the price of the stock will rise and who intend to sell as soon as it has done so in order to repeat the performance with another stock. Hence it has truthfully been said that the chief service a stockbroker provides is a service to other speculators.

In the ordinary way, what causes the price of a stock to rise is an increase in its dividend, or the anticipation of such an increase. The price will normally stand at such a level that the purchaser finds his investment bringing him in $4\frac{1}{2}$ per cent or thereabouts. (The actual figure varies according to the degree of risk attached, the profitability of alternative forms of investment and other factors.) Thus if a certain company is paying 9 per cent dividend, its £1 shares or stock-units will stand at about £2. But it cannot be said that changes in the price of stocks always represent changes in the company's earning power. For the object of the speculator is not to buy stock in companies which *he* thinks will do well, but stock in companies which the public thinks will do well. And this he does even when he thinks the public to be sadly in error. Stock exchange speculation has been defined as the attempt to forecast what the majority of the people suppose the majority of the people will believe.

This fact may cause dangerous fluctuations in the price of stocks. The sale of a large block of stocks consequent upon the death of the holder may depress prices and cause nervous holders to sell out, depressing prices still further. Conversely, when the price of a promising stock begins to rise, speculators may rush to take advantage of the rise; the mere fact of their doing so suffices to drive the price still higher. When the more expert speculators judge that the price has gone as high as it is likely to go, they sell their holdings, precipitating a fall which carries the price far below its proper value.

But what, the reader may ask, does all this matter to the world at large? If amateurs are foolish enough to gamble and lose, so much the worse for them. Unfortunately stock exchange

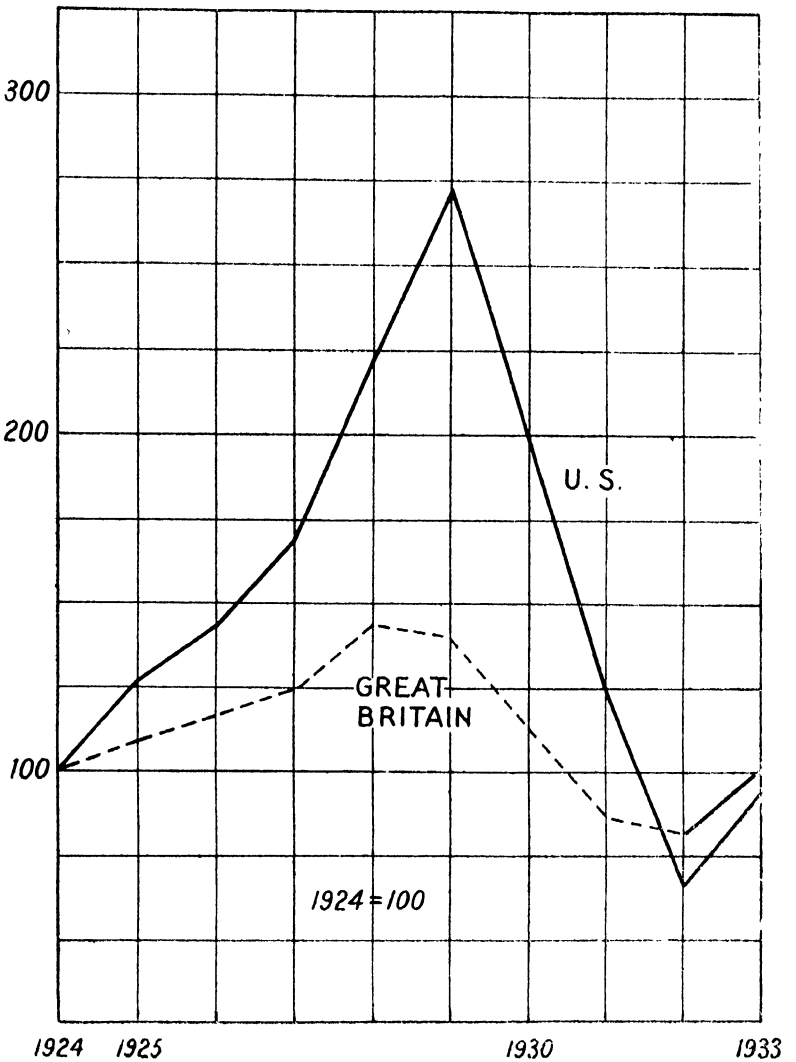


FIG. 29.—THE STOCK MARKET BOOM IN GREAT BRITAIN AND U.S.A. This was the boom of paper values which set the slump on its way.

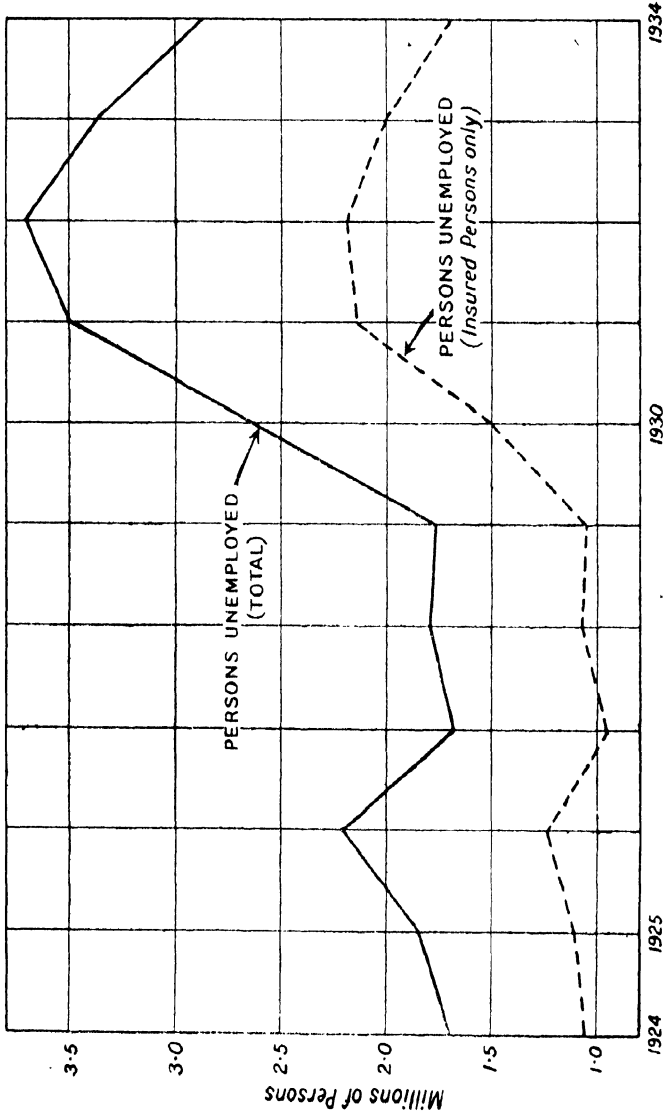


FIG. 30.—THE SLUMP: UNEMPLOYMENT IN GREAT BRITAIN.
There have been a lot of graphs showing unemployment figures printed in recent years, but most of them show unemployment only among those registered for unemployment insurance. Here a sample of these figures is compared with Professor Clark's estimate of total unemployment.

fluctuations may have consequences of the most far-reaching nature, as we shall now see.

STOCK EXCHANGE BOOM

So far we have considered only fluctuations in the price of single stocks, but it regularly happens in a period of general prosperity that stock prices as a whole begin to move slowly upwards in reflection, perhaps, of genuine increases in earning power resulting from prosperity. Such a movement is normal, but it may get out of hand.

If the public is in an optimistic, speculative frame of mind and has money to spare, as often happens towards the peak of a boom, they may turn in growing numbers to the stock market to invest their money—not with the object of drawing dividends but to take advantage of the price-rises which are in progress. Since the number of available shares is limited the entry of a considerable number of additional speculators into the market is enough to stimulate prices into rising much more sharply. This attracts more investors and prices rise more steeply still.

It is not the case that a runaway boom in share prices will *always* occur in a prosperous period. Perhaps it requires an exceptional degree of optimism, based on exceptional prosperity. Perhaps it requires an abnormally 'get-rich-quick' mentality on the part of the public. At any rate this is what occurred in the New York stock market in 1928, with results which we shall recount more fully in the next chapter. Prices rose to astronomical levels as more and more people hurried to buy shares. Thus more and more money was sucked into the vortex of speculation. It became increasingly hard to obtain money for legitimate industrial purposes as everyone was devoting their savings to speculation. At first only the United States was affected, but before long money was drawn out of Europe. Speculators transferred their short-term balances from London, Paris and Berlin to New York and in accordance with the gold standard mechanism, gold had to be transferred from these countries to America. The central banks of these countries reacted by raising interest rates to try and draw money in to fill the gap, but all they

succeeded in doing was to make money harder to borrow and thus to strangle their own trade. In the end the whole of the industrialized world was being starved of money that people might blow up a speculative balloon in New York.

The metaphor of a balloon is a good one, for the astronomical rise in stock prices had no basis in reality; the earning power of the companies whose stocks were being dealt in was unchanged. In some cases it was even falling. The values were simply paper ones. Prices were high because people wanted shares. And the reason they wanted them was simply because everybody else wanted them. It only needed a few people to lose their nerve and sell for the tightly-distended balloon to be pricked.

This speculative boom was made more serious in its extent and consequences by the practice known as buying 'on margin'.

BUYING ON MARGIN

It is customary on most stock exchanges to settle accounts not at the time of the transaction but on specified settling days which occur every two or three weeks. So a man who buys shares shortly after one settling day and sells them before the next, need put up no money. If the shares rise during the interval he receives a cheque for the difference without having had to put his hand in his pocket at all. If the shares fall in value, he need only pay the difference. (There is also a small fee and stamp duty to pay.) Even at the end of the two-week period he can take advantage of various devices for carrying the transaction over for another two weeks, at the cost of a small charge.

Since transactions can only be performed by members of the stock exchange, it is necessary for the speculator to have the confidence of a broker, since the broker will have to meet any loss on the transaction if the speculator fails to pay up. Consequently the broker may ask the speculator to put down a deposit, and reserve to himself the right to sell the shares if they fall in value sufficiently to absorb the whole of the deposit. This is called buying *on margin*. It enables the man with £100 to spend to buy £500 or £600 worth of shares and greatly increases his power to gamble.

The danger in a general inflation of stock market values on these lines is that the speculators holding shares with high market values believe themselves to be rich. They take it for granted that they can easily sell out and fill their pockets with cash. But in reality only the first few who sell can realize cash at current prices. If everybody were to try and sell, there would be no buyers and prices would slump almost to zero. And, of course, it only takes a few people trying to realize their holdings to bring the boom to an end. As soon as a few people sell out, prices begin to hesitate, cease to rise. At once a good many people decide the time has come to sell. Prices fall sharply: at once everyone throws their shares on the market in a wild rush to get out before prices are any lower. The whole house of cards collapses. Such a stock market collapse takes place with sensational speed when it comes, and the higher the balloon was blown the faster it collapses. In the New York stock market crash the price-gains made over two or three years were lost in a few hours.

When this happens, prices fall to unprecedentedly low levels and even those who held shares as a genuine investment are impoverished unless they can afford to wait until the return of normality. Those who bought on margin or borrowed from the bank in order to speculate are ruined, for their brokers will not have time to sell their holding while it is still covered by the 'collateral' deposited and they will have to sell or mortgage their personal property to raise the money to cover their debts.

Moreover, since the mass of speculative investors do not realize that ninety-nine per cent of them are doomed to ruination they embark on expenditure which they cannot really afford, for what they are spending is money they have not yet obtained. They reduce their reserves of ready cash or pledge their credit against the expectation of being able to settle by selling stock. What is even more serious, they undertake contracts stretching into the future, such as the rent of a house or hire-purchase arrangements, and these are unable to keep up, with adverse consequences on those who have given them credit. A stock exchange crash is followed by a wave of bankruptcies.

In short, public speculation in the stock market may have

the widest repercussions on prosperity and is an unmitigated evil however you look at it.

BULLS AND BEARS

This system of settling transactions at the end of a period has another result.

A man who buys stocks or shares expecting a rise in the price is called a *bull*, and the transaction is a *bull operation*. But it is also possible to deal in shares in the hope that the price will fall. For if a broker is asked by a client to supply him with a certain number of shares at the current market price, the broker knows he does not have to make delivery until settling day. If he expects that before that day arrives the price will have fallen, he naturally postpones obtaining the shares he has undertaken to deliver until the last possible moment in order to take advantage of the fall.

To sell shares (or anything else) which you have not yet bought, in the hope that the price will fall before you are obliged to conclude the deal, is called *selling forward* or *selling short*. The man who does it is a *bear;* the operation is a *bear operation*. From the point of view of the buyer the stuff sold is called forward stock, forward dollars, forward wheat, according to what the deal is in, and stands in contrast with spot wheat, spot dollars, spot cash etc. which are commodities bought for immediate delivery. (If the buyer himself expects a fall in price he may insist on being charged less than spot prices.)

When a boom in a particular stock (or commodity for that matter) is nearing its peak, brokers may sell it short, and then deliberately throw their own holdings of stock on to the market in order to cause a price-fall. In itself this price-fall would be insufficient to bring them a profit on their forward sales sufficient to justify the operation, but the chances are that once the price-movement has been reversed the public will take fright and sell out causing a substantial drop in the price. As long as prices are rising strongly, the operators will prefer to hold on to their shares to take advantage of the rise, but when the price begins to level off there is a strong temptation to convert it into a slump by operations of this sort.

Manipulations of this kind are widespread and an immense part is played in them by rumour. In fact, the majority of the price fluctuations on both stock and foreign exchanges are caused not by real changes in the prosperity of firms or nations but by quite baseless rumours about what is going to occur.

Many of these rumours are the result of the over-nervous attitude of professional dealers who anxiously reckon the possible consequences of every trade and political development, and each new theory as to what will happen is passed rapidly round. But others are started deliberately, and this is true equally of dealers in produce as of dealers in securities. If, for example, a big group of dealers expects a shortage of a certain commodity and consequent high prices, they may spread false rumours that there will be a glut, at the same time making heavy sales forward—if necessary, to persons with whom they are secretly in league. This forces prices down, and the uninitiated speculators, thinking the big operators have inside information, hasten to follow their example, causing further price-falls. Meanwhile the big operators privately buy up all they can in small lots. When prices have sunk as low as they are likely to, they begin to buy publicly also and may manage to corner a large part of the supply.

By this time the shortage which they secretly expected materializes, and prices begin to rise; but since the big operators hold the bulk of the supply they can refuse to sell, intensifying the shortage and forcing prices still higher until they reach a level at which they will consent to sell. In this way they both buy at artifically low prices and sell at artificially high ones, the money they make being abstracted from the pockets of producers and consumers alike. Clearly the dealer who behaves in this way is simply acting as a parasite on producers. The honest dealer serves a purpose by minimizing price fluctuations. The dishonest dealer intensifies them.

Selling short has the danger that the operator may undertake to supply more shares (or commodities) than he will ultimately be able to obtain, in which case he cannot keep his contract except by offering fantastic prices to the owners. He is therefore faced with the alternative of ruin or disgrace, since thenal peties

for non-fulfilment of contract are usually withdrawal of the licence to operate.

It was by making use of this fact that the millionaire Vanderbilt laid the foundations of his fortune. A financier named Drew had the idea of persuading corrupt members of the New York Common Council to sell Vanderbilt short on stock in the New York and Harlem railway and then to revoke a city ordinance which permitted Vanderbilt to run a tramway in connection with it. They calculated that the closure of the tramway would cause the shares of the railway company to slump: they would then be able to buy them at a lower price than they had undertaken to sell them at.

Unknown to the council, however, Vanderbilt already held all the shares in the railway himself. He therefore steadily 'bought' from the council, who, when the day for delivery came, were naturally unable to obtain any shares with which to make delivery except from Vanderbilt himself at his own price. He took 500,000 dollars off Drew alone. This incident was repeated a few years later in connection with the Erie railway, the instigator again being Drew and the conniving parties members of the senate.[1]

Coups such as these harm only the professional pirate engaged and we need waste no pity on them. But it can happen that their financial operations embarrass the companies whose shares are being manipulated and interfere with the flow of productive economic activity to the loss of the community as a whole. This is frequently the case when the manager of the company is himself a dealer or speculator. For instance, the financier Drew, mentioned above, obtained control of the Ohio and Erie railway simply in order to manipulate its shares. Having allowed the company to get heavily into debt he would announce one day that it would meet its debts, whereupon the shares would go up, the next that it would default, whereupon they would fall. By buying and selling in opposition to the public he restored his personal fortunes, at the cost of the company's.

[1] For further details of the methods of Drew, Vanderbilt and others of their kidney, see the fascinating group of thumbnail biographies in H. G. Wells' *Work, Wealth and Happiness* in the section titled 'Short Studies in the Acquisition of Wealth'; and for more modern instances, Pecora's *Wall Street Under Oath*.

STOPPING SPECULATION

It is impossible to resist the conclusion that these piratical excursions have no place in a sane economic system. At best, they are a waste of energy and ability; at the worst they handicap the productive process, upset the financial system and play a part in spreading depression and disaster throughout the world. Figures gathered in the United States show that the bulk of the income of people earning more than £50,000 a year comes from stock exchange speculation and allied practices. Thus speculation is also revealed as an important factor in bringing about the maldistribution of incomes which is the proximate cause of over-saving.

But how is speculation to be checked? At first sight the task seems almost impossible. We have said the prime condition is that the dealer shall know his job; the amateur must be excluded. But how can the public be excluded from buying shares? Once you grant freedom to buy and sell the rest follows inevitably. The most you can hope to do is to make speculation more difficult. For instance, you could forbid the practice of buying on margin and of carrying over transactions (as Britain has in fact done for the duration of the war); you could make bear operations more difficult by increasing the number of settling days; and you could increase the stamp duty so as to discourage rapid buying and selling of stock.[1] But these are, at best, palliatives.

The problem seems insoluble only because we take for granted the whole mechanism of financing companies by the issue of shares carrying limited liability. Yet this system is less than a hundred years old. There is nothing inevitable about it. Speculation is merely one more black mark against this system which we have already criticized on other grounds. Speculation will only vanish when we change the system. Before 1856 you were liable

[1] It is interesting that on the London stock exchange fortnightly settling days were reinstituted as from Jan. 1, 1947—that is, at the end of the longest bull market in stock exchange history, during which the restrictions had little effect on speculation, and just in time for the subsequent bear market, when the restrictions might have been some use.

for the whole debts of any company in which you invested, should it go bankrupt. To meet the need for capital in a rapidly expanding economy, it was ruled that you were not liable for more than the amount of your investment. Hence sprang up the modern practice of financing companies with thousands of contributions from different individuals. The consequence of the practice of selling these fragments of ownership is that the ownership of industry is perpetually changing as individuals try and make themselves owners of the most prosperous firms. In this struggle some are bound to lose—to be left with the dying firms.

What is the social value of this perpetual struggle for security? None, for it is just those who most need security—the proverbial widow with her small investment gives us the picture—who are left holding the baby. The big full-time dealer, in touch with the market reaps the advantages. If, as suggested elsewhere,[1] we provide a general pool of investment funds, paying a standard dividend, the temptation to play at this game of snakes and ladders vanishes. Those who do not wish to take advantage of the pool can invest independently—but must retain their investments, for better or for worse, as they have always had to do in the past. The word ownership will then regain its true meaning.

[1] Chapter 22, p. 379.

19

Scenario of the Slump

'Oh, you can't help that,' said the Cat. 'We're all mad here. I'm mad. You're mad.'

THE ECONOMIC disasters of the period 1919–39 cannot be blamed on the first world war, though it did much to intensify them. On the other hand these economic disasters did play a significant part in bringing about the second world war, and a repetition of them in the years to come might well help to bring about another. It is therefore of considerable practical interest to study the mistakes that were made and learn from them.

The story of the inter-war years will also give a practical illustration of the theoretical principles which we have been considering in the foregoing chapters; we shall notice how the interaction of one national economy on another often causes the development of the trade-cycle to depart from the simple 'type' pattern which we have described.

Already before the first world war great changes had been taking place in the world's trading structure. Primary producing countries were industrializing themselves; technical progress was rendering older industries obsolescent or, anyway, reducing their importance. For instance, the development of hydro-electric power and oil, as well as the opening up of new coal-fields, reduced the market for British coal. The erection of cotton spinning mills in India and Japan forced contraction on the Lancashire mills. The advance of industrialization in Australia and South Africa reduced the market for British engineering and manufacturing industries.

The war aggravated the structural problem; for many countries, finding supplies cut off from the belligerents, started new industries to supply their domestic needs and even sought to capture the

belligerents' former export markets. But when peace was restored they were unwilling to restore the status quo and imposed tariffs to protect the upstart industries, thus leaving the belligerents with excessive export industries.

What made these structural maladjustments far more serious than they had ever been in the past was the fact that the long phase of imperialist expansion and population growth had now come to an end. While the system was rapidly expanding, the loss of a market merely meant that the industry concerned grew less rapidly than others: the decline was relative, not absolute. The industry affected might have to cease growing but it did not actually have to contract. But by 1914 several national industries were faced with absolute contraction; by 1920 many were.

Why this structural readjustment constituted such a problem was that the export industries refused to undergo the contraction forced on them. In theory, the inability of firms to sell their goods should have forced them into bankruptcy, or at any rate into switching over to new fields of production. In practice, entrepreneurs hung on even at a loss; wage-earners accepted cuts in wages; stockholders put up with non-payment of dividends. Consequently great swamps of depression continued to poison the national economy.

This problem of structural readjustment has now arisen with redoubled force after the second world war and if not tackled will undoubtedly inflict new misery.

The burden of these structural readjustments was made more onerous by another factor: the action of the self-regulating system. For when a country failed to export it soon developed an adverse trade balance, whereupon the self-regulating system imposed a deflation which was supposed to restore the balance of trade. It reduced imports by reducing prosperity. Thus non-export industries were blanketed by depression throughout the 'twenties and this naturally made it much harder for labour, enterprise and capital to leave the export industries. A worker who left the coal-fields or the shipyards had little prospect of getting a job elsewhere; so he preferred to stay in the coalfields and work part-time.

Britain, as a great exporting country, suffered especially

acutely from the existence of these pools of industrial stagnation, 'depressed areas' as they came to be called. Unfortunately, it was not only that the great British export industries were quite unwilling to accept their fate and that they had sufficient influence to prevent the government making any attempt to speed up their contraction. Still more were British financial interests opposed to a reconstruction of British industry, for the change had colossal implications. If industry was to manufacture for home consumption, wages would have to be raised and profits reduced; the foreign lending which created the demand for British heavy exports would cease. In short, it was asking industry and finance to give up the 'jam to-morrow' policy on which they had battened for so long, and the power and security that it offered them, in order to create work and employment for the mass of the population.

The logical counterpart of a policy of reviving export industries would have been to under-value the pound, so as to make exports cheap in the world market. The paradox is that Britain returned to the gold standard in 1925 with an over-valued pound and thus entered the critical years with mutually inconsistent industrial and financial policies. How this came about we shall see in due course.

PLIGHT OF AGRICULTURE

These structural maladjustments attained a peculiar intensity in the case of agriculture. The development of food production in Australia, New Zealand and the New World had already turned most of central and south-east Europe into a vast rural depressed area, to say nothing of the Caribbean and the Far East.

Over and above this, the growth of biological knowledge was bringing about astonishing increases in productivity per acre and per man so that agriculture was beginning to produce more food than could be consumed at the current level of demand. To correct this it was necessary to transfer labour and capital out of agriculture into industry. But many of the agricultural countries did not have the technical knowledge, the capital, the financial machinery or even the political stability to create

industries to absorb the surplus labour. It is a task that cannot be carried out overnight.

Furthermore, during the war many countries had increased their output of food and when peace came proceeded to protect and even enlarge their agriculture. For all these reasons during the 'twenties the world found itself able to produce more food than could be consumed. At first some of the surplus was absorbed by higher standards of living, while various restrictive schemes were set on foot to reduce output; but around 1928 many of these schemes broke down while the world was blessed with a series of bumper harvests. As a result over-production became serious and farm prices began to sink. Unfortunately the farmer (including the grower of coffee, cotton, rubber and so on) reacts to a price-fall by increasing production, hoping to maintain his income by selling a larger amount at the smaller price. Hence over-production soon becomes catastrophic.

Since some sixty per cent of the world's population is engaged in agriculture a fall in the price of agricultural produce not only inflicts misery on a large number of people but also, by reducing their power to buy manufactured goods, speedily reacts on industry and generates depression there as well.

The fall in agricultural prices hit the United States farmer with especial violence, for while he had to sell his output at the low world prices he bought his manufactured goods in America where prices were steady. Thus in 1928 the prices of U.S. farm products were only 39 per cent above the pre-war level while the prices of goods bought by farmers were 56 per cent above it. Hence there was a strong tendency for American farm workers to leave the land and seek work in the towns, intensifying urban unemployment.

Parallel with this great structural problem which was, for the most part, nobody's fault but was the inevitable consequence of economic and technical progress, there were a number of monetary problems which were by no means inevitable but were created by the complacency, ignorance and selfishness of those who rule our economic destinies. Of these the most serious was the shortage and maldistribution of gold.

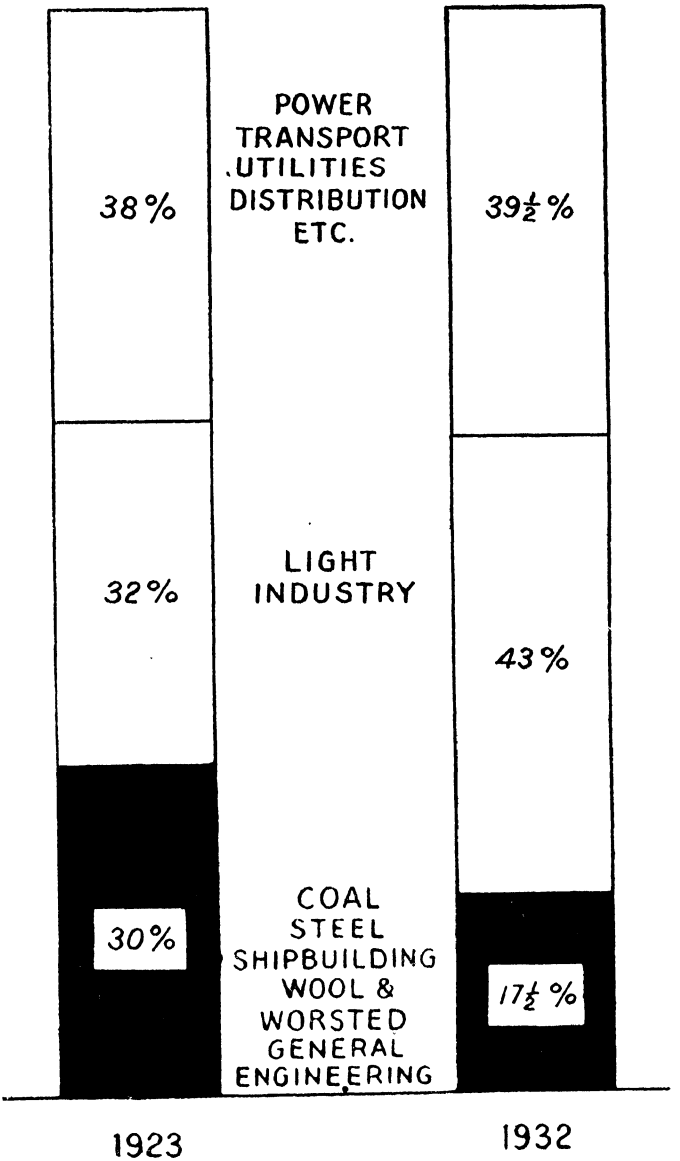


FIG. 31.—HOW BRITAIN'S INDUSTRIAL STRUCTURE CHANGED

WORLD GOLD SHORTAGE

Underlying most monetary problems in the inter-war years was the fact that the supply of gold was unequal to the demand for money.

Every year, owing to increasing output and increasing population, the world needed 2 per cent to 3 per cent more money—but the supply of new gold (as explained in Chapter 9) was decreasing. Thus when peace was signed, the broad general outlook was a deflationary one. The Gold Delegation of the Financial Committee of the League of Nations calculated that there would be a gold deficit of $34 million by 1940 if trade increased 2 per cent per annum, and of $170 million if trade increased 3 per cent per annum during the period.

As we have emphasized, a deflationary situation is stifling to trade whereas an inflationary one stimulates it. Since the main job after the war was to get trade going again, there was everything to be said for avoiding deflation and even engineering a mild inflation. But what actually happened was that the nations which had suspended the 'self regulating system' during hostilities hurried back on to it, and thus committed themselves to an era of slowly falling prices. They took what steps they could to economize in the use of gold and to make an inadequate supply of gold provide an adequate supply of credit; but, on top of this general shortage, which was more a potentiality than an actuality in the early 'twenties, there was another factor affecting the price-level far more drastically: the maldistribution of such gold as there was.

WAR DEBTS

Already before the war America was becoming a creditor nation. The war greatly accelerated this development: since during the war the U.S.A. had sent, without payment, large quantities of aircraft, guns and shells and other equipment to the Allies, now that the time for repayment had arrived it was the job of the Allied countries to send manufactured goods to the U.S.A., also without payment, for a debt of goods can only be paid in goods.

The mechanism by which this would normally be accomplished was for Europe to send gold to America in payment of part of its debts, and for America to use this gold to buy goods from Europe; the Allies having thus got the gold back again would use it to pay a further instalment and so on. The same applies in the case of reparations owed by Germany to the Allies.

But suppose America refrained from buying in Europe with the gold she received? According to the classical theory the gradual accumulation of gold in her central bank would cause the issue of more currency and U.S. prices would rise. This would enable European producers to undersell American producers with the result that European goods would flow into America and the gold would seep back in payment.

Unhappily for theory, American producers did not relish the idea of a flood of cheap European goods entering America and competing with their own products. They insisted on steps being taken to keep the European products out. Similarly the Allies objected to being flooded with German-made goods, Since this question of repaying debts has arisen again on an even more extensive scale after the recent war, it is worth seeing just why it proves so unwelcome in practice.

The first difficulty is that the repayment of these huge debts involves changes in the industrial structure. If Germany is going to supply America with, let us say, 100,000 typewriters then obviously some American typewriter factories will become redundant. What you would be obliged to do in a rational settlement is to make a list of all the goods America requires, and then allocate their manufacture between the two countries, America and Germany, together with any other countries involved. You may say: Germany shall produce the typewriters, and America will make the television sets, in which case America will have to turn her typewriter factories into television set factories. Or you may rule that the onus of the change shall rest on the debtor, in which case Germany will have to undertake the manufacture of televisors. Under the existing system, the onus of changing the industrial structure is forced on the creditor; the process being that he finds his typewriter factories undersold by the debtor country.

It is completely fatuous to talk of 'making Germany pay in goods', as is stated to have been agreed at the Moscow Conference in 1943. These huge debts can *only* be paid in goods. The existing monetary mechanism whereby the debtor country is declared to owe so much money, the idea being that that money will be used by the creditor to buy goods from the debtor, is merely a convenient device for bringing the payment in goods about, and has the advantage of greater flexibility. The problem would arise just as acutely if Germany did 'pay in goods'. If ship-loads of free German typewriters were distributed in England, British typewriter manufacturers would complain loudly.

The idea that these huge debts can be paid solely in money is naïve, because (*a*) there isn't so much money in the world, and (*b*) it is no use to the creditor country if it cannot or will not spend it.

It is possible for Germany to pay a large debt with a small amount of gold if every time she sends the gold to America, Americans spend it buying German goods. Thus the gold returns to Germany and can be used to pay a fresh instalment on the debt. This process is repeated indefinitely, the net result being that a stream of goods flows from Germany to America. But if America holds on to the first instalment of gold, the whole system breaks down. Money is like a conveyor belt bringing you goods. To hold on to the money is like reeling in the belt instead of letting it run back to the starting point underneath the rollers. When you have finally reeled in all the belt, the supply of goods ceases. You have made the mistake of confusing the *means* of payment with the payment itself.

The American citizen demanded the payment of war debts (and the Allied citizen demanded the payment of reparations) because he believed the arrival of the money would enable him to go out and buy the refrigerator or radio set which he wanted. This, of course, was an illusion. As long as foreign goods were kept out the arrival of the money would only have caused a price-rise. On the other hand, if the cheap goods from Europe had been admitted his existing income would have gone farther and thus he would have reaped the benefit.

Allied policy to Germany (and American policy to the Allies)

was therefore completely unrealistic: they believed they wanted reparations, but when it came to the point they didn't.

There was even a further contradiction. If the Allies really wanted Germany to pay reparations, they should have taken care, in their own interests, that the German productive machine was undamaged. But the French went to the peace conference with the fixed determination to make Germany militarily powerless. To this end they deprived her of most of her coal and steel, her merchant fleet and much other industrial equipment.

Indeed, the Allies' policy to Germany was based on a threefold contradiction: first, they imposed reparations to please the British ('squeeze them till the pips squeak' was the cry); then to please the French they tried to wreck Germany's productive machine and therewith her power to pay reparations; finally America lent her the money to rebuild the wrecked productive machine—but refused to take delivery of the goods which consequently accrued. To impose on a country the obligation to make goods, to ban it from consuming the goods itself and to refuse to take delivery of the goods yourself is to impose on it disastrous unemployment, economic breakdown and a bitter sense of frustration. I make no plea for Germany; I merely draw attention to the obstinate fact that in economics the only way you can have your cake is to eat it.

All this was perfectly clear to the economists at the peace conference. John Maynard Keynes foresaw the results of this idiocy and wrote a book, *The Economic Consequences of the Peace*, which ought to be compulsory reading to-day.

As I write, the story is repeating itself; the demand is heard: render Germany powerless, and also the demand: make her pay for the war. When will people learn that you can do one or the other, but not both?

What occurred in practice was this. As soon as the belligerent countries had somewhat reconstructed their industry they began to try and sell goods to America, but the U.S.A. soon erected tariff walls to keep them out. America steadily accumulated gold as war debt instalments were paid; at first she lent this back to Europe (and also to South America) and in this way Europe again received the counters with which to make further war debt

payments. Above all, she lent to Germany to help her reconstruct her industrial system which had been disrupted not so much by the war as by the demands of Clemenceau. But soon there were no further opportunities of investment left in Europe. Europe had borrowed all it could stomach. In consequence, gold immediately began to pile up in the vaults of the American banking authorities. At first this led to an inflation of American prices in accordance with the principles of the self-regulating system. But after a while the financial authorities became alarmed and decided not to issue any more currency against the gold received. As the bullion arrived from Europe it was put away in underground vaults at Fort Knox in Kentucky and was never heard of again. This was called 'sterilizing' the gold. France, too, because she had under-valued the franc and because of payments from Germany, was able to accumulate very large quantities of gold and also resorted to sterilization. *By 1928 nearly two-thirds of the world's gold supply had been sterilized in this way.*

Naturally this greatly intensified the shortage of the metal; it also prevented the self-regulating system working as it should—it prevented the rise in prices which should have enabled European goods to flow into America and restore the balance of trade.

The decision of the French and American authorities was crucial: it made disaster inevitable. It scuttled the only system of international trade regulation in existence without substituting anything else and so rendered inevitable the attempt of every country to reconstruct its economy on a national basis during the 'thirties. It was, in fact, a primary cause of the war. Yet the blame cannot be placed solely on the French and the Americans. It belongs to every country which clamoured for reparations without having any intention of accepting them in the form of goods when the time came.

During the period 1920–30, then, we must picture the world's gold draining out of Europe, silting up in France and America, forcing prices down and down, making trade ever harder to carry on. And all the time the debtor countries are faced with the increasingly difficult task of finding yet more gold with which to pay their debts. Economists and financial authorities everywhere were perfectly aware of the impossible state of affairs

which was developing, but what could be done? The initiative was in the hands of the United States. Either the American industrialists must permit goods to come in, or the American government must cancel the debts.

But the American man in the street, long accustomed to think in terms of money rather than goods and subject to propaganda from big business, bitterly resented the idea of a 'default' on what seemed to him his just debts. The American government did not dare either to cross its industrialists or to risk the displeasure of the ordinary consumer; other creditors of Germany behaved similarly. And so the world careered on towards the slump.

THE BURDEN OF INTERNAL DEBT

Finally there was a third major source of trouble—the existence of huge internal debts. Since during a war the quantity of goods available to the public in the belligerent countries was much reduced, it was necessary to reduce the public's purchasing power. Only part of this reduction was achieved by means of increased taxes; the remainder was made by means of borrowing; that is to say, people lent to the government money which they might otherwise have spent, to be paid back after the war. Even this did not bring the reduction to the required point, and as a result the price-mechanism came into operation and prices rose until equilibrium was restored. In Britain they rose to roughly three times the pre-war level.

As a result of this borrowing the interest on internal debt had come to comprise nearly 40 per cent of the total budget and the government was left with little for the reconstruction which was urgently necessary. To raise taxation further would have been no solution, because it would have reduced buying power and depressed business. The fact was that the creation of war debt had caused a large amount of income to be transferred to people who were more disposed to invest it than to spend it on consumption goods. The Investment/Consumption ratio had moved still farther from the equilibrium position.

In this dilemma, one way of escape lay open: to inflate and devalue so that the internal debt formed a smaller proportion to

the budget; but such a course was a partial default on the debt and was certain to arouse the bitter opposition of those to whom the debt was owed. It had one more serious disadvantage. Large sums of money were owed to countries abroad, especially the U.S.A., the price of which was fixed in the foreign currency; devaluation had the effect of increasing the weight of such debts, since a larger and larger number of francs or pounds would be required to obtain the given amount of dollars.

In a nutshell, then, the position was that the various governments had got themselves into the fatal position of owing big internal debts. In this dilemma there is no honourable way out; you are faced with the alternatives of default or collapse.[1]

WHAT THE BELLIGERENTS DID

In this impasse some countries chose default, others tried to honour the debt.

Or, to put it another way, some countries chose the sensible course of refusing to honour an unjust commitment which should never have been made; others condemned their entire populations to depression in order to preserve the rights of a wealthy minority.

France and Germany, notably, chose inflation. Germany carried the inflation to the utmost extreme until her currency became worthless, thus wiping out her internal debt entirely. France inflated to a more moderate degree, and stabilized at five times the pre-war level. Freed from the burden of debt, she prospered exceedingly.

Britain, on the other hand, chose deflation. Exports were down to one-fifth of the old volume; the national debt stood at £7800

[1] Apart from the dubious ethics of war loans, anyway, in the 1914 war they were made the occasion of a disgraceful ramp. The banks invited clients to *borrow* money from them at 3 per cent with which to buy war loan at 3½ per cent. Obviously any war loan bought with money created by the banks for the purpose does nothing to reduce purchasing power. All it does is to put the country in debt to the banks (with a ½ per cent commission to the tools in the transaction) for no earthly purpose. It is actions like these which shatter the banks' claim to be acting in the public interest. (See *The Capitalists and the Nation* by Tom Johnston, M.P., for further variations on this theme.)

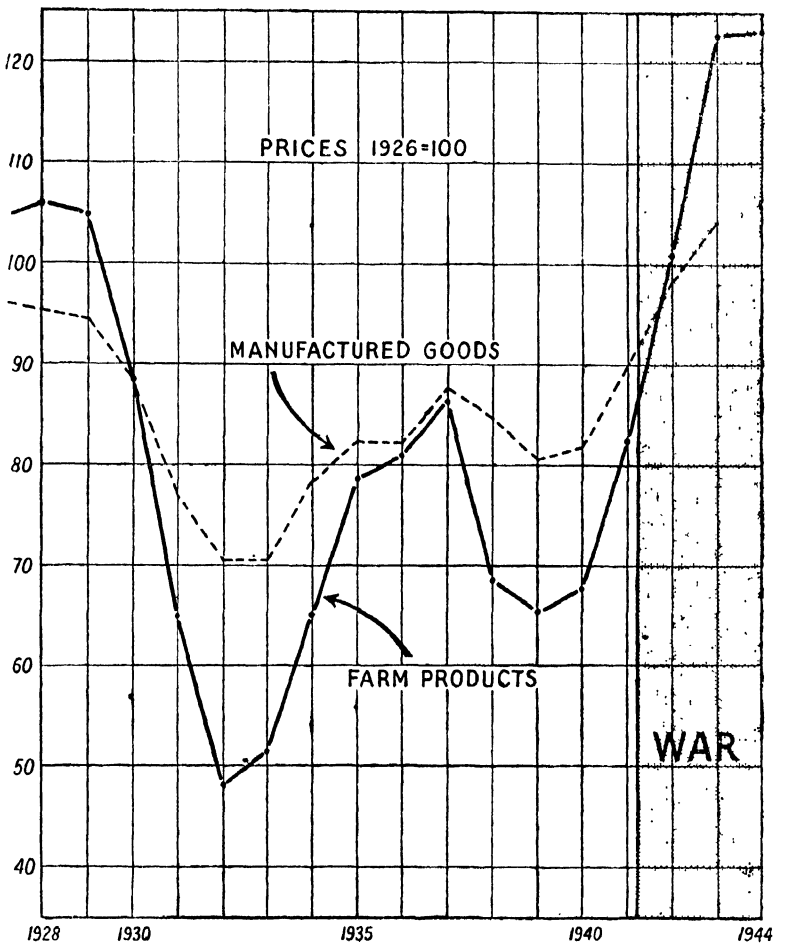


FIG. 32.—THE U.S. FARMER IN PROSPERITY AND DEPRESSION (1).

Throughout the 'thirties the U.S. farmer was selling at prices which were lower, relatively, than those at which he had to buy the things he needed. Hence farmers' real incomes were reduced and their purchases of manufactured goods declined, thus spreading depression to industry. The war, however, reversed this trend.

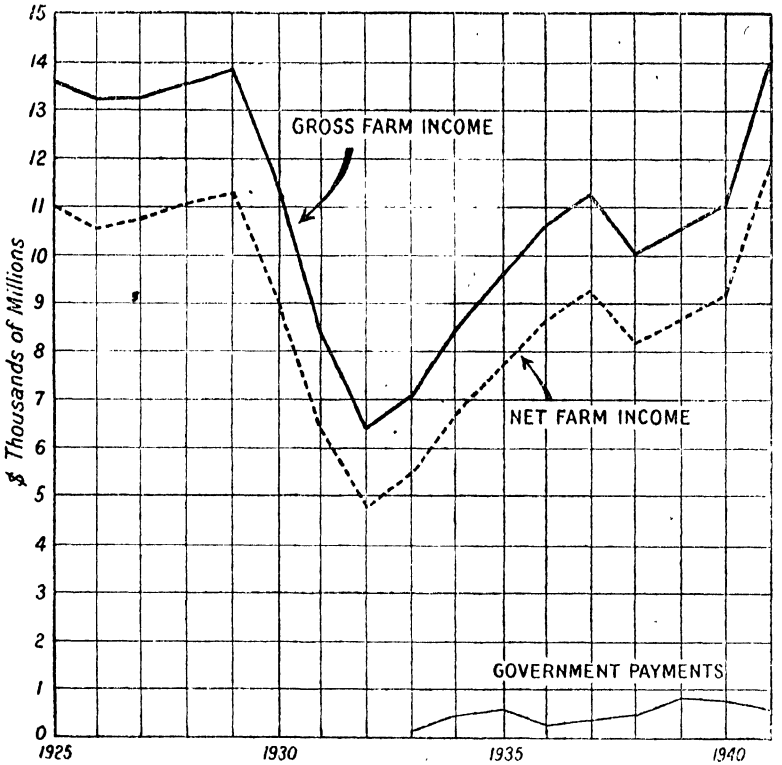


FIG. 33.—THE U.S. FARMER IN PROSPERITY AND DEPRESSION (2).

Net farm income is derived from the sale of crops and livestock and from government subsidies to the farmer. Gross farm income is net income plus rents and plus the value of farm produce consumed on the farm.

Note how farm incomes fell by one half—an enormous decrease—between 1929 and 1932.

million—nine times the pre-war level. Despite these strong motives for inflating, the authorities would not even consider stabilizing at the new level. Instead they sought to force prices down to the pre-war level. In a year British prices were forced down to 64 per cent of the 1920 figure and the fall continued until by 1931 the objective had been achieved and they stood at 34 per cent of the 1920 figure, or about the same as 1913. So 1931 must have been a year of great self-congratulation for the British financial authorities.

Since the volume of credit depends chiefly on the loans made by banks to industry, this deflation was achieved by cutting off these loans—at a time when the sane thing to do was to encourage the adaptation of old factories and the erection of new ones so as to absorb the men being demobilized from the army and the labour being discharged by war factories. One of the ways in which credit is restricted is by raising the cost of borrowing, and since interest rates depend on the bank rate, we can read this deflationary story in the bank rate, which was put up to $4\frac{1}{2}$ per cent in 1925, and subsequently to 5 per cent, $5\frac{1}{2}$ per cent and even higher.

Undoubtedly the reason for this suicidal policy was that the British authorities were chiefly interested in the external significance of the pound's valuation, and especially in its relationship with the dollar. The higher British prices were allowed to remain, the larger the number of pounds which must be surrendered to obtain a given amount of any other country's currency. By forcing down British prices it was possible to relate the pound to gold at a high value and so magnify the City's power to make foreign loans, thereby increasing its power in the world of international finance. The vast lending now being done by New York threatened to make it the world's financial centre, and the City was ready to sacrifice every other interest to retain that position.

In addition, of course, this policy had the great attraction of restoring the real value of investment incomes.

Had the bank been able to force down prices sufficiently the pound, even at its high value, would have become under-valued; that is, the prices of British exports would have been low in terms of foreign money and export trade would have been

stimulated. What defeated the bank's intentions was the steady fall in the world price-level. As fast as British prices fell, world prices fell even faster. So that though, by 1931, British prices had reached the 1914 level they were still well above world prices, and the export industry was in the doldrums. The trade balance was adverse.

It was claimed in justification of the policy that it made it easier to pay British war debts, for a given sum in pounds obtained a larger sum in dollars. But this, in the event, was fallacious, because it is in gold that the payment is finally made, and the real limit to debt payments is thus the gold reserve. By bringing about an adverse trade balance the devaluation policy led to loss of gold and made payment of war debts harder.

In imposing this misbegotten policy on the country, the authorities described it by the inviting phrase 'enabling the pound to look the dollar in the face'—a fairly spruce example of the well-known propaganda technique of trying to associate unpopular policies with favourable emotional patterns.

Such were the main factors at work in the years after the first world war. Let us now sketch the story of what happened in chronological order. And what a story! The tragedy of half a planet.

BACK TO GOLD

Immediately peace was signed, a brief boom flared up, as the ordinary man, in trusting optimism, began to order the goods he had long done without. But a rush of orders could not disguise the disintegrated state of the economic machine. It was bound to be long before raw materials would flow smoothly into retooled factories, still longer before overseas customers would order goods in pre-war quantities. Discharged soldiers spent their gratuities—and joined the ranks of the unemployed. Dealers, unable to get goods, placed duplicate orders with several firms—and cancelled the duplicates when delivery took place. Optimism soon dissolved. The expected fall in prices started in Japan and spread rapidly across the world, first to America, then to Europe, sparing only those countries which were inflating.

In Britain the government had been continuing to borrow

wildly to balance the budget. In sudden repentance it speeded demobilization, sacked temporary civil servants and cut the wages of the remainder. Though the government could thus rid itself swiftly of its obligations, the men could not be absorbed into industry so fast. The money which formerly had reached the men as wages via government borrowing must now reach them as wages for productive work performed—but employers were not ready to take them on for productive work. The fact that the men were now without an income only had the effect of discouraging employers from ever taking them on. But the government achieved its objective, a balanced budget: and the fact the figures were tidy was the main thing.

After this brief flicker of hope, we open on the first act of the post-war drama. The scene discloses Britain, her export industries at a standstill, her unemployed numbering two million; Germany, gripped by a frantic inflation which carries the wholesale price-index to 126,000,000,000,000 times the pre-war figure; France in comparative prosperity following the cancellation of four-fifths of her internal debt by a controlled inflation and her export industries reviving under the stimulus of her devalued franc. Across the Atlantic, the United States is receiving an annual toll of gold in payment of debts and reparations, her price-level is rising and prosperity seems assured.

True, America has erected tariffs to protect her bloated war-time industries, but happily she is engaged in lending back to Europe the gold that is streaming out of it, so that the underlying maldistribution is concealed. And the European countries, at various conferences, decide on economies in the use of gold which postpone the effect of the underlying shortage.

Germany, her inflation accomplished and a new mark installed, began with grim determination to reorganize her dislocated industry, maimed by the loss of steel and coal. She rationalized her consumption industries (with the aid of loans from America) until their efficiency exceeded that of most of her competitors. But rationalization may have one of two possible results. It may enable you to produce a larger amount of goods with the aid of the same number of men as before, or the same amount with fewer men. In Germany the latter occurred. Wages (and therefore home

consumption) were necessarily low—since heavy taxes had been imposed to raise the reparation payments—this after all was the idea, to cut Germany's consumption and raise her creditors'—but her creditors refused to consume their share. As a result, exports could never be raised to a figure which would keep the whole of Germany at work. During the time that reconstruction was under way, and borrowed money was being paid out as wages, the wage-bill remained reasonably large, but as reconstruction approached completion, unemployment began to rise steeply.

While Germany struggled with the task of reconstruction, the other European countries bent their main efforts to returning to the self-regulating system; by the end of 1926 the gold standard had been restored in all the major countries. The question was, at what price-level to restore stability? Most countries had blown up the balloon of money to many times its pre-war size: should they hook it on to the gold anchor at its current size, blow it up still further so as to minimize the national debt, or deflate it to pre-war dimensions? While France, Belgium and Italy and some other countries accepted an inflated price-level, Britain, Denmark and Norway sought to deflate to the pre-war level. Britain was chiefly concerned about the relationship of the pound to the dollar, and, seizing a moment when the price-level in the two countries was nearly identical, went back on to gold at the old pre-war parity of £1 = $4.86. Unhappily the correspondence of the price-levels was only temporary; though the British price-level continued to fall, the world price-level fell even faster, and the pound remained over-valued, handicapping the already stagnant export industries and causing unemployment. In the years 1925–9, unemployment in coal and steel industries averaged 22 per cent and in shipping nearly 28 per cent.

During these years gold was steadily flowing into the United States and, to a lesser extent, into France, both in the form of war debts and reparations and also in response to export surpluses. But as the gold came in, America steadily lent it back to Europe, with more besides, and also lent to South America and Japan. Germany was the biggest borrower; to finance her reconstruction she borrowed about £750 million at par between 1924 and 1928—about twice as much as she paid in reparations during the

period, if we include payments in kind. France was also leaving gold abroad, letting short-term balances accumulate in foreign capitals, particularly London. The high British bank rate (imposed to assist deflation) attracted such money.

In this way the position grew more and more dangerous, but its inherent instability was concealed. Gold remained in European banks, but most of it was owed to America or France. It was only necessary for these countries to call in their debts for the whole structure to topple. As it happened, the event which finally precipitated disaster was the U.S. stock exchange boom and the subsequent crash.

U.S. STOCK MARKET BOOM

At a superficial glance, the United States was doing famously. The national income increased by 40 per cent between 1922 and 1929. But this prosperity was achieved by building capital goods without, however, doing anything to increase the public's power to buy the consumption goods resulting. High as American wages were, they were too low for her productive capacity. The index of productivity rose 43 per cent between 1922 and 1929 but wages remained at the same level from 1926 onwards.

Preserved from the tribulations of Europe, and with payments flowing steadily in, the American citizen concluded that the United States was miraculously immune from economic misfortune; an era of unparalleled prosperity seemed to have dawned. In this mood the American public began buying shares on the general principle that almost any share was bound to appreciate in value in the golden age which was just ahead. Naturally share prices began to rise and seemed to the ignorant to justify this optimism. Even those who realized that the rise of share values had no connection with any real growth in consuming capacity—unemployment remained at the two million level even at the height of the boom—joined to take the advantage of the rise in values.

In 1928 the Federal Reserve Bank, which had been savagely attacked by the Hearst press, became alarmed and raised the discount rate to 5 per cent, engaged in open-market operations and sought in every way to restrict credit in an attempt to 'stop

the boom by stopping prosperity'. But in vain. The mass of American speculators, which by now included taxi-drivers, bar-keepers, nurses, even page-boys, were quite ignorant of finance and unable to read the signs of impending collapse, while the professional speculators banked on being able to get out at the last minute, leaving the public holding the baby. Share-values mounted to nearly three times the 1924 value, while the Federal Reserve Bank raised the discount rate to 6 per cent.

Consequently Americans who had previously lent their money to Europe, now withdrew their loans in order to invest them in New York. Simultaneously large sums of money owned by foreign investors everywhere also flowed into New York to take advantage of the boom. Thus the process of foreign lending—which up till now had been staving off the effect of the continual payment of gold to the U.S.A.—ceased. In addition a good deal of the world's mobile resources were shifted to New York intensifying the maldistribution of gold. The card castle was about to collapse.

This withdrawal of funds caused serious difficulties to Germany, which tried to fill the gap caused by the withdrawal of U.S. investments by short-term loans from Britain, Holland and Switzerland at high rates of interest, the loans being made through the German banks. Meanwhile the only way in which Germany could get the gold required to make her reparation payments was by reducing imports and expanding exports so as to acquire a favourable trade balance. But to expand exports in a sick world with a falling price-level was no easy task. So she began to subsidize her exports with money obtained by raising the price of goods sold at home; that is, she began to 'dump'. As a result the standard of living fell and unemployment steadily mounted.

Britain also began to feel the draught. She had been importing more than she exported—as a result of the impoverishment of agricultural countries to which we have referred—and she had been making heavy foreign loans. As its gold stock dwindled, the Bank of England raised the discount rate still further in an attempt to retain the funds which were flowing to the New York stock market. Similar steps were taken throughout Europe: bank rates were raised in the effort to attract gold, while prices began

to fall sharply in consequence. The costs of production increased (as interest rates rose) and firms sought to economize by reducing the number of employees. Unemployment spread. As the volume of production contracted, efficiency fell and costs mounted further. The whole spiral of deflation developed with gathering speed.

WALL STREET CRASH

Then, on 29th October 1929, the Wall Street collapse came. Share values, which had risen like rockets, came down like the sticks. Paper fortunes vanished into thin air.

American investors, reacting from their former confidence, were now scared to invest at all and began to call in their remaining overseas loans. American banks also began to call in foreign loans to meet the obligations consequent upon unwise investment at home. The French, too, were busy changing their holdings for gold, while the vast Hatry forgeries added to the general alarm.

Germany had been the principal borrower and was therefore the country most severely hit by the withdrawal of loans. The great German inflation had wiped out all the working capital of industry and it had been replaced by loans from the German banks, who in turn had raised the money by borrowing abroad. Now that the German banks had to repay what they had borrowed, they could not in their turn call back what they had lent to industry, for to have done so would have been to have cut its throat. So the German banks found themselves precariously short of funds.

And Germany still owed reparations. During 1930 and 1931 she made really extraordinary efforts to build up a balance of exports over imports, cutting her imports in 1931 to half the 1929 figure (itself lower than previous years), a remarkable achievement. She was unable to prevent her exports falling, for depression was spreading rapidly over the world, but the amount by which they did so was small in the circumstances. Both in 1930 and 1931 she created a positive trade balance (Rm. 78 million in 1930, Rm. 206 million in 1931) although in previous years the balance had lain the other way. So in these two years

Germany, for the first time, was paying reparations out of her own resources.

This remarkable result was achieved at a terrific cost in internal depression. Already in the first quarter of 1931 Germany was near the end of her tether. In May the Vienna Kredit Anstalt had to close its doors. This caused a heavy run on German banks, which (it was only too justly feared), would soon have to follow suit. At this point President Hoover proposed that the payment of all international debts should be excused for one year. Every country agreed—except France, which haggled for several months while German banks continued to lose funds. By July withdrawals totalled 3000 million marks. While the discussions dragged on, German banks began to crash like plums falling from a tree. The Hoover proposal was finally accepted and was followed by the Berlin 'standstill' agreement by which payments between German banks and their foreign creditors were suspended.

But this did no more than create a breathing space. It was essential that the fantastic anomaly of war debts should be solved once and for all. A conference to discuss the problem was called for January 1932, to be held at Lausanne. In the meantime the country was verging on breakdown. Food riots broke out in many towns. Internal chaos was only held off by rigid control. Communist membership increased by leaps and bounds and so did membership of the Nazi party. The country was in a fever of resentment and despair.

But before we carry the German story further let us see how Britain was faring meanwhile.

THE CRISIS IN BRITAIN

During the 'twenties Britain had never seen prosperity. Unemployment never fell below a million. When, in 1929, a Labour Government was elected, investors began to transfer their funds to New York, fearing that Labour might impose on industry the handicaps of shorter hours, higher taxation and minimum wage agreements. The Wall Street boom soon accelerated this process and the Bank of England began to lose gold.

Meanwhile the trade balance continued adverse, for the plight

of the agricultural countries prevented them from importing in their accustomed quantities, and also prevented them from repaying their loans. Fearless action was needed to stop the outflow of gold: restrictions on the export of capital, rationalization of industry and changes in structure to correct the trade balance, and cheaper money to stimulate home investment. The new government did not have the courage for such a programme; it did not have the backing of finance and industry; perhaps it was too late anyway.

The Bank of England therefore set out to attract gold to London by raising the bank rate, despite the cost in internal depression. Much of what it gained it lent at short-term to Germany to ease the situation there. The officials of the Bank of England were now living in a fools' paradise. They had let the bulk of their gold go abroad in long-term loans and they had replaced it with gold lent at short-term. Foreign speculators began to wonder how long the bank would continue to be able to sell gold on demand. Then, in mid-1931, the great series of German bank crashes exposed the hidden weakness with dramatic suddenness. A terrific run started on the Bank of England and the bank was finally reduced to borrowing £50 million in Paris and New York.

At this point the famous, or infamous, May Committee on National Expenditure issued its grossly alarmist report to the effect that the British budget would show a deficit of £70,000,000 in the current year and £120,000,000 in 1932. Instead of recommending a reduction of the internal debt, which owing to the fall in prices had now assumed enormous proportions and was the largest single cause of internal depression, it recommended drastic retrenchment in salaries. No policy could have been stupider. At a time when buying power was already at far too low an ebb, to suggest a further cut was lunacy. But it must be remembered that a Labour Government was in power; the motive of this cynical political manœuvre was to discredit that government. The good-hearted British public, vaguely remembering that it had won the war by economies, vaguely supposed that it might defeat the depression by similar methods and accepted the reductions with its usual grace.

The Conservative press savagely attacked the 'insane extravagance' of the Labour Government and their articles were reprinted with embellishments in the Continental press. European bankers, thoroughly alarmed, began to withdraw funds: one article in a London daily is said to have been responsible for the withdrawal of £11½ million in a single day. Soon the Bank of England, down to its last £100 million, told the government: 'You must go off the gold standard'—*i.e.*, cancel the bank's obligation to sell gold at a fixed price—'or else let us borrow again'.

Bewildered by the mighty forces which were buffeting them, and fearing that to abandon the gold standard would cause the public to lose confidence in them and depose them from power as the Conservatives planned, the Labour leaders told the bank to borrow more in the hope that this would avert the responsibility of a decision.

The bank reported that it could raise £80 million in New York—but on conditions. These were that the budget be balanced and the dole be cut. It may seem extraordinary that New York bankers should be able to dictate conditions to the British government, especially when their own budget was far more unbalanced than Britain's, but Ramsay Macdonald clearly admitted the fact in Parliament later. The Labour leaders did not feel able to agree to cutting the dole, and resigned, Macdonald appearing as the head of a 'national' government on 25th August 1931, and promising to 'save the pound' by drastic economies.

The government immediately proceeded to economize as promised; that is, it thrust down prices, reduced wages and expenditure, handicapped industry and, in fine, did all it could to make matters worse. Of course, the drain on the bank's gold continued and by 20th September it had lost £200 million in ten weeks. It was therefore forced, at long last, to ask the government 'to be relieved of the obligation to sell gold at a fixed price'. Thus, only twenty-six days after the 'national' government had been returned to power on the promise of saving the gold standard, Britain abandoned it. The men, who a month before, had preached that to do so would cause inflation and social disaster now began to turn cart-wheels in the effort to explain that it was really the best possible thing after all—the fall in the pound would stimulate

our export trade and generally prove beneficial. It was one of the most extraordinary political switches in history.

And it certainly might have proved beneficial, if the 'national' government had so desired. If the pound had been allowed to find its own level, and if the government had followed this up by an expansionist policy and had taken steps to correct the structural maladjustment, the conditions would have been created for a trade recovery. The only rejoinder other countries could have made would have been to devalue their own currencies and thus free the world as a whole from the dead weight of the gold anchor. The way would then have been clear for a settlement of the vexed questions of tariffs and war debts.

But the 'national' government did not want this kind of prosperity. It wanted, above all, to see gold streaming back to the vaults of the Bank of England and the pound kept at the highest value practicable. These orthodox methods, it hoped, would restore the confidence of investors and in two or three years trade might begin to improve in consequence. So it proposed still more savage economies at home to balance the budget, and a network of tariffs to handicap the countries which traded with Britain, and so restore the balance of trade. The British public, badly scared by this mysterious and incomprehensible financial tornado, returned the government to power on this insensate programme with a record majority.

CONCLUSION

In short, most of the world's post-war problems were structural ones. War debts and reparations could not be paid because this involved structural changes in the creditor nations. British exports had declined because of structural changes in her customer nations. Tariffs had been erected to protect structural changes brought about by the war. Agricultural over-production was largely due to structural changes.

The logical course was to readjust this warped structure; to close down the industries which the progress of industrialization or the coming of peace had rendered obsolete. Instead each country persisted in its course.

In attempting to bring about the necessary readjustments the 'self-regulating system' imposed depression and unemployment on the redundant industries—without, however, achieving its object. But governments were unwilling to sit idly by and watch economic distress among those who had elected, and might one day unseat, them; so they imposed tariffs, granted subsidies and, above all, restricted immigration. Thus they were resisting the operation of the self-regulating system in the real world while still adhering to its rules in the monetary sphere.

On top of this came a new problem. The United States won the international money game and collected the jack-pot. She won it by breaking the rules. For though her productive genius and her advantageous position in the early part of the war made it possible for her to export on an unprecedented scale, the self-regulating system could have dealt with this. But the United States imposed high tariffs and sterilized the inflowing gold, thus wrecking the machinery which would have restored the gold to circulation.

For a time she kept the game from petering out by lending part of the money back to the other players; but when the Wall Street crash caused her to cease so doing, the other players had to drop out of the game. The only alternatives were for the United States to redistribute the gold and start a new game, as children do when they have won all the counters, or for the other players to start a game on their own with some sort of substitute for money. But they hesitated to take the step.

By a stroke of poetic justice, the withdrawal of loans precipitated a slump in the United States, for they had been the only thing postponing the onset of over-saving. But there was little satisfaction in this, for the self-regulating system at once transmitted the slump to the other nations. In the case of Britain and Germany this led to repudiation of the government and the substitution of governments which at once withdrew from the game. Now let us carry on with the story.

20

Prelude to War

'Of all the unsatisfactory—' (she repeated this aloud, as it was a great comfort to have such a long word to say) 'Of all the unsatisfactory people I ever *met—' She never finished the sentence, for at this moment a heavy crash shook the forest from end to end.*

The next moment soldiers came running through the wood, at first in twos and threes, then ten or twenty together, and at last in such crowds that they seemed to fill the whole forest.

As 1932 dawned the slump showed no signs of abating.

In Britain, deposits in joint stock banks rose by £70 million during the year, despite an interest rate of ½ per cent. Advances to borrowers fell by more than £114 million during the period. In other words no new enterprizes were being started and deflation was intensified. But, encouraged by the return to power of a mainly conservative government and by the orthodoxy of its policy, foreign investors took heart and gold flowed back to Britain, with the result that by March 1932 the pound appreciated slightly in value. The fact that unemployment reached 3¾ millions was of lesser consequence.

Britain, however, was relatively fortunate. It was Germany and America which really plumbed the depths of misery. The situation grew worse and worse, with nearly a quarter of the working population out of work in each country.

In Germany, obliged by the Young Plan to remain on gold, the Reichsbank imposed a further severe deflation in an attempt to maintain the exchange value of the mark. This caused (according to the official British report on 'Economic Conditions in Germany') 'a terrifying increase in bankruptcies'. The amount of capital written off in the first six months of 1932 alone was

£48,250,000 at par. As wages were forced down unemployment grew. By the first quarter of 1932 it topped six million, not counting widespread unemployment among those not covered by the statistics. As hunger and desperation grew more and more people turned to Communism, until the Rhine industrialists, in dire alarm, opened their coffers to an almost bankrupt nationalistic party which promised them a more profitable solution.

It was obvious that Germany could keep up her reparation payments no longer, but at the insistence of France the proposed Lausanne conference was postponed again and again and did not meet until June. At the conference the British, realizing the seriousness of the situation, demanded complete cancellation of reparations, but the French, miserly and revengeful to the last, would not agree. After months of haggling they said they would consent provided the United States would agree to a reduction of war debts. But the American leaders were in the throes of a presidential election, and, though they recognized that Germany could not pay, they did not dare to tell the electors so. Congress announced that no proposal could be entertained for scaling down debts to the United States. As the discussions dragged on, the situation inside Germany deteriorated rapidly and finally the Bruening government collapsed, paving the way for the accession of Hitler in January 1933. The French statesman who insisted on the fatal postponement was—Laval! The self-centred attitude of these two countries was therefore directly responsible for the final collapse of the Weimar republic.

And all the while France, Belgium, Holland and Switzerland continued to accumulate gold, until by October 1932 the Banque de France alone held £662 million. (It had £160 million in 1925.) The price-level fell steadily. By now sheep were selling for a shilling in the south of England and in the United States wheat was fetching ten cents a bushel. World unemployment, according to a League of Nations estimate, totalled 25 millions.

The unbelievable thing is that no constructive effort was made to meet this ghastly situation. Had there been even a few dregs of good-will and co-operation, it would have been possible to economize in the use of gold, to agree to simultaneous devaluation of currencies so as to stimulate the price-level, and

to consent to a scaling down of tariffs. These three policies, at least, stood plain to see for anyone with even a modicum of economic knowledge. But the various governments were by now too palsied with fear for action: their only idea was *sauve qui peut.* Their only decision was to postpone the date of the proposed World Economic Conference until the following year.

No, I apologize; one step *was* taken. A convention was called at Geneva with the object of declaring a truce in the tariff war. Immediately after ratifying this agreement not to increase tariffs, the United States imposed the Hawley-Smoot tariffs, probably the most vindictive ever devised.

In America by this time unemployment had passed the 12 million mark and bread lines were a common sight in every city. The people, their inherited peasant caution reasserting itself, began to withdraw their funds from the banks. Since the U.S. banking system was composed of a large number of independent banks, many of them small, these soon began to find themselves unable to meet their clients' demands for cash and many were forced to close their doors. As the presidential election was fought a major banking crisis was gathering way and it was in an atmosphere of impending disaster that Roosevelt came to power in the November polls. But in the United States, supposedly so contemptuous of tradition, the new president may not take over control until four months after the elections, a measure designed in the eighteenth century to allow delegates time to cross the continent by a stage-coach! During this interregnum, during which no counter-measures could be instituted, distrust grew rapidly and many banks crashed, thus accelerating the run on the others; when Roosevelt took over in March the economic system was on the verge of collapse.

Meanwhile Hitler had come to power in Germany, had repudiated all foreign debts, and begun to control the country's adverse trade-balance by organizing her foreign trade under a system of licences. Thus the beginning of 1933 marked the end of an epoch. Three out of four of the great Western Powers had jettisoned the 'self-regulating system' and now sat down to rebuild their economies according to conscious policies of state.

THE WORLD PICTURE

With the abandonment of the international gold system, the countries of the world now grouped themselves into a number of 'economic islands' or zones. When Britain abandoned the gold standard most of the Empire, Scandinavia and subsequently some other countries likewise devalued, in many cases by the expedient of linking their currency to sterling, *i.e.* declaring that a fixed quantity of it would exchange for one pound. Thus exchanges remained stable between all such countries, which became known as the *sterling bloc.* This arrangement was not very satisfactory, since if Britain became wrongly valued with regard to the rest of the sterling bloc, she had no means of readjusting the exchange rate, for whatever she did the other countries would do also. Furthermore, if she changed her relationship with the dollar all the other sterling bloc countries shared in the variation, regardless of the relationship between their purchasing power and America's.

Similarly, many Latin-American countries linked their currencies with the United States dollar.

The countries which remained on the gold standard, notably France, Belgium, Holland and Switzerland, became known as the *gold bloc.* Technically, Germany was still on gold, but her rigid control of foreign trade and of all exchange payments, to say nothing of her failure to pay for her adverse trade balance, gave the mark a real value quite different from its nominal value. And when Germany began her career of conquest, first economic then military, later in the decade, most of south-east Europe became dominated by the mark.

Trade naturally tended to remain confined within these economic zones, but the existence everywhere of huge tariff walls meant that international trade could never reach the same volume as before. Even in 1937, at the peak of the boom, when output in most countries was higher than in 1929, the volume of manufactured goods entering into world trade was still 14 per cent below the 1929 level. Moreover, when any group of countries endeavoured mutually to reduce tariffs, the other powers opposed

the move, fearing to lose some part of their own exports through it. For instance Britain succeeded in killing both the Oslo Convention of 1932 and the Ouchy Convention of 1937, by which respectively Scandinavia and the Low Countries sought to establish low-tariff areas between themselves.

Consequently, during the 'thirties the tendency was to rebuild industry very much more on the lines of national self-sufficiency than before.

THE PROBLEM OF RECOVERY

In a capitalist economy, recovery can only be brought about by restoring the confidence of entrepreneurs in the profitability of business. As we have seen, it is the decision of the business men to invest which increases purchasing power and turns on the tap of credit expansion, so starting on its career the snowball process we call a boom.

The only way in which this confidence can be restored is by the sight of firms actually earning good profits. So the only course the government can pursue is to restrict output until scarcity develops. This causes prices to rise and enables those firms which are in business to make good profits, and, lo! the simple entrepreneur breaks into a smile and hurries forth to share in them. Paradoxically enough, therefore, the government can only bring on a boom by making the depression worse.

It was at one time a widely-held theory that the state could start the ball rolling again by spending large sums on relief and public works. This, it was argued, would increase the buying power and restore profitability. Roosevelt now experimented with this course in America, but experience showed that as the money came into the hands of entrepreneurs they failed to spend it again because they felt that at any moment the government would turn off the tap and profitability would vanish. In short, the move failed to restore confidence. Its advocates failed to realize that the problem is more psychological than economic.

Furthermore, it is essential not to undermine the confidence of entrepreneurs in any other direction. An unbalanced budget fills them with the fear of inflationary borrowing which will make their incomes worth less in terms of goods and may even lead

to a devaluation. High taxation also appals them, and so does the suggestion of state interference in their business.

Under capitalism, therefore, the creation of scarcity, combined with financial orthodoxy, is the only policy which will induce the industrial and financial magnates to restore prosperity.

The governments of Britain, the United States and Germany set out to tackle the slump in three contrasting ways. Britain pursued the orthodox line of restoring 'confidence' among entrepreneurs; Germany used her dictatorial powers to compel investors to invest; America tried to restore purchasing power by a policy of public works.

RECOVERY IN BRITAIN

In pursuance of the principle of restoring 'confidence' the British government imposed a wide range of tariffs, called for wage-cuts and invited producers to eliminate excessive capacity, all of them steps designed to enhance the chance of making profits. In addition they decided to reduce interest rates in order to provide suitable conditions for the borrowing of money by entrepreneurs when their 'confidence' had been sufficiently restored. The bank rate was reduced to 2 per cent and in addition £2,000 million of war loan was successfully converted from 5 to $3\frac{1}{2}$ per cent, a step which reduced the cost of the national debt by £30 million per annum, and one for which Chamberlain must be given due credit.

Pressure was immediately developed by financial interests to stabilize the pound at its new level, but this Chamberlain had the wisdom to resist, recognizing the fundamentally unstable position created by over-valuation of the gold bloc countries. This pressure was renewed at frequent intervals but fortunately in vain.

The government's policy of economy, by intensifying the depression, had caused many firms to go bankrupt and so decreased the supply of goods, while the imposition of tariffs had cut down imports, so that a shortage of goods was developing, and prices began to rise. At the same time it was necessary to face the fact

that the steel, coal, shipping and cotton trades had permanently contracted, so the government invited them to form associations with power to scrap redundant equipment and rationalize production, under threat of removing the tariffs if they did not. Unfortunately the associations thus formed contented themselves with raising prices and restricting output without doing anything to raise efficiency. Nevertheless the government did not carry out its threat. Unsatisfactory as this was from the nation's point of view, it did protect profits and so aid in restarting the upward swing of the trade-cycle. It was more than two years, however, before recovery got under way, and, when all is said and done, it is questionable whether it was aught but the natural forces of recovery which did the trick. All the Government did was to prepare the way and wait.

THE NEW DEAL

Roosevelt, in America, took rather similar steps to restore the profitability of business. He reorganized the banking system and cheapened interest rates by various ingenious methods. He weakened competition, reduced output and raised prices by the institution of 'fair trading' codes under the National Recovery Administration. He could not, it is true, raise tariffs any further, but he did what amounted to the same thing: he strongly undervalued the dollar by reducing it to 59 per cent of its former value. This protected American industry to the same extent as a 60 per cent increase in tariffs, and in addition assisted American export industries.

Roosevelt, however, was not willing to sit back and wait two or three years for the drooping plant of business confidence to revive. He therefore supplemented these measures by a grandiose attempt to create purchasing power. In the course of four years he distributed more than $12,000 million in relief and public works. He hoped that, as the recipients went out and spent the money, demand would revive, profits would expand and entrepreneurs would once more begin to invest. In this way the ball would once again be set rolling. This expectation was disappointed, for two reasons. Firstly, though the revival of demand caused

existing factories to get going again, it did not seem to entrepreneurs to justify the erection of new ones. They feared that at any moment the government might turn the tap of relief off. And though it would not have reduced demand even if the government had done so, provided that investment had been successfully restarted, yet entrepreneurs *thought* it would and that was sufficient. Thus millions suffer unemployment because of the ignorance of a minority!

Perhaps these vast expenditures might in time have succeeded in their object, had it not been for a more serious threat to confidence. Roosevelt's measures seemed to entrepreneurs to be 'left wing' and this was enough to depress them. In particular, his attempts to form trades unions under the NRA, with the object of raising wages and hence purchasing power, antagonized business. Moreover the huge budget deficits by which he financed his vast expenditures offended against the canons of orthodox finance. Once again entrepreneurial ignorance was the national undoing. Consequently the great sums Roosevelt distributed simply flowed into the coffers of entrepreneurs, whence he again borrowed them for further distributions.

Entrepreneurial timidity also handicaps a programme of public works. As long as Roosevelt confined himself to road building and afforestation the expenditure brought no prosperity to capital industry. If on the other hand he created public utilities, such as the Tennessee Valley Authority,[1] which lent prosperity both to heavy industry and to consumers alike, he was accused of competing with private enterprise and entrepreneurial confidence suffered a sharp blow in consequence.

The consequence of entrepreneurial mistrust was that Roosevelt's measures created a certain measure of prosperity in consumption industries but none in capital industry. By the end of 1934 unemployment had fallen from 26 to 21 per cent. But the continuation of this mild degree of recovery was wholly

[1] The TVA was resented because it forced down electricity charges in the area. In the event this led to such an expansion of demand that the profits of private electric companies were enlarged, not decreased. A remarkable commentary on the claim that private enterprise is more enterprising than public ownership! See *TVA* by David Lilienthal and *TVA: Adventure in Planning* by Julian Huxley.

dependent on the administration continuing to make its huge expenditures. At first entrepreneurs, stunned by the disaster, had offered little opposition to the President's revolutionary methods—indeed they even welcomed the weakening of competition brought about by the NRA—but as the shock wore off and the President turned to the formation of trades unions and schemes such as the TVA they began to organize opposition. In 1936 they were successful in getting the NRA declared unconstitutional, and, soon after, the Agricultural Adjustments Act, by which Roosevelt had succeeded in raising farm prices, suffered the same fate.

RECOVERY IN GERMANY

In contrast with the slow convalescence of the democracies, recovery in Germany was rapid and complete.

Huge orders for armaments assured prosperity for heavy industry: more than that, they created a strong demand for the expansion of investment. At the same time the Nazis limited the expansion of consumption industry, while holding prices to fixed levels. In consequence the citizen had no alternative but to save. The Nazis then compelled the banks to use the large deposits they were acquiring to take up public loans. Thus the money the government spent came straight back to it to be spent again. At the same time they limited dividends to between 6 and 8 per cent; the balance of the large profits heavy industry was now earning could only be put into further investment or into government loans, since no overseas investment was permitted.

It is worth stressing, though, that such a policy was only possible as long as confidence in the regime remained strong. Entrepreneurs would not have invested if they thought that the government would be unable to finance its expenditure and prevent inflation and an adverse trade balance. If the Nazi government had encountered firm opposition from the democracies or come up against determined economic countermeasures, the public might have preferred to hoard its balances, thus breaking the magic circle. Economic success was based on political success. Political successs was based on failure elsewhere.

Rearmament is a magic key to prosperity because it creates

demand in the form which matters most—demand for the output of heavy industry. Within two years German unemployment had fallen by more than 3 million, and private investment had risen by 250 per cent.

The penalty of such a programme was a big increase in the national debt. But the Nazis could afford this, in the first place because they started their career with a national debt of negligible dimensions (the great inflation had wiped out the country's former national debt) and in the second because they were confident of their ability to convert the debt to a lower rate of interest should it ever grow onerous.

Technically the mark, which was still nominally 'on gold', was much over-valued in consequence of British and American devaluations. The Nazis left it so because this enabled them to buy the maximum of foreign goods with any gold they were able to acquire. At the same time they prevented the normal result of over-valuation—an adverse trade balance—by imposing a rigid system of import licences. Having done this, they could even introduce a degree of internal inflation in order to stimulate recovery and reduce private consumption, thus over-valuing the mark still further.

Nazi foreign economic policy went much further than merely preventing an adverse trade balance. The system of import licences made it possible to confine imports to essential raw materials. Export trade was also subjected to licences as were all foreign exchange transactions. Turning their attention to the depressed agricultural areas of south-east Europe, so long ignored by the democracies, they placed long-term contracts for the supply of food and raw materials, thus injecting new life into their stagnant economies. When the time came to pay, they offered not cash but only such goods as they had been unable to dispose of elsewhere. When the customers demurred, they threatened to cut down their purchases, which would have plunged these countries back into depression. The governments of the Balkan countries dared not risk this, more especially since there were active Fascist parties ready to exploit any public unrest.

As the trade of these countries came more and more to depend

on the continuance of Nazi favour, the Nazis demanded, with each new economic transaction, more and more political concessions. Meanwhile the economies of these countries were twisted more and more to the task of serving the German war-machine. As Germany grew internally stronger and externally more influential, her principal opponent, France, grew steadily weaker and more friendless. The whole balance of power in Europe shifted, and in that fateful reorientation economic forces played a critical part.

TWILIGHT OF THE GOLD BLOC

While the nations which had devalued were slowly climbing out of the depression, the countries of the gold bloc—France, Holland, Belgium, Switzerland—were falling into ever-greater difficulties.

Thanks to their over-valued currencies, they developed adverse trade balances; gold went abroad to settle them and as a result credit contracted, strangling trade. Export industries stood idle. As industry sank into depression and unemployment rose, revenue fell off and expenditure increased, so that budgets became unbalanced. In theory, two alternatives lay open to them. They could either alter the exchange value of their currencies in such a way as to restore the balance of trade (devalue), or else try and force prices down so as to justify the existing exchange rate (deflate). But in reality there was only one alternative. As we saw in Chapter 17, deflation is disastrous because debt is incompressible; even if you succeed in compressing wages and prices, debt comes to absorb an ever larger proportion of purchasing power and over-saving develops. Also the fact that revenue has declined while the cost of the national debt has not makes it increasingly difficult to balance the budget. In addition, many types of prices, such as rents and other contracts, are exceedingly difficult to compress.

In reality, then, there is only one course open: devaluation. But this is always opposed by rentiers, who feel they are being cheated because prices will rise. Actually it by no means follows that prices will rise, while if they are forced down by deflation the rentier certainly gains more than his share. The paradox is

that the government's attempt to deflate usually leads to inflation, because the budget becomes unbalanced and the government has to resort to inflationary borrowing to restore it. This inflation makes devaluation all the more necessary. Once devaluation has become a likelihood, speculators transfer their funds abroad in in the hope of profiting from the readjustment, happy in the knowledge that their action is the thing most likely to make the readjustment unavoidable.

Nowhere was the folly of over-valuation and deflation more strikingly displayed than in France. In 1929 she had zero unemployment and the second largest accumulation of gold in the world. During the ensuing decade unemployment grew steadily, the trade balance became adverse and gold trickled away year after year. Yet it was not so much the adverse trade balance as the export of capital by speculators which was responsible for the Banque de France's loss of gold. The story of those years is one of repeated attempts at deflation, leading to unbalanced budgets, involuntary inflation and speculative attacks on the franc. The consequences of the repeated deflations were a continual industrial and financial weakness which made it impossible to rearm.

The blame for France's weakness, and thus for Germany's triumph, must go primarily to the miserly self-seeking of the rentiers who preferred to plunge the country into depression rather than risk a loss, but ultimately to the financial leaders—above all, the Regents of the Banque de France—who rallied and encouraged them to resist every devaluation proposal. Part of the blame must also go to labour, whose continual strikes and demands for concessions held down productivity, handicapping export trades as well as rearmament itself. But the attitude of labour was, at least in part, the fruit of the long years of corruption and depression which had been inflicted on them, so that here again the ultimate blame attaches to the financiers. Also of course to the politicians, none of whom would associate his name with the unpopular policy of devaluation. None, that is, save Reynaud, who constantly advocated it, in return for which, he was consistently vilified in the press and excluded from the cabinet.

HITLER REOCCUPIES THE RHINELAND

In 1934, soon after the Stavisky scandals had rocked France, things came to their first climax. Tired of corruption and depression, the people started to riot in the streets of Paris. Flandin and Bouisson in turn put forward deflationary programmes but the Chamber refused to pass them. Then a third premier proposed deflation; simultaneously the Fascist Croix de Feu organization held widespread demonstrations. Alarmed, the Chamber gave him leave to proceed. The statesman who thus inflicted a further spell of depression in France, thanks to the fortunate coincidence of Fascist activity, was—Laval.

Waiting until the 14th July holiday was past, he announced savage economies. Riots in the shipyards at Brest and Toulon greeted the new measures. They were quelled by the army with machine guns. It is odd that Laval received military help, when Daladier, a few months before, had been refused it.

Laval's deflation failed, as was to be expected. The French Treasury found itself unable to carry on without inflationary borrowing and asked the Banque de France to rediscount Treasury Bills. This privilege, which had been refused to the devaluation-minded Flandin was at once granted to the safely deflationary Laval. In September the Chamber met after the summer recess; the Radical Socialists, who would have come to power if Laval had been defeated, did not have the courage to shoulder the problem only six months before an election and the deflationary decrees were ratified. Once again the unwillingness of French statesmen to compromise their own careers combined with the effectiveness of the Regents' anti-devaluation propaganda to prevent the taking of the only step which could have saved the situation.

Meanwhile Laval had still to solve the problem of the unbalanced budget and the dwindling gold reserves; to have inflicted further deflation so soon before an election would have damaged him politically, so he took the usual course of a French premier in a quandary: he resigned.

During the early months of 1936 the parties of the Left gathered

strength and speculators transferred gold abroad in unheard-of quantities—3000 milliards of francs were withdrawn in two months, and Frenchmen alighting from taxis with suitcases containing gold bars became a common sight in Threadneedle Street. France's financial situation was becoming desperate. The opportunity for which Hitler had been praying was presented to him. He announced his intention of occupying the Rhineland. We now know with what anxiety he did this; how the generals opposed the move, saying the French would surely resist; how the German army had orders to retreat at the first sign of opposition.

At first the French favoured resistance, but when Sarraut learned from Gamelin that mobilization would cost 6 milliard francs, he feared that this additional strain on the budget would make devaluation inevitable and decided against resistance. As Dr. Einzig said at the time, Sarraut had to choose between defending the franc and defending France. . . . He chose that which was dearest to him, and so doing ultimately lost both. This was the first of the German aggressions, the moment when they might have been stopped. Its success paved the way for the revolt in Spain, convinced the Balkan countries that Hitler was a better patron than the French, and confirmed Hitler in his belief that the democracies would not resist aggression.

THE BLUM EXPERIMENT

The origin of France's troubles was, in the last analysis, the embittered struggle between capital and labour—for once, at least, the Marxian analysis was sound. Labour demanded a larger share of the national income. Capital refused to grant it. Labour backed up its demand by strikes. Capital replied by refusing to invest and transferring capital abroad. Each of these actions reduced the sum total of wealth available for distribution. It was a case of the irresistible force and the immovable post. Neither civil peace nor prosperity was possible until one side or the other gave way.

What made the problem truly insoluble was the fact that quite often the abstractions of 'capital' and 'labour' were embodied in the same individual. The artisan with his life-savings

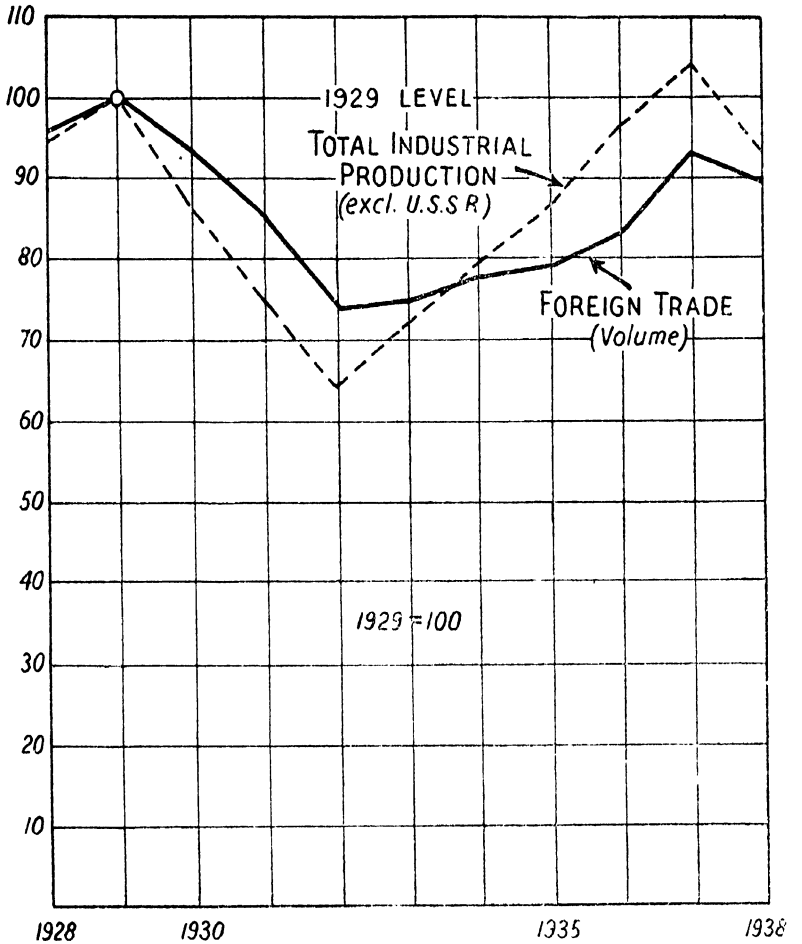


FIG. 34.—DECLINE OF WORLD TRADE.

After the slump, world trade never recovered its pre-slump (1929) volume, even though total production exceeded it. Had Russian industrial output been included in this diagram the difference would have been still more marked.

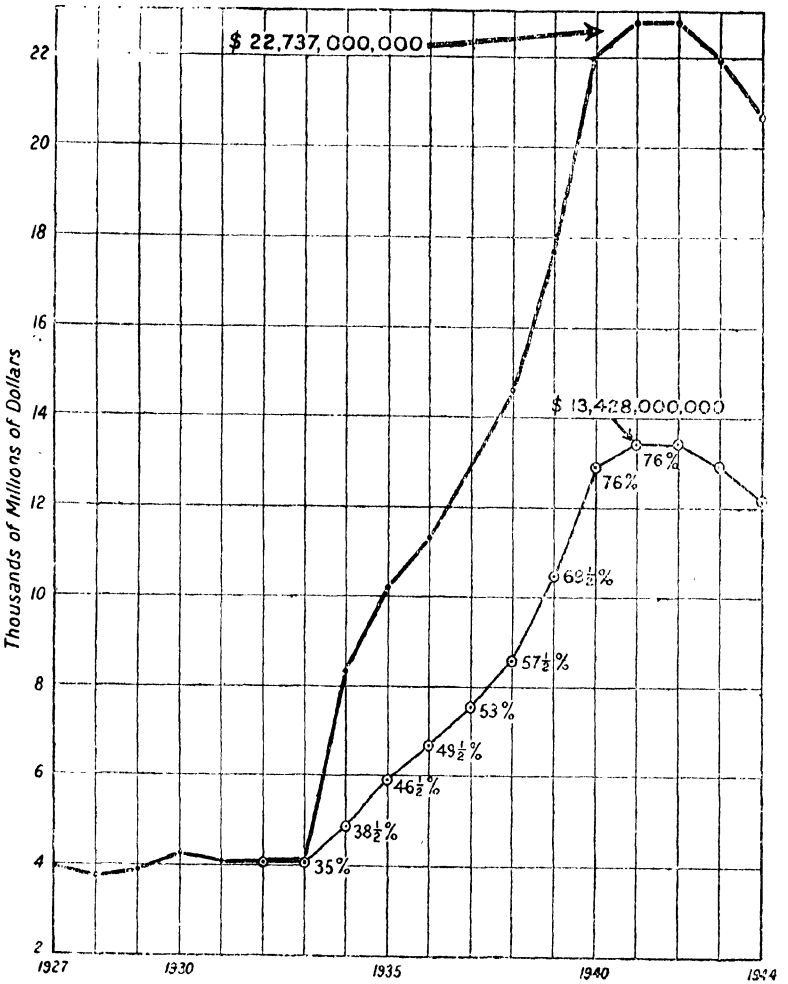


FIG. 35.—GROWTH OF U.S. GOLD STOCK.

The upper curve shows gold and foreign assets reserve; the lower, central bank gold reserve only. The difference represents 'funk money' transferred to America during war scares and war itself. Much of it was previously held in London. The figures show U.S. central gold reserves as a percentage of the total gold reserves of all countries (U.S.S.R. excepted).

invested in French funds was both the striker who wanted higher wages and the rentier who looked askance at devaluation. And if it was not the artisan who transferred funds abroad it was only because he lacked the opportunity to do so. Yet this does not absolve 'capital' from blame for the disaster, for it was the big owners of capital who exploited the public ignorance of the facts to create opinion against devaluation and who refused to concede the not-unreasonable demands of 'labour' for higher wages.

The advent to power of a Labour government under the premiership of Blum at the April elections brought this conflict to a head. The Banque de France lost over 1000 million francs in the week following the elections and by June had lost a total of 11 milliards. At the same time there was a widespread outbreak of strikes. As soon as the two-months' interregnum was over, Blum made a number of concessions to labour, notably wage-increases, paid holidays and the 40-hour week, which alarmed investors and accelerated the flight of capital. These concessions raised the costs of production and so handicapped exports, while the initiation of a public-works programme further unbalanced the budget, making devaluation inevitable.

Blum now sought to bring about devaluation by an oblique method. He brought forward a bill to effect long-overdue reforms at the Banque de France, and embodied in it clauses giving the Banque power to devalue without consulting the Chamber. All was going well—the Chamber appeared to regard this as a painless way of bringing about what everyone knew was inevitable but no one cared to take on—when the new Governor of the Banque, Labeyrie, Blum's own nominee, suddenly deserted his leader and organized a protest. The clauses were struck out and the Chamber went into recess.

Meanwhile the capital drain continued. The gold reserve—down to 62 milliards just after the election—sank to 54 milliards, to 52 and finally to the 'last ditch' figure of 50 in September. On 26th September the Banque of France asked to be relieved of the obligation to sell gold. Blum immediately devalued the franc by 25 per cent and covered his action by signing a Tripartite Agreement with Britain and the U.S.A., by which no further changes would take place without mutual consent.

The Agreement was hailed as a triumph by the orthodox financiers and vested interests who had long been pressing for stabilization, but it was in fact a disaster, for it perpetuated the under-valuation of the dollar. With the elections only three months ahead, the U.S. authorities were unwilling to take this opportunity to readjust the valuation. 'America must have its fair share of gold', Morgenthau declared, insisting on the under-valuation. She already had 10,000 million dollars worth. At the same time it left the franc over-valued. Twelve months before, a 25 per cent devaluation would have been ample, but in the meantime higher wages and the 40-hour week had further handicapped the trade balance. Moreover, Blum proceeded with his anti-capitalist measures and the outflow of gold proceeded unchecked. Unable to devalue further, since this would have broken the Tripartite Agreement, Blum sought to introduce restrictions on the export of capital. The bill was passed by the Chamber, but Caillaux, an old opponent of Blum's, to satisfy a private grudge, rallied opposition to it and it was defeated in the Senate.

Blum, realizing the strength of the opposition he was up against, resigned. Chautemps, who succeeded him, proved unable to balance the budget, and, as the summer of 1937 wore on, fears of a real disaster spread and Frenchmen carrying gold bars again appeared in the streets of London. By October the sterling-franc rate, which had been 105 at the beginning of the year, had declined to 152.

Faced with these difficulties it is easy to see that the government could afford to spend little on armaments and less on maintaining friendly relations with Rumania and other former allies.

PAYING FOR REARMAMENT

In 1937 the trade-cycle passed its peak and unemployment began to mount again. Economists were loud in their prophecies that a new slump was impending, and these announcements discouraged investors. The growing fear of war also acted as a depressant, for when war seemed imminent people said industrial equipment would be destroyed by bombing, and when it seemed remote they said armament orders would cease. By November,

unemployment among registered workers in Britain had risen by 100,000. It was almost true to say that there was a set-back because people thought there would be one. The barometer, a wit said, had spoiled the weather.

But in the event, the slump did not materialize. It was averted by the growing expenditure on rearmament. The reoccupation of the Rhineland, which was a breach not of the Versailles Treaty but of the voluntarily signed Locarno Pact, had caused general alarm. Both Britain and France began to rearm on a scale which, though small indeed in comparison to German rearmament, yet involved expenditures by no means negligible economically.

The question was, how were these large expenditures to be paid for? The money could be raised either by taxation or by borrowing. The objection to borrowing was that in both Britain and France the national debt was already very large and was absorbing some 40 per cent of the national revenue in interest. To increase it would involve raising taxation for all time. The obvious course was to devalue and inflate so as to reduce the burden of internal debt, but the Tripartite Agreement prevented any such step, while in the case of Britain there was the added difficulty that all the sterling bloc countries were linked to sterling and would share in the devaluation. In any case capitalists in both countries were determined to resist any such inflation. Yet it is obvious that someone has to pay in the end, and it is only right that those who have most shall pay most: in fact it is inevitable.

The problem presented itself somewhat differently in each of the two countries. In Britain the expenditure on rearmament tended to draw into employment great numbers from the considerable reservoir of unemployed. Thus it increased the profits of enterprise. It was therefore perfectly reasonable to increase taxes on business, for this would not leave them any the worse off. Arguing on these lines, Chamberlain proposed a so-called National Defence Contribution. This moderate suggestion evoked something like a Rich Man's Revolt. There was a panic in the City and the Federation of British Industries began to organize opposition. In the House of Commons the industrial group colloquially known as 'the Forty Thieves' was among the

most active opponents. Not only did big business oppose it; for some inexplicable reason the socialists also objected, and the plan was dropped.

Chamberlain therefore decided to float a £400 million loan, at the same time raising income tax to 5s. 6d.

The problem was somewhat different in France because something like full employment existed. The 40-hour week so increased the demand for skilled labour that already shortages were appearing. Furthermore, the government was still finding it impossible to balance the budget. What was needed was a government with the authority to rescind the 40-hour week and impose taxes on both rich and poor.

'ANSCHLUSS'

But the story of the governments which followed Blum is, for the most part, a monotonous tale of weakness, mismanagement, self-seeking and intrigue. Thanks to the French multi party system, no one group held a commanding position in the Chamber. Each clique was determined to make political capital from the difficulties of the group in power.

Under Bonnet's stewardship, the franc depreciated from 110 to 153, the gold reserve declined, the budget deficit increased and the Exchange Equalization Fund was drained dry. In January the socialist members of the Cabinet resigned over the refusal of employers to negotiate a Labour Charter and a new government was formed under Chautemps. Confidence was not restored. In March, with France heading for a new crisis, Hitler chose the moment to seek an 'Anschluss' with Austria. Every Frenchman expected that France would be called on to come to Austria's support. But on 10th March, as the crisis reached its height, Chautemps, who was speaking in the Chamber, for reasons never explained abruptly broke off his speech and resigned—leaving France without a government at the critical hour. Hitler could hardly have planned it better. He immediately increased his pressure and Austria fell into his lap.

Everyone now expected a national government to be formed. But even in this grave hour French politicians could not forget

their ambitions and refused to co-operate. In the end Blum took over again. He immediately renewed his attempt to introduce exchange restrictions, but Washington and London obstinately refused to permit it, and Blum resigned. As Daladier took over, Hitler developed pressure against the Czechs, but Daladier firmly devalued without further ado and Hitler abandoned his attempt. Response was good: £100 million of capital was repatriated, and the trade deficit declined.

Daladier's show of strength postponed the crisis for four months, during which Hitler prepared for a different approach. When the crisis came again it revealed the French premier's lack of real initiative, for following the Munich crisis France granted Daladier plenary powers until 15th November. The days slipped past without a decision and on 15th November there was still no lead forthcoming. Meanwhile, Reynaud, at last made Finance Minister, imposed the long overdue taxes which would pay for rearmament. A wave of stay-in strikes followed and Reynaud became the most hated man in France. The unrest culminated in a general strike on 30th November.

AID TO THE AXIS

Chamberlain's decision to borrow £400 million for re-armament was interpreted at the time as a sharp warning to the Axis. In reality it was nothing of the sort. Since it represented a rate of armament less than one-fifth of Germany's, it was an unmistakable signal to go ahead, a frank admission that Britain did not intend to stand up to the Axis.

Besides, money is not the only requisite for an arms programme; you must also allocate your resources of equipment, labour and raw materials. This Britain entirely failed to do. The expenditure of money on armament enlarged popular buying power, creating a boom in the sale of consumption goods. Soon the manufacturers of consumption goods were competing with the arms factories for raw materials and labour. The resulting price-rise decreased the volume of arms the government got for its money and as actual shortages of skilled labour developed, it greatly delayed delivery of the orders. The scarcity of skilled

labour also reacted on the services, particularly the R.A.F. which was unable to get mechanics and other technicians.

The laggard pace of rearmament was by no means the only form of encouragement given to Germany. Indeed when we glance at Chamberlain's and Simon's economic policy during the final years of peace it is difficulty to resist the conclusion that, so far from resisting the Nazis, it was their intention to assist them. For instance, they did nothing to resist Germany's determined efforts to acquire gold for the purchase of vital raw materials. To begin with, Germany had an export surplus to Britain, so that every month British gold was being paid over to her. If Britain, following the example of Germany towards other countries, had insisted on a 'reciprocal trade agreement', *i.e.*, an agreement to the effect that each country would buy as much from the other as it sold, the gold drain could have been stopped.

As a matter of fact, Germany's export surplus to Britain was largely the consequence of the ill-judged Anglo-German Trade Agreement of 1934. The German default on the Austrian debt after the 'Anschluss' would have provided a good opportunity of denouncing this agreement and replacing it with something more equitable; nevertheless the government was strangely reluctant to do so.

But this was only the beginning of the story. For many countries, particularly Sweden, Finland, Poland and Russia, had export surpluses to Britain but import surpluses from Germany. Thus the British gold which went to these countries in payment was immediately passed on to Germany. Dr. Einzig commented at the time: 'Taking this into consideration, there can be no doubt that practically the whole of the free exchange available to Germany for the purchase of raw materials was supplied directly or indirectly by Great Britain. If the day of reckoning ever comes, the liberal attitude of the British government in this matter may well be responsible for the lives of many British soldiers and civilians'.

Nor did Chamberlain seek to restrict Germany's power to acquire essential materials by more direct methods. Despite the existence of a system of export licences which made it simple to prohibit undesirable exports, licences were freely granted for the

export to Germany of raw materials which Britain herself needed. This laxness continued up to the declaration of war itself, so that only forty-eight hours before the start of hostilities a British firm was able to export 3,000 tons of copper—a vast quantity—to Germany for the manufacture of shells which might be used to kill its fellow-citizens.

Another direction in which Britain's economic policy, or lack of it, assisted the Nazis was the continued failure to counter the German penetration of south-east Europe. Following the Munich crisis, the President of the Board of Trade and his opposite number, Mr. Hudson, pressed repeatedly for a trade drive in south-east Europe, but the Treasury, backed by Simon and Hoare, obstinately opposed the granting of funds for the purpose. A few concessions were wrung—a loan was made to Turkey and the United Kingdom Commercial Corporation was formed—but nothing approaching an organized drive was developed. The pressure by M.P's also forced the government to take the Export Credits Guarantee Bill out of turn, but after it had passed its second reading it was mysteriously abandoned until the following year.

The most mysterious move of all took place in March 1939, when the representatives of British industry (the FBI) met the Rhine industrialists at Duesseldorf and agreed on an Anglo-German trade pact. Within a few days of this, Chamberlain made his astonishing 'millenium' speech in which he declared his belief that a new golden age of prosperity was about to dawn and his hope that he would soon be able to call a world disarmament conference.

How are these extraordinary activities to be explained? The only view which seems to me to make sense is that Hitler had convinced Chamberlain that his only object was to conquer Russia—a scheme which was naturally attractive to British capitalists. When he had done so he would have no further territorial demands and would be glad to order large quantities of industrial equipment to develop the new-won territories.

In the light of such a theory Chamberlain's attempt, in conjunction with Daladier, to send an expeditionary force to Finland to fight against Russia takes on a new significance. Involved in

war with Russia, Germany would have become our ally. The refusal of the Swedes and Norwegians to grant transit facilities for the Allied force emerges as one of the most crucial decisions in the history of the world.

It would take us far beyond the scope of a book on economics to trace how the political developments which followed led to Britain's entry into the war nominally in defence of Poland and to the final collapse of the 'leave Germany alone' policy with the advent of Churchill to the premiership.

WHAT WENT WRONG?

This brief economic history of the 'thirties is already over-long, although so much has been omitted. We have said nothing of the part played by the over-valuation of the peseta in bringing about the Spanish Civil War. We have neglected the story of how Italy's problems led to the conquest of Abyssinia, with Laval again appearing as *diabolus ex machina* clutching the Hoare-Laval pact. We have not described how the small gold-bloc countries were forced into devaluation as reluctantly as France. The Far East we have neglected completely. We might have stressed how Japan invaded Manchukuo while Britain and America were preoccupied with the slump. We might have related the tragi-comedy of Chinese silver, disclosing how the pressure of American silver-mine interests contributed to Chinese weakness in the face of aggression. Or we might have explained how Britain's abandonment of the open-door policy in Malaya and the Far East depressed the native standard of living to starvation point and provided fertile soil for Japanese promises of a 'Far East co-prosperity sphere'.

But instead of plunging farther into the thicket of detail, let us stand back and get the process into perspective against the background of a century of modern industrialism. What were the decisive trends at work?

In the nineteenth century the 'self-regulating system', *i.e.* the international gold standard, functioned reasonably effectively, serving not only to balance international payments but also to bring about structural changes. Its comparative success was

dependent on four circumstances. (1) Structural changes affecting established industries were rare. (2) The whole system was expanding so that contractions were generally relative and not absolute. (3) The mass of the population had no vote and were ignorant and unorganized, so that there was effective opposition to deflation and structural unemployment when it was inflicted by the gold standard. (4) The British fleet soon brought to heel any small nation which disregarded the rules on which the system depended.

But by the early years of the twentieth century late-comers in the industrial race were threatening the leaders, while the pace of technological change was accelerating. Meanwhile the period of expansion was coming to an end. Thus the gold standard was required to bring about much more drastic adjustments than ever before. The war naturally magnified the structural problems still further. But precisely at the time when the gold standard was being asked to carry out unprecedentedly vast adjustments the conditions of its successful operation were vanishing. An enfranchised and unionized population could bring great pressure to bear on governments to reduce unemployment and protect wage standards.[1] Governments therefore restricted immigration and imposed tariffs—thus abandoning the gold standard in principle. And the countries which did this were not insignificant states which could be called to heel, but great powers like America, Germany and Russia.

The United States struck the death blow when it decided to 'sterilize' its gold surplus. Previous measures had thrown sand in the wheels of the self-regulating system, but this was unhooking the pendulum of the clock. With each country that edged off the gold standard, its forces pressed with added violence on those that remained. It was only a matter of time until some nation declared formally what had long been a fact; that the gold standard was on the scrap-heap.

[1] Professor E. H. Carr has stressed the importance of popular opinion in this context (see *Nationalism and After*), but it should be added that several countries were heading towards economic control for other reasons. Germany never possessed a laissez faire economy in the ordinary sense and introduced tariffs as early as 1879. In Russia, discontent led to control via a revolution and not via enfranchisement.

Having scrapped the gold standard, no one attempted to put anything in its place. Since the United States was the leading economic power and since she was so largely instrumental in jettisoning the old system, the responsibility for establishing a new one was primarily hers. Alas, she was not ready to assume the rôle of leadership which history was offering her. When Britain had been offered a similar rôle a century before, she, fortunately, had a long tradition of world-wide interests and responsibilities to guide her. Not so America. Wrapped in a struthious isolationism, she concentrated on poulticing her own stomach-ache and let the world go hang. Not, I think, from indifference but from pure lack of imagination. Schooled to the idea of individualism without public responsibility, no other course occurred to her.

During the 'thirties, therefore, there was no international system of regulation. The industrial nations each attempted to insulate themselves from the effects of general economic and technological progress by erecting tariff walls and severing their monetary systems from gold. They each tried to throw the burden of absorbing change on to other countries and to avoid it themselves. Each country to whom the ball was thrown immediately threw it back again: each discriminatory act provoked still more savage retaliation. The resulting atmosphere of embittered economic isolationism naturally fomented the forces of political nationalism. Unready to co-operate in the economic sphere, the nations were unlikely to co-operate in the harder task of making a stand against aggression. And so the way was paved for war.

THE LESSONS

At the cost of repeating myself, let me tabulate the lessons which can be learned from this gruesome recital.

First, we must recognize that the vaunted self-regulating system—the international gold standard—is a hopeless fiasco. The most serious of the charges against it is that it is guaranteed to magnify any depression and spread it as rapidly as possible over the rest of the world. Internally, depression makes it impossible to balance the budget: in the attempt to do so the govern-

ment reduces expenditure and intensifies the slump. The international consequence is that imports decline; as a result countries trading with the depressed nation develop an adverse balance of payments. To correct this they deflate, provoking depression, and cut imports not merely from the country which is the cause of the trouble, but from every country. Since several nations are doing this at once, the result is a sharp contraction of world trade, leaving export industries idle everywhere. The resulting unemployment starts off snowballs of depression on every hand.

The second thing we can learn is the necessity of coping with the mighty flood of technical and economic change. There will always be depressed areas—and there will always be international bitterness—until we can painlessly liquidate national industries which have been rendered obsolete by the march of industrial progress. (Here again the gold standard plays a dire part, since it attempts to compensate for the failure of superseded industries to sell their goods abroad by imposing an irrelevant deflation.)

Thirdly, we must note the palpable dangers of a policy of jam to-morrow. If a great lending country chooses for any reason to cut off the stream of loans, or still worse, to call loans in, it can plunge the borrowers into bankruptcy. Equally, if a country with an export-surplus fails to lend, it can gradually drain the world of gold.

Fourthly, we see the pernicious effects of speculation. Stock exchange speculation may divert funds from vital uses and may even administer a shock sufficient to set off the spiral of depression. International speculation menaces exchange stability—or, if we favour the gold standard, can throw a country's monetary system into chaos and precipitate exchange adjustments which might never have been necessary.

Fifthly, we see the disruptive effect of war debts and reparations. Clearly a creditor nation must cancel them or bear the consequence; a flood of cheap imports.

Lastly, (though the list could be lengthened) we see the folly of abandoning the gold standard without putting anything in its place as an international regulator. For the gold standard at least *tries* to bring about an adjustment of trade balances on a world scale. Moreover it does this not only by contracting imports

but equally by expanding exports. Whereas in the absence of the gold standard, each country reduces imports by imposing tariffs, usually more drastic than is necessary, which only provokes other countries to retaliate in self-defence until finally all international trade is stifled while the intended effect may not even be achieved.

FURTHER OUTLOOK UNSETTLED

As we look towards the future, one fact, at least, stands out very clearly. Conscious control of the volume of money and of international payments is here to stay. No nation will again submit to deflation or being drained of gold. Every nation will assume the right to prevent an adverse balance of payments by the use of tariffs, exchange control or other methods. Still less will they hesitate to restrict immigration if they so desire. So, unhonoured and unsung, the gold standard is dead and buried. If in the future anything is offered to us in that name, be sure it is a pseudo-animated corpse.

That leaves us with the problem of what to put in its place. And to-day the tasks awaiting international regulation are more formidable than ever. The second world war has created new monetary and structural maladjustments. War-time inventions, the harnessing of atomic energy, and inventions still in the womb of time will unleash a cataract of change. Left to themselves, nations will entrench themselves behind a barricade of tariffs. It will be futile to hope to scale them down by international agreement, because no country can afford to give up the weapons it needs to ensure a balance of payments. That is why the endless conferences held with this object in the 'thirties were so abortive. Nothing short of placing the whole process in the hands of an impartial, supra-national body and loyally accepting its decisions can possibly be effective. But that is tantamount to suggesting that nations should give up a small part of their so-called national sovereignty, by which is meant the right to behave exactly as you please regardless of anybody else. Any such proposal (so we are told with slightly suspicious regularity) would be 'unrealistic'. And, knowing the minds of a good many statesmen, perhaps it would. 'Realism' (once a favourite word of the dictators) used to

be at a discount in the democracies. It was 'realism' to co-operate with Hitler. It was unrealism, better known as faith and courage, when Britain held on alone. Times change. 'Realism' is at a premium again in 1947.

If in these chapters I seem to have spoken hardly of the Americans and French, let it be remembered that I have spoken no less hardly of the British. Why is it that people who are capable of courage and generosity in their private dealings should be so incapable of them in their public capacities? Or how is it that people devoid of such qualities attain positions of power? If a private individual were to behave in his private concerns as the statesmen and financiers of great nations behave in their formal activities, he would become hated and friendless in short order.

Perhaps it is the case that the circumstances of life in western civilization act to suppress and abort courage and generosity, so that it is only in the young that we normally find it. The shining exceptions serve but to emphasize how usual is the process of survival of the slickest. And yet unless the world can find the imagination and courage and generosity to constitute a world-wide system of economic management the tragedy of the past decades must, beyond any doubt, repeat itself.

21

Achieving Full Employment:

(1) Planned Money

'The first thing I've got to do,' said Alice to herself, as she wandered about in the wood, 'is to grow to my right size again; and the second thing is to find my way into that lovely garden. I think that will be the best plan.'

HAVING NOW surveyed the intricate web of forces of which the economic system consists, the moment has come to ask ourselves a decisive question. Is it possible to believe that the system can ever be made to function satisfactorily without a conscious, co-ordinated control of the numerous variables? Only in America and a few other countries would the bulk of the population still answer yes. In Britain, as in Europe as a whole, an almost unanimous opinion regards laissez faire as dead. The only remaining issues—and they are most important—are how much control is needed, and who is to wield it?

This is not to say that the problems could not be greatly reduced if we were to change our pattern of living and amend our motives, but, in any society engaging in large-scale production, some degree of central regulation would seem to be inevitable. Once, the working assumption was that systems would operate themselves and the onus of proving otherwise rested on those who disagreed. To-day the position is reversed. It is up to those who oppose any kind of control to prove how, without it, disaster can be averted.

Of course, to say that control is essential is not the same as declaring for socialism (or communism or fascism) forthwith. Possibly a slighter degree of control than socialists or communists

envisage may prove sufficient. Possibly that control can be exerted without resorting to the measures, such as nationalization of key industries, on which socialists rely. Above all, control may be utilized without accepting the whole array of social, political and philosophical beliefs to which socialists or communists subscribe, and without adopting the general policies which derive from them. This might seem too obvious to mention if it were not for the astonishing fact that none of the opponents of socialism have ever produced a comprehensive alternative solution supported by adequate theoretical work—except, indeed, the fascists.

Accordingly in this chapter and the next I propose to review as impartially as possible the various fields in which control is bound to operate. At the same time I shall indicate the sort of devices which are currently being advocated as the bare minimum necessary to effect such control. About these suggestions there will be nothing dogmatic. They are no more than instances of how the thing might be done. When it comes to the point, considerations—possibly unconnected with economics—may dictate some quite different technique. Above all, no proposal should be judged as if it were final and permanent. The economic system is an evolving organism. It always remains open to anyone who can think up a better way of doing things to come forward and say so. No one will be more delighted than the economists, who realize very fully the imperfections of their proposals. Methods which seem advanced to-day will look reactionary and antiquated in a hundred years' time.

So much for preliminaries.

The advance must take place on three main fronts: stabilization of the price-level, reduction of structural unemployment, and maintenance of purchasing power (*i.e.* reduction of oversaving). Let us consider the question of price-level first.

1. Stable Price-level

Properly expressed, our objective is to protect the price-level from any variations which may arise from failure to adjust the supply of money (MV) to the supply of goods, while leaving it free to respond to decreases in the real cost of production. To

achieve this end, our main weapon is adjustment of the supply of money (M), though a part can also be played by preventing abrupt and unnecessary variations in the supply of goods.

The first step to realizing such a policy is a psychological one. One must create a state of mind such that if major variations in the price-level occur, people start asking pointed questions. If the government wishes, for some reason, to bring about a permanent change in the price-level, then the matter should be subject to debate in the House of Commons; a movement which enriches one section of the population while impoverishing another should not be put through on the quiet by the Bank of England and the Treasury, as for instance after the 1914–18 war.

Having accepted the stabilization of the price-level as a national policy, the next step is to reform the machinery by which money is issued so that the amount can be adjusted easily and at will. Here we come up against the difficulty that at present money can only be put into circulation in the form of loans. If it is our wish to cause the least possible dislocation to existing practices, we will not sweep away the present system whereby banks create money to make loans, curious though it is; we will accept it, but we will arrange that any extra money needed, over and above the amount created by the banks, shall be created by a properly constituted body, and supplied to the government for the paying of wages. The simplest method we might employ would be to establish a money control office which would inform the Chancellor of the Exchequer every year, at the time of the annual budget, that he could rely on a specified sum, which can be added to his revenue; this would enable him to reduce taxes or duties by a corresponding amount, and thus the benefit of the '*fiat money*' would be diffused over the whole population. This procedure also permits a reduction in the volume of money, should banks through their loans be creating excessive amounts. In this case, the Chancellor would be informed that he must regard a specified sum raised by revenue as cancelled.

This device would also enable us to get rid of the strange system by which the Bank of England attempts to control the volume of money by influencing the lending operations of the joint-stock banks. As we saw in Chapter 8, if the Bank of England

wishes to bring about a reduction in the volume of money it compels the joint-stock banks to call in loans, thus strangling industry and perhaps precipitating a slump. By the new method, industry is left unharmed. This change, however, alters the responsibility of the Central Bank. It must now regulate the cash holdings of the joint-stock banks in such a way as to keep *bank loans* at the most desirable level (instead of the volume of money, as before).

But is this good enough? One can imagine circumstances in which bank loans were reduced to a very small figure, although the total volume of money in circulation was far larger than ever before. In this case, the demands of bank customers for cash might well exceed the number of notes available. Is it really a good idea to prolong this strange system whereby the banks only possess one-tenth of the money they have lent, and are permanently insolvent? Would it not be better to provide the banks with whatever quantity of notes they may need to meet the demands of their customers?

But if we do this, the joint-stock banks must be restrained from simply using the extra notes to extend their loans and so recreating the original problem. The rational, sensible thing would be for the banks to regulate their lending by the needs of the country, and nothing else. But they cannot serve two masters: they cannot be responsible to the country and their shareholders both. This suggests that they would have to operate on a public utility basis, earning a fixed profit and not responsible to the shareholders, but to the country as a whole, for their stewardship.

CO-ORDINATION OF BANKING POLICY

It also suggests that the banking system as a whole has outgrown the loose organization of a central bank dominating a group of competing joint-stock banks and that it needs to become integrated into a single co-ordinated machine for the control of money. Once we abandon the system whereby the joint-stock banks follow their own sweet will within limits imposed by the central bank and suppose them both devoted to a common purpose, there ceases to be any point in the scrupulous mainten-

ance of barriers between them. They can pool their knowledge of industrial conditions and can co-ordinate their lending policies. I do not mean by this that we should proceed to the logical extreme of a single ubiquitous state bank. I believe, on the contrary, that there are advantages in decentralization. But I think that the bankers might work out some scheme—representation on each other's directorial boards, or a bankers' council—for a closer co-operation, once the non-profit-making basis had been established.

The central feature of any such plan is the money control office, whose task we have defined as studying the monetary needs of the country and creating fiat money in appropriate quantities. (I need not go into the refinements of this task: it is clear, for instance, that its duties cannot end with the issue of fiat money at yearly intervals—it must also see that it comes into circulation in appropriate quantities week by week.) The money control office will, in reality, be exercising the age-old sovereign privilege of minting money, but in a form which has evolved consonantly with the change in the nature of money itself. Since this innovation renders the device of the fiduciary issue superfluous, it is clear that the office will have to be subject to democratic control. The Bank of England is the only body with anything approaching the experience, the staff and the statistical services necessary for carrying out such a job and it has now been nationalized in principle if not in fact. The sensible course would therefore be to delegate this function to the present note issue department of the bank and to charge the governing board with the duty of regulating the volume of money so as to maintain a stable price-level. It will then remain to throw open the conduct of the board to discussion in the House of Commons. For unless the bank is answerable to the country through the House it might just as well never have been nationalized.

The side of the bank which controls the volume of internal money must necessarily work in the closest harmony with the side which manages international payments, even when the volume of internal money is no longer dictated by them. For instance, it would be ludicrous if the gold-holding side were to pursue a policy of attracting loans from abroad by raising the bank rate,

at a time when the note issue side was trying to reduce lending. The central bank is therefore the only logical body to manage the control of money.

COMMODITY CONTROL

Prices are the product of supply and demand. Thanks to the trade-cycle, demand drops off and returns every eight or nine years. Success in controlling the trade-cycle must considerably simplify the task of the monetary authorities in maintaining a stable price-level. But there is no necessity to let supply plunge about wildly in the wake of the trade-cycle until we have found ways of taming it. We can also engage in direct control of the productive process, and if we can stop it following these periodic changes, we greatly ease the violence of the monetary fluctuations.

It has therefore been suggested that the producers of basic commodities (wheat, sugar, rubber, copper, oil, etc.) should adjust their rate of output to the world's average requirements. In slump years, when demand was small, they would pile up stocks and would draw on them during the boom years when demand exceeded supply. These *buffer stocks* would be a most valuable stabilizing factor; they do not, of course meet the problems of permanent structural maladjustment, and would have to form part of a wider scheme of structural control, such as is discussed in the next chapter.

REFINEMENTS OF PRICE CONTROL

Complete price stability cannot be achieved simply by adjusting the whole supply of purchasing power to the whole supply of goods. Such an average stability may conceal violent movements in different price-fields. Thus a transfer of purchasing power from luxuries to necessities might cause a fall in the price of the former and a rise in the price of the latter. Similar see-saw movements may occur between capital goods and consumption goods, or between agricultural goods and manufactured goods. The ultimate object of price-policy must be to attain a fairly high degree of stability in every single price-field. The stability of

individual prices depends on the whole physical operation of adjusting supply to demand (dealt with in the next chapter). The monetary problem cannot be solved in isolation: it must be tackled conjointly with the management of real things.

One such see-saw movement of particular importance is that between capital and consumption goods. Increased investment, with the absorption of unemployed labour, increases the demand for articles of popular consumption. Hence changes in the investment rate bear on the subject of price control. In short an effective price-policy can only emerge conditionally upon success in the solution of other monetary problems.

BALANCE OF TRADE

Finally there is one more implication in a stable price policy which must be faced. It commits us to the abandonment of price changes as a method of causing imports and exports to balance. The alternatives available for this purpose are the periodic readjustment of exchange rates and/or the use of trade controls such as tariffs, quotas and subsidies for exports.

The general trend of opinion to-day favours the more elementary device of exchange rate adjustment. In order that such readjustments should take place in an orderly manner and not provoke counter measures which would undo their effect, we require some international body to supervise the making of changes and, what is more, with power to compel countries to make the desired adjustment. For if any country consistently undervalues its currency, other countries will be forced to lower the valuation of theirs. If the first country then devalues, they will have to do the same. A devaluation race will ensue; and since the internal counterpart of devaluation is inflation, this might have dangerous consequences.

The Bretton Woods Conference sought to set up such a supervisory body, but failed to equip it with any powers except that of expelling recalcitrant members from the organization. Bretton Woods also failed to tackle the tariff question which is closely interdependent with the subject of exchange rates. For if America (for instance) excludes British goods by the imposition of

a tariff, Britain's trade will probably become unbalanced and she will have to alter her exchange rate. As long as each country is free to erect tariff walls of different heights, exchange rates will rest in quite artificial positions. The countries with the lowest tariffs will be penalized.

The truth is that the problem needs tackling in an altogether bolder way. The primary task is to get each country producing the goods for which it is fitted in the volumes in which they are needed. Exchange rates and trade controls (tariffs, etc.) should then be adjusted to suit. At present we adjust production to suit exchange rates and tariffs. The first step is to draw up a *world production plan*: having organized production on a rational basis, the next step is to fix exchange rates as near the 'fair' position as possible, instead of using them to cut off our own noses as at present. Finally control devices can be used to bring about any remaining adjustment necessary, and for no other purpose. They must certainly not be used for maintaining inefficient industries as they are at present, unless there is some over-riding social or political reason for so doing.

Such a concept of world trade is sadly remote from anything envisaged by those who talk so loudly about world trade to-day. On either side we hear shouts in favour of free trade and of protection. Both are equally irrelevant. If you hear someone advocating free trade, ask him how he proposes to correct an adverse trade balance. Ask him what he proposes to do in face of discriminatory tariffs imposed by other countries. If you hear someone advocating protection, ask him how he proposes to prevent it being used to shelter inefficient production. Ask him how he proposes to prevent other countries nullifying it by counter-protection.

Stable prices are seen to be the outcome of a smoothly integrated productive process. Obviously they can never be stable as long as we rely on their fluctuations to bring about the integration of the productive process. Thus in a rationally ordered economy, stable prices are a by-product; the real problem is to so control the industrial and financial machinery that it adapts itself smoothly to human needs. Control of real things comes before control of money, and not vice versa.

GOVERNMENT ATTITUDE TO PRICE PROBLEMS

That we have had to devote such a large portion of this chapter, and indeed of the whole book, to problems of price stability may serve to throw into relief the remarkable ignorance and neglect of all such problems displayed by those in authority. Instead of seeing prices as the outcome of a confident management of money and resources, they ignore them except when they threaten to rise precipitately and then they scurry wildly about like an amateur ground crew trying to hold down a large balloon in a high wind. This was especially noticeable in the 'national' government's White Paper on full employment. It contains, to be sure, a section called 'Stability of Prices and Wages'—the title alone shows that the authors are chiefly preoccupied by the possibility of wages rising. This is borne out by the text, which starts by declaring that workers must 'exercise moderation in wage matters.' Then—as if over-charging by price-rings were more than a tiny incidental factor in determining the price index—it adds that the government would seek power to check restrictive arrangements. These (the reader will hardly believe it) are its only suggestions for ensuring stable prices. They show nothing less than a total ignorance of economics: and that is no exaggeration.

The first suggestion betrays that the government was thinking purely in terms of checking inflation, whereas it is deflation which is the paramount danger. The second point, though important in the context of over-saving, has nothing to do with the general price-level at all! Apart from these two irrelevant observations, nothing. No mention of banking policy, no mention of the trade balance, no mention of the velocity of circulation, nothing.

Sad to say, there is also no recognition of the need for stabilizing prices in Lord Beveridge's widely read work on full employment, except a pious aspiration.

2. MAINTAINING PURCHASING POWER

Let us now turn to the maintenance of purchasing power and the prevention of basic unemployment. According to the analysis

in this book, purchasing power becomes deficient because more is diverted into the channel marked 'saving' than can be absorbed by the investment market. The maintenance of purchasing power is consequently a matter of reducing the proportion of income saved and of enlarging the opportunities for investment. But the point at which the two factors are brought into congruence must be related to the community's real needs. It would be lunacy to prevent over-saving by building more capital equipment than was really needed; it would be hardly less satisfactory to cut down saving to a level below the country's real needs.

Hence the logical course is to start by agreeing on a national investment rate. After a war in which much capital wealth has been destroyed or allowed to fall into disrepair, the rate may well be high. In a country which has acres of slums, an inadequate system of roads and an ill-equipped agriculture, the rate may well be very high. In a country in which great changes in the income structure, and hence in the nature of demand, are taking place, there is also good reason for a high investment rate. But these circumstances will not always obtain.

At the same time it is necessary to decide how much foreign investment shall be done: how far it is right to assist other nations to raise their standard of living, and how far they can be relied on to honour their debts. Perhaps there should be an annual debate on the subject in Parliament. Perhaps the matter should be settled by the economic planning committee and approved by the Cabinet. These are matters of machinery. What I want to establish here is that we should take, by one means or another, a conscious decision on the point, instead of leaving it to chance.

The decision once made, the chances are that the practical problem will fall into two halves: (1) enlarging investment opportunity, (2) reducing saving. (We can, I think neglect the possibility that the investment rate should be fixed so high that saving would have to be increased, or so low that investment opportunity would have to be reduced.)

1. *Enlarging Investment Opportunity:* When we read reports revealing the out-of-date nature of the equipment of many British industries or see figures showing how much more highly than Britain the United States is mechanized it is clear that there

is plenty of room for the investment of savings in this country. Why is this investment not carried out? In the first place, because the decline of competition has removed the spur to modernization; competition was the force which, at least in theory, eliminated the unprogressive firm.

So an obvious step towards maintaining purchasing power would be to break up the various price-rings, trade associations, cartels, chain stores, trusts and monopolies which are able to maintain prices at levels which protect the inefficient. Another would be to revise the patent law, which to-day is so often used as a means of restricting the introduction of new devices. A third would be to reduce protective tariffs so as to expose inefficient home industries to the pressure of foreign competition.

But, in their blissful ignorance of economics, the great industrial magnates are the first to oppose any such course although they simultaneously bleat about the need for a higher rate of 'saving' (by which they mean investment).

There is however a more serious obstacle to the enlargement of investment opportunity: this is the fact that many forms of investment which are socially necessary are commercially unprofitable. Thus we are all agreed on the need for clearing away the slums, draining and re-equipping farms, providing a new road system and financing scientific research. But there is no money to be made from doing these things. (Scientific research, perhaps, is occasionally profitable, when it yields means of reducing costs or provides new devices and substances for which there is a demand, and that is why we now hear something about the need for research; but there is no enthusiasm for research in psychology, economics, preventive medicine, astronomy, embryology, and the like, for their discoveries cannot be marketed.)

There would therefore seem to be a case for the setting up of some kind of national investment fund to finance such enterprizes at nominal interest charges or even interest free; and it would be appropriate if the money were obtained not from the great pool of general revenue but by a tax on ordinary investment or alternatively on sums left idle at the banks. But the question of how the money is to be raised is part of the subject of reducing over-saving. Here I only wish to suggest that state-sponsored

investment, instead of being wrung from the Treasury piecemeal by the ministries and departments concerned, should be planned as a whole and proper sums provided without hesitation. The general tendency of governments is to keep all such expenditure to a minimum because expenditure means taxation and taxes are unpopular. As already argued in Chapter 17, such expenditure should be comprised in a special 'capital budget'.

In illustration, I would like to take the case of the railways, which illustrates several aspects of the problem at once. Most people would agree that (with minor exceptions) the dirt, inconvenience, ugliness and incompetence of British railways are a disgrace—certainly anyone who has travelled on American railways. Money might well be spent rebuilding stations, replacing rolling-stock and providing better services. To some extent this state of affairs is due to the decline of competition—for, although there is strong road competition, it chiefly affects short passenger hauls. Few people will travel from London to Scotland by bus, and few will send large tonnages of coal or machinery by road. To a greater extent it is due to the fact that further investment would not materially increase profits. Replanned stations and new rolling-stock will not cause a large increase in travellers, even though they increase the comfort of those who do travel.

The problem can also be analyzed as a failure to write down the capital costs of obsolescing equipment in the past. When the railways were making good profits they distributed too much as dividends, put too little into modernization. As a result they now have a huge arrear of modernization to perform and no funds. If they raise new capital by borrowing in the ordinary way, they must write off the bulk of the old—which will not please the holders of railway stock—or else they must increase charges to the public in order to pay the interest on the loan. The steel, coal, textile and shipping industries are in similar predicaments.

The conclusion we must draw from all this is that the restoration of a greater degree of competition (supposing we could do it) will not of itself open up investment opportunities in the fields where they are most needed even in the sphere of industry—let alone in the sphere of social improvement. It is hard to see how the problem can be solved without a change in the nature of

ownership. Something is needed to make the managers of industry responsible to the community and the only method of achieving this so far devised is the institution of some form of public ownership. To this issue I shall recur in the final chapter.

2. *Reducing Over-saving:* We will consider personal saving and institutional saving separately.

Personal saving is chiefly motivated by the desire for personal security and independence, so we could reduce the urge to save by providing more state insurance against sickness, unemployment and old age and also by making it easier to borrow capital to start small enterprises. It has been argued that such a course makes people dependent on the paternalism of the state and saps their independence and initiative. If this is so, we shall be obliged to confine our efforts to reducing commercial saving. In any case, commercial saving is the biggest source of saving and our success or failure will depend on our measures in this sphere much more than on the reduction of private saving.

Commercial saving is regulated by entrepreneurs' judgment as to what is sound business conduct, and it is therefore bound to be very difficult to persuade them to reduce it. Nevertheless, there is some evidence that commercial saving could be smaller without really damaging business. The entrepreneur is at the same time too pessimistic and too optimistic. He tries to provide for the worst disaster which may befall him. As a result business collectively saves more than is needed for the disasters which will, in fact, occur. (It is as if everyone should save enough to rebuild their house should it burn down. Since only a percentage of all houses do burn down, it is really only necessary to save a percentage of the cost: this is the well-known principle of insurance. If one could devise some similar system of pooling savings for business, they could afford to save less.) At the same time the entrepreneur is too optimistic. He hopes that his enterprise will be such a success that he will have to expand, and he saves money for this purpose. But only a proportion are so successful.

Unfortunately, it seems impossible to devise any satisfactory scheme of pooling savings. For the risks and opportunities to be covered cannot be actuarially calculated, either in size or frequency.

Even if such a fund could be satisfactorily administered, it would not follow that entrepreneurs would reduce their saving to the requisite amount.

It seems impossible to escape the conclusion that we must interfere directly with the decision of the entrepreneur to save. But how is this to be done? *If* business were anxious to co-operate, it would suffice if every firm notified some central body of the amount it was saving each month. Whenever the central body found the total too high it could instruct each firm to scale down its allocation by a suitable percentage, or scale it up if the total were too small. But we cannot assume that business would co-operate squarely in such a scheme. Firms would over or under-state their requirements in an attempt to forestall whatever instruction they expected. Each time the central body ordered reductions, the following months' claims would be pitched higher and higher. The only circumstances in which such a scheme would work would be if all the firms were state owned. And this, in essence, is how saving is arranged in the U.S.S.R.

Another suggestion has been that all savings should be written down by a proportion of their value every month, so that they ultimately disappear. Apart from the enormous difficulties of administration, this scheme is open to sabotage in the same way as before. Firms would simply respond by increasing their allocations to reserve. One must conclude that short of state ownership it is impossible to influence the *proportion* of profit saved; we are therefore driven back on the cruder method of trying to limit saving by limiting profits as a whole.

LIMITATION OF PROFITS?

This is not (it must be conceded) a satisfactory device, for any reductions we may effect in profits will be distributed more or less equally over reserves and dividends. Thus we shall not only reduce saving but reduce purchasing power—which means that we must bring about a further reduction in saving, and so on. Nevertheless, let us see what we can do in this direction.

Taxation is a most unsatisfactory way of reducing profits. Instead of letting profits accumulate and then confiscating them,

it is more sensible (and less disagreeable) to prevent them accumulating in the first place. This can be done either by raising wages or by lowering prices (or both)—but here we come up against another difficulty. Firms vary widely in efficiency; if we fix wages at a level which allows a reasonable profit to the least efficient firms in the field, the most efficient will be earning excessive profits. Again, raising wages is less satisfactory than lowering prices, for some industries are making faster technical progress than others. As a result wages in these favoured industries will rise rapidly while those in non-technical industries and occupations remain static. This is unfair, so once again we are brought back to the restoration of competition as a means of keeping prices to the minimum, unless, indeed, we are prepared to undertake comprehensive control of prices. There is no easy road to profit limitation.

It is, however, only partially correct to regard the profits of enterprise as coming from the sale of goods or services; part of what appears on the credit side of the balance sheet is the interest on investment. The reader may demand whether we could do anything to reduce this source of profits or to prevent it being used for further saving. We can certainly reduce its volume, for any measures which reduce the profitability of business as a whole will cause it to cut down dividends, including those paid to other firms. But this is our only line of attack; we cannot stop the money being devoted to saving. Even if it is distributed as dividends and not put to reserve, a large part of it will fetch up in the balance sheets of other firms.

The fact is, to a large extent industry is owned *by* industry. If we examine the lists of shareholders in one firm, we find that many of the shares are held by other firms. All these firms are engaged in a game of handing their profits back and forth from one to another and steadily increasing the lump of capital which collectively they control. Thus it is true to say that it is the one-sided distribution of capital which is the main cause of over-saving. The difference between large *salaries* and the smallest salaries or wages is unimportant, relatively, as a cause of over-saving. But we cannot break up and disperse more evenly this great clot of capital because to do so would leave firms without the

reserves which they regard as essential to the proper conduct of their business, and still more because confiscation of capital would provoke frenzied resistance on a point of principle. There is no weight of public opinion in favour of this, the only irresistible weapon against over-saving.

As far as personal accumulations of capital are concerned, death duties provide a valuable means of redistributing and dispersing capital.[1] But the limited company has all the legal rights of an individual without his mortality. It would at least be logical if we decreed that every limited company must expire at the end of three score years and ten.

The long and short of it is, business is continuously engaged in an attempt to accumulate an ever bigger pile of capital. The only circumstances in which this can continue without eventually causing so great an aggregation that over-saving occurs is if all the time, in other parts of the system, forces are breaking down the clot of capital as fast as it is built up. Every spendthrift son, every bankruptcy, all estate duties are factors postponing the onset of over-saving.

For some time now the breaking-down factors have been completely swamped by the building-up factors, with the result that capital has become so hopelessly maldistributed as to make over-saving inevitable. For any redistributory devices we introduce must become more and more burdensome as the clot of capital grows, while a direct attack on the right to accumulate capital strikes at the foundations of the 'capitalist' system. We cannot prevent over-saving without abolishing capitalism.

THE ADJUSTMENT OF WAGES

We have dealt with the subject of over-saving solely in terms of reducing profits, since this is the form in which the problem presents itself to-day. However, we should not ignore the possibility of the converse problem emerging. In conditions of full

[1] It is worth reading *The Economics of Inheritance*, by Josiah Wedgwood (Pelican Books), for suggestions on the breaking-up of private accumulations without doing too much injury to the family of the deceased accumulator.

employment, wage-earners might well demand wage increases on such a scale as to bring about under-saving. Seeing their employers making high profits, workers easily imagine that a share in these profits could simply be diverted into their pockets, without realizing that it would at once be incumbent on them to save a great part of any such addition to their incomes. Such under-saving would, of course, provoke a slump.

It is rather obvious that we cannot hope to get a division of the national income between profits and wages such as will keep saving at the right level by employing the crude pull-devil-pull-baker method we use to-day. Logically, we should draw up a comprehensive wage agreement and insist on its observance by both sides. But be it noted this suggestion implies abolishing the right to strike for higher wages. Either you have a species of warfare in which either side is free to get what it can: or you have arbitration in which the decision is binding on both parties. You cannot expect it to be binding on the employer but not on the men.

Unfortunately a wage agreement, unless continually revised, cannot hope to cope with our fluctuating national income. At present, employers take all the surplus in the good years but also bear some of the losses in the bad. We can only avoid this situation by abolishing the dual method of payment and making both workers and employers the recipients of a share in the total profits. The snag here is that workers in prosperous and efficient firms will do better than those in poor or backward firms—not necessarily a bad thing, but in direct opposition to the whole policy of the trade unions who have concentrated on standardizing wages. We can only get round this difficulty by pooling the profits (or that section of the profits intended for payment to workers) of a large number of firms before division. Naturally this will be easier if all the firms have a common owner—which brings us to the subject of nationalization or state ownership of industry. However, for the moment we will confine ourselves to noting that it possesses advantages in this context and pass on.

One further point remains. We have tacitly assumed that the sole object of income redistribution is to adjust saving to the optimum level. But we may have social reasons for carrying

dispersion much further, in which case under-saving will emerge. This suggests that the government should make up the difference, drawing the requisite money from the populace at large in the form of taxes. Such taxes need not take the familiar form: thus, if we adopt the pooling system mentioned above, the state might simply appropriate a proportion of the pool. And, if it seemed wise, it might distribute the dividends on such investment in due proportion to those who had contributed, or it could simply reduce, proportionately, the size of its deduction from the pool.

TAMING THE TRADE-CYCLE

When (if ever) we have succeeded in matching saving to investment in a general way, there still remains the task of smoothing out the periodic spurts of capital construction which take place during the booms into a smooth, steady flow. In other words, we must try and damp down the oscillations of the trade-cycle. To the extent that these oscillations are aided by price fluctuations, the proposals already considered will play their part. What we have to consider now is the fact that entrepreneurs call for new capital goods during the boom in large numbers, while in slump years they hesitate to initiate new enterprises and employment in capital industry declines.

Once again we are faced with the same problem: how to induce entrepreneurs to serve the public interest; but, oddly enough, in this case the public interest coincides with private interest. For capital goods are cheap during the slump, dear during the boom, and it would pay entrepreneurs to spread their orders more evenly, quite apart from the major consideration of avoiding a trade recession which none of them want.

The problem can be split in two: (1) restraining entrepreneurs from undue optimism during the boom, (2) encouraging investment during the slump. It looks as if it will be advisable to institute some system of licensing new projects during the boom, while during the slump the government may have to step in and fill the gap left by the defection of private enterprise.

In order to limit investment during the boom, it will probably be necessary to create a National Investment Board with power

to issue or refuse licences to all new projects. But it is advisable to face the true implications of such a step. Such an investment board cannot remain neutral. For when it has to turn down applications it is bound to discriminate between desirable and undesirable projects—there would be strong public criticism if it did not. Thus it becomes an instrument of planning and would have to work in subordination to some master planning organization.

Incidentally, the expression 'national investment board' is sometimes used in different context, as will be seen below, and the reader should make sure which is meant when judging proposals he may meet in real life.

It is sometimes suggested that the volume of investment could be controlled by limiting the issue of shares on the Stock Exchange. This might be necessary (it has been used in the war) but it is naïve to suppose that it could effectively limit the volume of investment by itself. For only a very small proportion of new enterprises is financed directly by the issue of new shares. The normal procedure is for the money to be privately subscribed in the City; subsequently the underwriters (as they are called) may pass the loan on to the public through the medium of the Stock Exchange, or not, as they see fit. In many cases, too, capital construction is financed from reserves and takes the form of extension to existing plant. Additionally there is considerable investment by municipal authorities, government departments, the Post Office, the B.B.C., the Electricity Commission, etc., which is financed out of revenue and not by public subscription.

To encourage investment during the boom is rather harder; for it is considerably easier to say 'thou shalt not' than 'thou shalt'. Something might be achieved by remission of taxes in consideration of new investment. The state might even agree to contribute a small percentage to any capital expenditure. But bait of this kind is useless if the fish are not in the mood to bite. If the entrepreneur is convinced that it will not pay to start a new enterprise, a slight reduction in working costs will not often change his mind.

Unless, therefore, we are prepared to go to the length of coercing the entrepreneur into activity, it seems that the only

thing is for the state to step in and initiate enterprises on a scale sufficient to make up for the deficiency of private investment. For such a measure to be effective it is essential that the state shall invest in precisely those fields of activity where business is proving shy, for only this will create work suitable to precisely those men who are unemployed.

But hitherto it has been a rigid principle in state investment that it shall be confined to non-commercial investment and never enter into competition with private enterprise. For to do so, it is asserted, would discourage private enterprise still further and lead to a further reduction of investment—so that in the end the state would have to take over the management of business lock, stock and barrel.

At present, in any case, there is no question of such a move. No one has gone further than suggesting that the state should increase investment in non-competitive fields, such as making roads and hospitals, while public corporations and bodies, such as railways, the Post Office, the B.B.C., should also expand investment during the slump and restrict it during the boom. There is no harm in such a proposal, but I am sceptical how much will be achieved thereby. The volume of investment thus to be thrown into the scale against the decline of business investment is relatively small; but, more than this, it is directed to the wrong channels. The unemployed riveter on the Clyde is not going to come south and work for two years on the construction of the Winchester by-pass until his private employers choose to whistle him north again. The unemployed iron-founder is not going to put in eighteen months manufacturing electric transformers because the Electricity Commission is enlarging the grid. What is going to happen is that the road-makers and transformer manufacturers are going to absorb labour from the unemployed and eject it again during the boom, so that this move will merely distribute the unemployment more evenly, some trades suffering unemployment during the boom, some during the slump.

It seems, therefore, that we need a National Investment Board armed with considerable funds and capable of competing directly with private investment. This body would also perform the lesser function already discussed of limiting investment during the

boom by administering a system of licences. Most of the proposals for an investment board, however, envisage only a body with powers of administering non-competitive investment (road-making, post-office development and the like). Such a board would be little better than useless.

If the government is to engage in enterprise on any such considerable scale, it becomes essential that its expenditure should be removed from the ordinary budget and presented on a special Capital Budget of the kind already advocated.

This chapter is already over-long, but we cannot leave the subject of the trade-cycle without mentioning one important and much-neglected factor: the rate at which wholesalers accumulate and release their stocks. It is also a factor bearing closely on the price-level. When wholesalers are buying they force up prices and encourage investment. During slumps the reverse occurs. The position of the wholesaler is really so important that it is remarkable how little attention is paid to it. His decisions, rather than the public's, turn on and off the tap of consumption, as far as producers are concerned. And at present wholesalers turn the tap in such a way as to intensify the trade-cycle rather than diminish it. If the wholesaling business were more highly organized there would be a powerful case for making it into a non-profit-making organization with the job of throwing its weight into the scale on the opposite side from the general tendency. Once again we are up against the old problem of reconciling the service of the public interest with the pursuit of private profit.

What has been said about wholesalers applies, mutatis mutandis, to the dealers in stocks and shares.

These remarks, of course, by no means exhaust the subject of damping the trade-cycle. The most intractable feature is that it is an international malady. Even if internal expenditure is maintained, export industries will suffer and this may be enough to set off the downward spiral of slump. Until such time as all the major industrial countries of the world have controlled economies, it will be advisable for the country essaying a planned economy to avoid engaging too closely in world trade. For if it does so engage, it can only escape the slump at the cost of periodically altering the trade structure—expanding home industries to offset

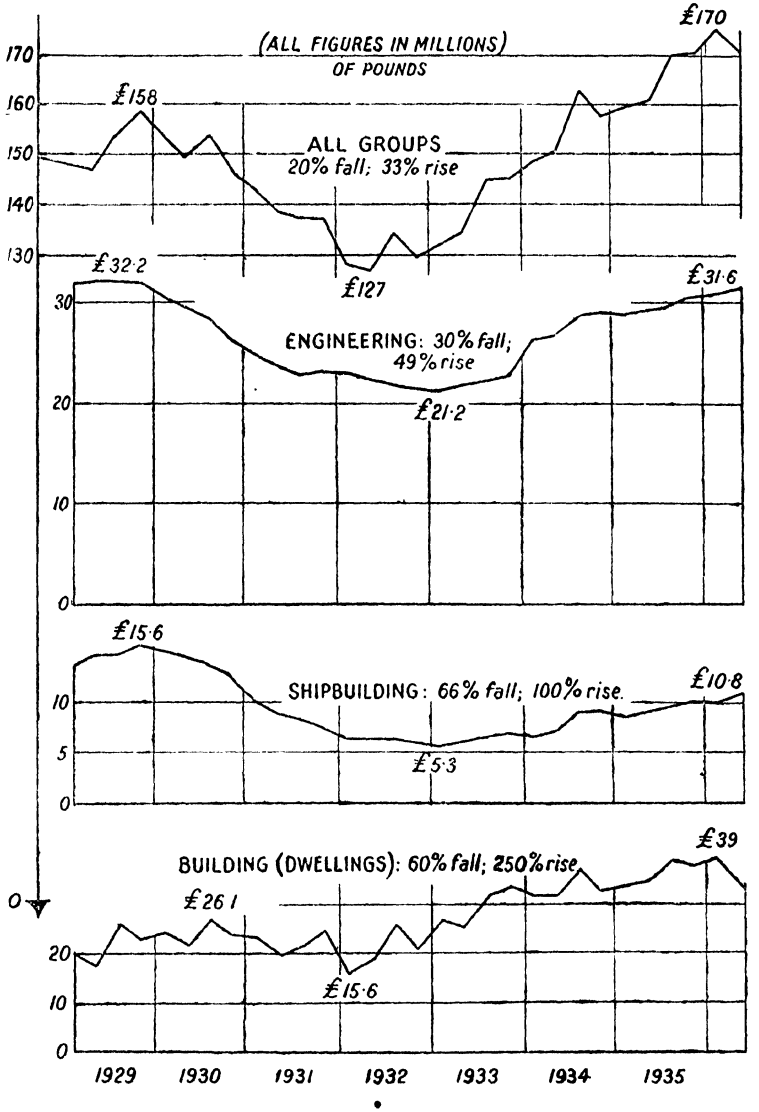


FIG. 36.—THE ERRATIC SHAPE OF INVESTMENT (3).

the contraction in exports—a process which would probably be so costly as to nullify the advantages of importing on so large a scale.

Summary of Points

It may help the reader if we now summarize the proposals put forward.

A. Price Stability: We aim to control the volume of money effectively by the institution of fiat money, and by the reorganization of the banking system so as to serve the public interest. Simultaneously the supply of goods must be regularized—this we shall deal with under the heading of structural problems in the next chapter. Finally, some degree of control of individual prices (including wages) is necessary to ensure price stability in each price-field. This implies the destruction of price-rings and like arrangements.

B. Equalizing Saving and Investment: (a) We need to increase investment opportunity: this means galvanizing the managers of moribund industries and a more liberal attitude to spending on so-called unproductive investment. (b) We must reduce saving. Apart from the little we can do by providing social security to reduce personal saving (if indeed that is desirable) we must try and force entrepreneurs to reduce their appropriations to reserve. The only available method, which is far from satisfactory, is to reduce profits. The best way of doing this is by lowering prices. We probably need a price control board. But the main cause of over-saving is inequality of incomes derived from unequally distributed wealth, which is an inevitable product of the system of capitalism.

C. Trade-Cycle Control: The main task is to limit investment in the boom, expand it in the slump. This suggests an Investment Board with powers to license new undertakings and with powers to engage in production on its own account. It would help if wholesalers accumulated stocks during the slump.

This quick conspectus reveals that fundamentally we are tackling but a single problem: how to induce various private entrepreneurs to serve the public interest. Whether they are bankers, industrialists, or wholesalers the problem is created by the fact that the pursuit of private profit does not serve the public interest. In each case we have suggested ad hoc expedients for overcoming this fact. Sometimes we have tried to limit the entrepreneur's power to damage the public interest by imposing

restrictions; in others we have been driven to the extreme of making him a public servant instead of leaving him the servant of the shareholders.

The primary problem is thus the problem of *management.* In the next chapter we shall see how it emerges even more blatantly in connection with structural problems, and in the final chapter we shall try and tackle it on, so to speak, its own ground.

Note on Lord Beveridge's Proposals.

Since the proposals made by Lord Beveridge have been so widely discussed, a few words on how they compare with the foregoing analysis may be of interest. Unlike the authors of the recent 'national' government's White Paper on full employment, Beveridge gives full recognition to the task of expanding purchasing power and his proposals at least have the merit of being constructive.

Beveridge spends very little of his time analyzing the causes of defective purchasing power—indeed one gets the impression that he abandoned the attempt to understand them. He simply goes to the heart of the problem in a bluff, British way: if the public are spending too little to provide full employment, he says, then the government must make up the deficiency. It must spend whatever sums are necessary to maintain purchasing power. There are plenty of things on which to spend them.

The government can raise the money by borrowing or by taxing, he adds, but preferably by taxing as we don't want to add to our internal debt.

If the arguments of this book are correct, Beveridge's proposal will fail. It will fail if the money is raised by taxing, because the taxation will have to be on such a scale as will discourage business. It will fail in the end if the money is raised by borrowing, because the government will have to borrow all the money which is being hoarded. The more successful it is in maintaining prosperity, the more will be hoarded and the more it will have to borrow. Moreover, each new loan creates a channel piping money back to those who want to hoard it. The burden will finally become overwhelming.

Beveridge produces figures showing that the requisite taxation will not be heavy in the first years; he assumes that the amount will not vary substantially thereafter because he does not ask himself where the missing purchasing power has gone; in reality the deficiency (and hence the taxation) will grow cumulatively.

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Achieving Full Employment:

(2) Structural Problems

Will you, won't you, will you, won't you, will you join the dance?
Will you, won't you, will you, won't you, won't you join the dance?

The little fishes' answer was 'We cannot do it, Sir, because——'

IN ESSENCE the structural problem consists in getting the structure of industry to follow smoothly and rapidly any changes in the structure of demand.

It is a problem which grows daily more pressing and extensive. Changes are continually taking place in the technical, social and economic spheres which impose corresponding changes on industry. And while the pace of change is constantly accelerating, the rigidity and inertia of industry increases. There is not the slightest prospect that the pace of technical advance will slacken: on the contrary, the laboratories contain the germs of many new inventions which may well wreak changes greater than any yet seen. There is not the slightest prospect that the rate of industrialization of backward countries will slacken: on the contrary, the war has had the effect of stirring huge areas such as China to a keener sense of the arrears of economic progress which they have still to make up. Neither is there any likelihood that the social structure will become more rigid: on the contrary, the redistribution of income is proceeding apace, with inevitable effects on the structure of demand.

And on top of this is thrust the immense task of converting the industrial structure from the purposes of war to those of peace.

We cannot hope to hold up this cataract of change. The

economist, anyway, must accept its existence and devote his main efforts to assisting industry to follow the demand-changes as smoothly and flexibly as possible; and it is this task which will occupy the bulk of the present chapter. Yet while it is beyond the scope of economics to diminish the volume of change, it may legitimately seek to tame it. Change to-day proceeds like a mountain stream, boiling and eddying and plunging over rocks in a succession of waterfalls and quiet pools. The economist has no authority to dam it up, but he is required to show how it can be converted to a smoothly flowing column of water speeding without noise or waste movement through culvert and aqueduct.

To this end we might discourage the attempts of salesmen to create short-lived vogues and 'crazes.' We might scrutinize great capital projects in the light of their influence on structure (the decision to build the electric grid caused a threefold expansion of the electric switchgear and transformer industries within a year, for example). We might try and time the release of major new inventions to coincide with contractions in the relative sphere. We might use 'protection' to cushion the shocks caused by changes in other countries. We might take proper cognizance of the structural effects of monetary changes such as deflation, social insurance and minimum wage agreements. In short, we might try and weave the myriad causes of change into a single harmonious pattern.

It requires no reflection to see how far we are from any such rational behaviour to-day. The co-ordination of change is not a subject of general discussion nor do the authorities appreciate the scope of the problem. In place of any such concept we have an unequal war between those who stand to benefit by changes and those who benefit most by the status quo, a war which leads to such wildly impractical proposals as the suggestion that there should be a hundred years' moratorium on all new inventions.

Let us turn, therefore, to the main task, that of expediting changes in the structure of industry. Just what does this involve?

It involves two things: changing people and changing things. It involves scrapping certain factories and building others and it involves shifting workers from one trade to another. But in

addition to this it almost certainly involves having a plan, having a directing organization to determine how great these changes should be and in what direction they must go. The reader may object: is it certain that a planning organization is really necessary? Could we not achieve our end by refurbishing those automatic forces of adjustment upon which we have relied in the past? I will postpone consideration of this question until we have discussed in more detail the nature of the changes required.

Let us take these three aspects of the problem in turn.

'MOBILITY' OF LABOUR

When an industry is contracting we can take three steps to minimize structural unemployment in it: we can discourage young people from entering it, we can retrain the men for whom there is no longer employment, and we can lower the age at which those who are too old to learn another job are pensioned off. At present we do none of these things. (For instance, the number of people seeking employment in coal-mining increased during the 'thirties, despite the fact that the number of jobs available was declining.)

It is not enough to tell young men seeking work for the first time that good jobs are to be had in some other industry situated elsewhere and about which they know nothing. In fact, it may not always be desirable to direct new labour towards industries which are short of manpower at the moment; we must also ask for how long they can continue to offer employment. We must look at the general trend as well as the immediate position. We must encourage boys to train themselves for industries which will be expanding in ten years' time even if they cannot immediately find employment in them—for it is easier for a young lad to change his trade than for an elderly and settled man. (We see already the need for some central body capable of studying employment trends and fashioning policies accordingly.)

Again, when we know that the market for their services is declining we can make it our business to retrain men for a new occupation *while they are still in work* rather than after a long and demoralizing spell of unemployment. Unfortunately, the trade unions who might be expected to support such proposals, oppose

them because they fear that the creation of adequate supplies of labour will make it possible for employers to depress wage standards. (You will recall how, in war-time, the trades unions opposed the so-called 'dilution' of skilled labour with unskilled.) A solution of this problem is therefore dependent upon a just and acceptable settlement of the wage problem.

Similarly we are handicapped in using adjustment of the pensionable age as a weapon in reducing structural unemployment by the fact that pensions vary in every industry and are the fruit of long years of negotiation and struggle. The essential preliminary is therefore the bringing of all pensions into a national scheme where they can be administered equally free from pressure by employer or employee. Doubtless employers and trade unions will join in resisting any such supersession of their powers and functions.

All this, however, touches but the surface of the problem. The real difficulty consists in the fact that men are not counters to be switched from one industry to another at will, but human beings with preferences and commitments. Advice and training are all very well, but the hard fact is that a man whose home, family and friends are in Sheffield may prefer to stay on there in hope of a job rather than moving to some distant town where the prospects of employment are more favourable. Similarly, a man who has reached a position of responsibility or who has developed a specialized skill will not readily abandon them to start again at the bottom in some unfamiliar field. And it would be crude to suppose that the difference in wages is the only obstacle. The change involves a loss of status and there are more recondite factors. Coulson and Reynolds, for instance, tell how an unemployed coal-miner could not bring himself to work in a silk stocking factory because he considered that it was no work for a man.[1]

It is because of the first of these difficulties that the question arises, where are new industries to be located? If siting is left purely to commercial considerations the chances are that they will be located near to markets or sources of raw material and this may mean that they are far remote from the dying industries

[1] *Human Needs in Modern Society* (Cape).

in which unemployment is heavy. Thus the light 'service' industries which grew up in Britain after 1931 were located largely in the Home Counties, far from the moribund steel, coal and shipbuilding towns of the north. Not only does such a development impose on the worker the expense and difficulty of moving his household, a serious obstacle to a married man whose children may be at work in the district, but it also wastes the huge fixed capital represented by the houses and public services in the moribund area. Accordingly, there are strong arguments for compelling the new industries to go to the areas where unemployment is endemic, in preference to bringing the labour to the new industries.

This naturally throws a burden on the undertakings concerned, saddling them with transport costs, higher rents, or other charges, and therefore industrial interests have always been strongly in favour of exerting pressure on the worker to move towards the job—the most obvious method being to stop his unemployment benefit if he refuses to accept a job when it is offered. But, comically enough, industrial interests have to represent themselves as opposed to such a policy, for it has long been one of their favourite accusations that socialism would mean 'universal industrial conscription'—though in reality a government elected by labour would be far more inclined to throw the burden of change upon the employers.

(It was therefore scarcely surprising that the national government's White Paper on full employment, though remarkably vague about industrial siting, contained full and satisfactory proposals for increasing the mobility of the worker.[1])

If our objective is simply to decrease unemployment, either method is satisfactory; but if our object is to safeguard the happiness of human beings we must exploit the first alternative to the fullest extent compatible with reasonable efficiency before turning to the second. We must aim at providing in every district a roughly constant number of each variety of job, subject to any over-riding

[1] Confusingly, the term *mobility of labour* is often used in two distinct senses: the transfer of labour from one district to another (geographical mobility) and transfer from one industry to another, possibly within the same district (specific mobility).

considerations about population movement and land planning. It is inconceivable that we could perform such a task without an expert body to study the varying trends and prepare industrial location programmes to harmonize them.

Thorny as the problem of labour mobility is, it is straightforward compared with the problem of adjusting the physical equipment of industry—that is to say, the problem of getting entrepreneurs to follow the dictates of the price-mechanism, or of a planning body should we ever have one. I shall therefore turn without further delay to this crucial subject, leaving the reader who wishes to pursue the question of mobility in more detail to read Edward Conway's scholarly summary *Post-War Employment.*

MANAGEMENT PROBLEMS

In essence the task is to close down redundant enterprises in fields where demand is shrinking (or where superior sources of supply have come into being) at the same time developing new undertakings in fields where demand is unsatisfied. The starting of new and the closing of outmoded enterprises provides a coarse adjustment to the necessities of long-term trends. Within these limits we may need a more delicate control; it may be necessary, particularly when a change is believed to be only temporary, to regulate the volume of output of individual firms. The latter problem is chiefly administrative. The greater problem contains the smaller. If we can induce a firm to accept complete extinction, we should not find it difficult to induce it to accept a temporary limitation of output.

The contractive process is obviously the main problem; yet we should not dismiss the expansive process as unworthy of attention. In times of bad trade or political insecurity firms may need special inducements to enter the desired field (especially if the siting of their factory is controlled), while at the other extreme lies the danger that firms may rush too precipitately into a new field and 'overstaff' it with the result that when the first spate of demand abates some firms will be found to be redundant. Hence there seems to be a case for limiting the entry of new firms into an industry—a course we have already advocated in the narrower context of the trade-cycle.

In theory the redundant firm is forced into liquidation by the action of the price mechanism. But, as we know, the growth of monopolistic practices has caused the price mechanism to function more and more ineffectively. Great firms, with a huge capital investment, choose to hang on at a loss and continue functioning part time in the hope that prosperity will one day return. And when they become aware that the recession of their prosperity is permanent they are tempted to resort to violent measures to retrieve it and particularly to the instigation of war.

Most firms cannot resist the iron laws of the market and must accept liquidation with a good grace, or re-equip themselves to carry out some new function (which is tantamount to the same thing). But no firm would willingly accept elimination at the order of a government body. Business would implacably oppose any such scheme.

Yet for industry as a whole change does not involve any loss. The prosperity of new industries counter-balances the extinction of old. It is easy to see if all industry were owned by a single body (whether a vast firm or the state) it would raise no objection to change, any more than a large firm objects to closing down an unsuccessful department. The objection to change which arises under the present system arises because specific groups of people are exclusively interested in particular bits of the industrial machine. These groups are 'vested interests' in the strict meaning of the phrase. The only way in which we can break the natural opposition of such groups to change—and at the same time ensure the security of the small investor—is by breaking the link between particular individuals and particular bits of productive property. Thus we might throw all investment into a vast pool from which all new projects would be financed. Similarly all dividends would be pooled and the total divided among investors in proportion to their contribution. In this way all participants would share the costs of obsolescence, all would benefit from the success of new enterprises.

It might be possible to realize most of the advantages of such a pooling of loss and gain without the administrative complexities of a single vast pool if we were to make use of a number of smaller pools. Something approximating to these small investment pools

already exists in the form of *investment trusts*. These concerns take the savings of a number of investors and spread them over a group of maybe two or three hundred enterprises. If they were to become the agents of a national reorganization of investment, however, careful attention would have to be given to the method of management.

The existence of such a pool or pools need not exclude the existence of a fringe of speculative investment, if desired, but the speculative investor would have to be resigned to seeing his investment vanish whenever the national interest called for the elimination of the firm concerned.

NATIONALIZATION AND STRUCTURAL PROBLEMS

Proposals of this kind are designed to free the men who manage businesses from the financial pressures which compel them to oppose the readjustments essential to the system as a whole: of course they do nothing to ensure that such men will make the best use of the resulting freedom. They may be described as nationalization of *ownership* without nationalization of *control*. Since reformers generally are dubious about the willingness of business men to act in the public interest, however much freedom they are given, most of the thinking on these lines to-day has concentrated on the aspect of nationalization of control. It is not difficult to see that if the state owns all enterprises, it both has the power to order the contraction of oversized concerns or industries and the necessary preconditions: for it always gains on the roundabout of new undertakings as much or more than it loses on the swings of the dying.

But, as it happens, this preoccupation with control has led to the strange result that the Labour Governments have confined themselves to nationalizing control while leaving ownership in private hands. Thus the original stockholders in the Bank of England, or in the firms which went to form London Transport, are guaranteed the payment of their original dividends though they no longer have a voice in the operation of the concern. Since it is the announced policy of the Labour Party to confine nationalization to the older industries, this means that it has taken on the

impossible task of guaranteeing dividends on dying industries without first equipping itself with the expanding income of young industries which have not yet attained their full stature: a policy which is not only financially disastrous but also one which makes it impossible to take advantage of nationalization to simplify structural change.

Naturally many industrialists (or at least their backers) are warmly in favour of nationalization, as such; how nice to have one's wasting assets purchased by the state, thus converting a doomed investment into a particularly favourable sort of gilt-edged stock! As I think Professor Hogben has already pointed out, the government would be better advised to confine nationalization to the young and vigorous industries and leave the technologically senile ones to their fate.

The truth would appear to be that the Labour Party, which has never been very strong on economics, has never thought of nationalization in the light of a weapon against structural problems. It has seen it only as a means of raising efficiency, reducing profit margins, improving conditions of work, and so on. For if it had a full conception of the magnitude of the task of structural change it would certainly have given higher priority to the establishment of a planning body to assess and regulate the structure of industry as a whole.

STRUCTURAL PLAN

Nationalization or no, can it be doubted that to effect these complex structural changes we need some central organization equipped for studying the whole complex mechanism of productive activity and ensuring that the various components interlock smoothly? We need a Production Planning Board.

Such a body would perform three functions. There would be a research side to assemble the multifarious data of production and consumption and condense them into easily comprehensible trends. There would be an interpretative and policy-forming section which would study the data and estimate the adjustments which were called for. Lastly, there would be an executive side to bring these adjustments into effect.

Even if we are reluctant to accept the need for an executive

side, there can hardly be any doubt of the need for the first two. Even if private entrepreneurs undergo a spiritual revelation and are seized with the desire to serve only the public interest, they will still require to know just what action is best chosen to achieve this end. The task of planning the industrial structure must be co-ordinated with economic decisions in neighbouring spheres. The Production Planning Board must co-operate with those who decide the volume of saving and the volume of investment, the dimensions of foreign trade, the volume of money and the level of wages. It must co-operate in any world production plan. Furthermore, all this economic planning must be co-ordinated with social policy, with the physical planning of town and country, the provision of housing, schools and hospitals, the development of roads and railways. There would therefore seem to be good reason to incorporate the Production Planning Board in a general Economic Planning Committee[1] and to incorporate the latter into a Ministry of National Planning and Development, with a policy-forming group at the top in close association with the Cabinet. It is vital that all these planning agencies should work in constant consultation and have access to the same statistics.

STATISTICS

At present any such organization is bound to be largely ineffective for lack of the essential data. To do its duty properly it needs such figures as the total of employment and unemployment (the present figures only cover workers registered for unemployment benefit), figures of savings and projected capital expenditure, figures of output, work in hand and stocks, figures of consumption, orders in hand and stocks. These are the bare minimum. Even the national government admitted its need for these figures and 'appealed with confidence' to industry to supply them. It may be added that this appeal created a minor panic in industry, especially in the City, which was already busy fighting proposals for more informative balance sheets.

[1] It will be interesting to see how far the recently formed economic planning committee realizes this description.

Business men appear to think that such figures may somehow 'give the game away'. If this is true (and presumably they should know) then we simply have one more instance of difficulty of reconciling the pursuit of private profit with the satisfaction of public needs. Business men object, with a certain justice, that the provision of these statistics will involve them in labour and form-filling (though it must be remembered that they are all figures which they would be compiling for their own purposes anyway). Precisely for this reason it is important that the assembly of statistics should be concentrated in the hands of a single department. Besides, it is not only necessary to obtain statistics, it is also necessary to co-ordinate them. They must cover the same periods of time and the same groups of people; they must be based on the same definitions. And they must be available to all. At present, unfortunately, each government department collects its own figures in its own fashion. There is much duplication; often the figures are not comparable; and departments are notoriously reluctant to make their data available to one another.

INDUSTRIAL SELF-GOVERNMENT

Following general recognition of the fact that the price mechanism fails to squeeze out unwanted firms in dying industries and often leads to the provision of excess capacity in prosperous industries, there has been a fairly widespread demand for the institution of some sort of planning or control of industrial structure. On the need for such planning both the left and right agree, but while the left feels that this control should be exerted by the state, or state-appointed bodies, the right declares that industry can control itself. What is the substance of this claim?

Let us start by considering the power to restrict new enterprise entering an industry. If such power is given to an industry it turns it into a monopoly. All expansion of business which may occur can be reserved for the existing firms, by the simple process of never permitting a single new concern to enter the industry. Further, the inventor of any new process is debarred from exploiting it himself; he is obliged to sell it to one of the existing firms. Similarly, a man who wishes to pursue a radically different

policy of production—such as large turnover and low price—cannot put his idea to the test. If these powers had existed in the British or American motor industries, neither Ford nor Morris could have created cheap motoring, unless by the tortuous and doubtful course of working their way up to seniority within an existing firm and then seeking to convert the board of directors.

We can judge of industry's readiness to close down redundant concerns by taking the cases of the British coal and steel industries. In 1931 the government aided the coal industry on condition it should improve its internal organization and close redundant pits. The preliminary to such closure was considered to be the merger of rival firms in each region, so that production could be planned without regard to sectional interests. At the outbreak of war, not a single merger of any significance had taken place.

The government, at the same time, granted protection to the steel industry on condition it put its house in order. What happened? The steel industry closed down the least efficient firms and concentrated production in the most efficient manner. This naturally enlarged the profits of the industry as a whole. These enlarged profits were then distributed between all the firms involved roughly in proportion to their former profits. hus the firms which were closed down, and whose plant had been turned to scrap continued to earn profits and pay dividends —and even bigger dividends—even though they existed only on paper.

This process of course is highway robbery; it is also suicide. Imagine what would happen if it were applied consistently throughout industry. In time we should all be contributing to the support of everyone whose grandparents had ever held a share. It is doubly destructive since it not only contributes to over-saving by enlarging profits, but it also blocks the forces which do something to break up aggregations of capital. In any sane country such a thing would have been made a criminal offence. If we were truly a democracy, there would have been mass demonstrations in Whitehall.

The fact is, no industry has the moral force, the detachment, to close down one of its own firms in such a way as to terminate

the value of the capital invested. If a firm is forced into liquidation by competition, its shares become worthless. No group of entrepreneurs representing an industry can be expected to impose this fate on the men they represent, for the individual firms would repudiate them. Nor do they wish to recognize a principle which may one day be used against themselves.

Similarly, it is virtually hopeless to expect an industrial body to control location—to compel certain firms to go to areas where their costs are higher while leaving other firms in a more favourable position. The hard fact is that control of industrial structure inevitably means loss of profits (otherwise there would be no need to control it). You cannot inflict the loss on some firms but not on others. So control is only possible if the industry has been merged into one huge firm. But no firm, huge or otherwise, will willingly accept a loss of profits. So the compulsion must come from outside.

If examples of this are needed, we have them in the shipbuilding industry, which, for instance, closed down the relatively efficient yard at Jarrow (despite the fact that it was the main source of employment there) while keeping less efficient yards open in other districts where unemployment was less serious. Subsequently the steel industry refused government requests to locate a projected new tin-plate rolling mill there.

Perhaps it is just possible that an industry might be induced to set up a fund in its palmy days with which shareholders might be bought out when trade had permanently declined. An industry would hardly consent to this unless faced with the threat of possible liquidation without compensation should need arise, in which case it might deem the fund the less unpleasant alternative.

But—unless the state controlled prices—the cost of such a fund would soon be passed on to the public in the form of higher prices. There is, however, not the slightest justification for imposing the cost of change on the public in this way, for it is a cost they would not have had to bear had the firm been eliminated by the force of unfettered competition.

In any case the problem is something far more than the occasional acceptance of a large-scale fait accompli of change.

The problem is to anticipate change and to do it continuously from month to month as demand alters. Business lacks any central body capable of foreseeing changes just as it lacks the authority to carry out the corresponding adjustments.

Let us turn finally to the international aspect; the problem of structural changes inflicted by the development or policy of one country upon another.

WORLD PROBLEM

The rational solution of structural problems on the planetary scale is the same as the national one: the creation of a world production council to plan production. But since no nation is willing to accept a scaling-down of industry at the orders of an international body (even though such a scaling-down may be forced on them in a more painful manner in the end) there is not the slightest hope of such a solution within the lifetime of anyone now living. (Nevertheless it would be well worth establishing a central institute to chart the course of world production, as Lubin's Agricultural Institute sought to pool agricultural data before the war.) Britain, more than any other country, has an interest in the attainment of a world production plan because she is so deeply immersed in international trade and has already suffered so deeply from the structural changes inflicted on her by the action of other countries. No plan, of course, can prevent such changes, but it can minimize the dislocation caused, by introducing them gradually and with due warning. Production planning is, if anything, even more essential on the planetary scale than on the domestic, because international trade is so bedevilled by tariffs and treaties and other devices. The conclusion of such pacts constantly inflicts changes on countries which in a rational world they would never have to undergo.

I see no hope of achieving any such plan at present, not only because the world is passing through a phase (or is it reverting to a state?) of unco-operative nationalism, but still more because no one seems to see the need for any such activity. The idea does not even receive the tribute of lip-service.

In the absence of an international plan, each nation will have

to make its own and decide for itself when to give way to the pressure of competition and when to fight it. To be sure, each nation may legitimately protect its industries from the first violence of competition but it must not seek to perpetuate indefinitely industries which have been outstripped, except to the extent necessary to protect the trade balance. In practice this means that a nation can legitimately impose tariffs to soften a violent structural jar but should take immediate steps to organize the necessary structural adjustment and should remove or scale down the tariffs when she has done so. Protection thus becomes a conscious instrument of planning and the old controversy between free trade and protection vanishes.

Unhappily the world is not even rational enough to coordinate its protective policies. If a country seeks to balance its trade or soften a structural blow, its competitors retaliate with barriers against its exports which only create the problem over again. Is it impossible to set up an international tariff control authority with powers to bring about a rational adjustment? It would have to be an authority with full powers, for the gloomy history of tariff conferences shows that nations will never accept a fair solution of their own free will. But even if it had no powers, the existence of a ruling might be of some value; it would help to crystallize public opinion against the nation which ignored the ruling and perhaps handicap it in future agreements.

Another makeshift measure which is of value while we lack a more comprehensive plan is the setting up of commodity control boards. I have already said all I need about them in Chapter 6 and will only repeat the warning that commodity-control must be subject to consumers. Commodity control run by producers for producers is worse than no control at all.

CAN AMERICA AVOID A SLUMP?

In the absence of any world-wide attempt to meet the structural problem, the only way in which a country can minimize this cause of unemployment is by withdrawing as much as possible from participation in world trade. Furthermore, if customer nations do not know how to avoid depressions it will be rash

to build up export industries which depend on their prosperity. What matters above all is whether the U.S.A. can avoid a slump, for she carries out about 60 per cent of world trade. Her fate is of especial interest to Britain since she is one of Britain's best customers. Any slump she undergoes must strike a paralysing blow at Britain. So the formulation of a full employment policy for this country must depend intimately on one's estimate of America's future prospects.

Unhappily, in America the danger of saving too much, the difficulty of spending enough, has reached unheard-of proportions.

During the war the national income increased by more than 50 per cent, so that, in the words of Mr. Davis, America is in the 'pleasant predicament' of having to consume 50 per cent more than in 1939 in order to maintain full employment. If the whole of the increment were to be given to the under-privileged classes it would be easy enough to ensure such additional consumption. But naturally no such redistribution of income is envisaged. Rather is every family expected to live 50 per cent above its pre-war standard. Since the average income per head of occupied population in America is in excess of £600 per annum, this means that a sizeable proportion of the population has reached the point where, having satisfied all its reasonable needs, it must buy luxuries for which its desire has, in many cases, to be artificially stimulated by advertising. Left to themselves, people might prefer more leisure to more goods; as it is, they must be taught to want goods they never needed before.

In a sane society people consent to work in order that they may consume. In America, people must consent to consume in order that they may work. Surely this is the final reductio ad absurdum of capitalism?

Despite a noisy campaign to boost consumption, a knowledge of the relative strengths of employers and labour in the United States makes it quite safe to predict that savings will accumulate faster than spending. Hence America's only hope of averting a slump will be to plunge once more into a policy of 'jam to-morrow'. If she can succeed in making vast overseas loans, and if she is prepared to reduce her tariffs sufficiently for borrowing nations to have some chance of paying the interest without being drained

of gold, she can postpone a more radical solution.[1] That such a policy cheats the American wage-earner need cause no concern, for his standard of living is alarmingly high already.

What matters is how long she can keep it up. Sooner or later borrowers will decline to commit themselves any further. Or possibly political conditions abroad will scare American lenders. Or even, as in 1929, a collapse of U.S. stock values may force investors to mobilize their resources. Then, as soon as the stream of gold is cut off, the gold standard will transmit it to the rest of the world. Or, as the gold standard will in all probability be a dead letter, the situation will develop through the decline of U.S. imports spreading unemployment in the export industries of those countries which export to her. They in turn must cut their imports and so the shock spreads over the world.

America carries out such a preponderant fraction of the whole of international trade that any depression she suffers irresistibly affects all other countries. And so the world's nations look apprehensively towards her, wondering whether she can avoid a slump. If they think she cannot, their best policy is to avoid entangling themselves, as far as humanly possible, by fostering self-sufficiency.

POLICY FOR BRITAIN

But for Britain the selection of a wise policy is peculiarly difficult. To begin with, Britain cannot divorce herself entirely from world trade: much of her food and some of her raw materials she has no choice but to import. In addition she has a heavy load of debt, and can only get the gold to meet it by achieving an export-surplus. But, alas, British export industries are barely half as efficient as American, so Britain can only hope to compete in world trade if she forces down wages or distorts the exchange rate to favour exports (*i.e.* undervalues the pound).

In this impasse the wisest policy for Britain would seem to be as follows: first, she must make an extraordinary effort to raise the efficiency of her export industries. She must be ruthless in

[1] That is why the loan to Britain was described in America as essential to American prosperity and why America is reluctant to refuse loans even to countries of which she disapproves politically.

over-ruling private interests where these impair productivity. She must be prepared to force amalgamation into units of optimum size, to compel the pooling of patents, and bring about co-ordination of sales machinery.

This done, she should make an equally drastic effort to reduce imports and reconstruct her economy on something near a self-sufficient basis. Exports she must have, to enable her to meet her debts, but she should aim at having no more than these. Such a reconstruction (which naturally could not be brought about at once) involves the countries which at present supply her in a similar reorganization, not least the United States. But once we accept the assumption that the United States is destined for catastrophic series of slumps, this becomes the best policy for them too. Better to sacrifice your market deliberately in your own time than have it vanish swiftly when you most need it.

Unfortunately, once the idea is accepted that a country must have *some* exports, people tend to go the whole way and assume it must maximize its exports. Those who wish to restore a policy of overseas lending naturally wish to build up a large export-surplus to obtain the gold with which to renew their overseas investments. Accordingly there has been, in this country, a steady stream of propaganda on the general theme: Britain must increase her exports. The undoubted fact that Britain must have some exports is used to support the idea that Britain must engage up to the neck in world trade. If the object of the propagandists were merely to restore the balance of payments, they would harp with equal vigour on the theme: Britain must reduce her imports. It is significant that they do not. Instead, they prefer to stress the magnitude of Britain's imports in order to be able to draw the conclusion: Britain *must* export or die.

EXPORT OR DIE?

Little consideration is given to the alternative, that we might make and grow at home most of the goods which at present we import. Two arguments are used in rejecting this alternative, both of them very thin.

The first is that in war-time we have only been able to reduce the value of our imports by a fairly small amount. But surely

war-time conditions are no criterion of what can be done in peace-time? We have had to import a great volume of goods because a great part of our man-power was in the forces, or busy making armaments, or engaged in other activities which would not be needed in peace-time. Such a rough-and-ready calculation as this proves nothing; we must go through the list of goods we customarily import and see which we are physically incapable of producing. The number will be found to be small. To start with the bulk of our imports are the common foodstuffs, many of which we can perfectly easily grow at home. Among the others will be found coal, steel, office equipment, typewriters, motor vehicles and many other things we can quite well make for ourselves.

The second argument is more serious: it is that we shall lower our standard of living if we fail to take advantage of the international division of labour, *i.e.* of the fact that other countries can make certain goods, notably food, more cheaply than we can. As several writers have pointed out, this is only true under conditions of full employment. It is always better to use your labour to make goods inefficiently than not to use it all. If adherence to free trade adds to your structural problems you are likely to lose much more on the swings of unemployment than you gain on the roundabouts of international specialization.

But the main fallacy here arises from treating Britain as if it were a single person, or anyway a homogeneous group of individuals. For the ordinary man the only question that matters is: will the rise in the standard of living consequent on importing food be greater than the fall in his standard of living which must result from depressing wages in order to compete in the international market? There is little satisfaction in saving 10 per cent on the price of your food if your wages have to be cut to half to make this possible.

We speak here in terms of lowering wages, though no doubt what will really be done is to leave wages substantially where they are and fix the exchange rate in such a way that imports become relatively costly and exports relatively cheap. So far, no one has attempted to show that there will be a net gain to the ordinary man when all the adjustments have been made.

Clearly if the gain from making use of the international

division of labour does not accrue to the wage-earner and salary-earner it must accrue to the entrepreneur and rentier. This is the real reason they are so anxious to restore a large volume of foreign trade.

The proponents of 'jam to-morrow' economics also make great play with the fact that Britain has sold a considerable part of her foreign investments. Before the war Britain was enabled to import more than she exported thanks to the stream of payments on foreign loans. Now that a great part of these loans have been sold up to pay for war-time needs, she can no longer enjoy the luxury of huge imports.

Once again, by talking vaguely of 'Britain' they attempt to slur over the distinction between different sections of the population. A moment's reflection makes it clear that the only people who really lose by the forced sale of foreign investments are the people who formerly owned them. It is the foreign bondholder who no longer receives the interest, and is poorer by that amount. The wage-earner is only affected inasmuch as he must be prevented from buying as much as formerly from abroad, since that would drain the country of gold—but there is not the slightest reason why he should not spend the money he formerly spent on foreign goods on home-produced goods instead. The only people who object to this are the steel-masters and coal-owners, whose trade must decline in proportion as the trade of people making consumption goods and supplying services increases.

And, of course, the foreign bond-holders. The proposition that British workers should accept lower wages in order that bond-holders can replace their foreign investments is a barefaced attempt to pass off the cost of selling up these investments on to the wage- and salary-earner.

CONCLUSION

If we try and condense the problem dealt with in this chapter into its simplest form we see that, once again, we are engaged in trying to induce entrepreneurs to serve the public interest at the cost of their own interests. The difficulties of so doing in this case are, if anything, even more acute than before. While

entrepreneurs would hardly like to be told how much to allocate to reserve and when to invest, they would probably jib entirely at being told how much to produce and when to go into liquidation.

Thus we are inexorably brought to contemplate the idea that the state should take over the conduct of business from them—a policy usually called socialism. For if we do not go thus far, if we try and content ourselves with 'controls', employers will engage in a rich man's strike and precipitate a slump. Thus no half-measures are possible. Either we must have full-scale capitalism, with slumps, or full-scale socialism, with (so many would say) serfdom. Even if we achieve a compromise and build a partly socialized society it is still true that we must put up with a fairly extensive degree of control. Regulation of the banking system, of foreign trade, of home and overseas investment, and of speculation does not, it is true, closely affect the ordinary man. But the moment we control the productive process, the moment we try and regulate prices, we enter on the sort of exasperating restrictions and invite the sort of black-market activities we have come to know since 1939.

Unfortunately we have not faced up to these facts. On the one hand we find people who fool themselves that we can have prosperity without controls; on the other we find people who propose controls without recognizing how tiresome they must be. In the warfare between right and left neither side tells the truth about its proposals.

Freedom and insecurity? Security and serfdom? When you have one, you want the other. When you are starving, controls seem unimportant. When you are well-fed but exasperated, freedom seems the paramount requirement.

It seems that we are in a dilemma. To find a way out is the great contemporary problem in the field of economics. So let us end this study by looking squarely at the *problem of management.*

23

The Problem of Our Time

'The game's going on rather better now,' she said, by way of keeping up the conversation a little.
''Tis so,' said the Duchess: 'and the moral of that is—"Oh, 'tis love, 'tis love, that makes the world go round!"' '
'Somebody said,' Alice whispered, 'that it's done by everybody minding their own business!'

IN THE foregoing chapters we have been forced to the conclusion that no permanent comprehensive solution of the problem of unemployment can be reached within the framework of the capitalist system. If regulation of the existing system is ineffective, we must perforce consider more drastic alternatives. But before undertaking such a task, let us stop for a moment and try and get the picture in some sort of perspective. After concentrating on the trees for so long, one is apt to lose sight of the wood.

What, in the last analysis, is the cause of unemployment? It develops because various people—including workers and investors but chiefly those whom we lump together under the heading of entrepreneurs—in the course of pursuing their various private interests, take decisions which are not in the public interest. Notably, they tend to save too much, to invest too much, to resist the elimination of obsolescent enterprises, to locate enterprises in the wrong places, and to start certain enterprises at unsuitable times. Workers, too, may add to unemployment by refusal to learn new trades and (at least potentially) by demanding wages beyond the power of the system to pay. It seems that we must recognize that the Victorian belief that private individuals, by pursuing their own advantage, automatically serve the public interest will not hold water. In fine, the basic task is to get individuals, chiefly entrepreneurs, *to act in the public interest.*

All our proposals in the foregoing chapters have had this as their object. For example, we suggested some kind of public ownership of the banks because we wanted to ensure that they should serve the public interest and not merely that of their shareholders. We suggested that it might be necessary to compel entrepreneurs to locate their factories in areas where structural unemployment was developing and not merely in whatever area will most enlarge their profit margin. We tried to find ways of influencing the amount people save, debated controlling prices and advocated regulation of foreign trade for precisely the same reason. The fact is that unemployment is not to be conquered by passing this or that law, inventing this or that new institution; it can only be conquered by persuading, compelling or teaching people—particularly but not exclusively entrepreneurs—to behave in a different way from what they normally do.

The problem of finding executives who will consistently act in the public interest and of ensuring that they remain free to do so is the great contemporary conundrum. Fascism, Socialism, Communism, Syndicalism, even Anarchy are largely attempts to solve this problem.

Now this is obviously a task of much wider scope than is implied simply by the problem of unemployment. Unemployment is merely a single aspect of the general problem of *management*. For entrepreneurs can harm the public interest in many ways besides those which create unemployment. They can, to take a few salient examples, pollute the atmosphere with poisonous gases, they can damage the health of their employees by neglecting to provide safe and healthy working conditions, they can waste real resources by producing shoddy and even dangerous goods, they can wastefully exploit limited supplies of raw materials, they can misdirect energy by making luxuries before essential needs have been met, and they can encroach on man's need for beauty, leisure and creative activity.

This naturally alters the balance of the problem: a proposal which might seem too costly or troublesome if it were only intended to reduce unemployment might become worth while if we knew it would also eliminate ribbon-development, the spoliation of beauty spots, the adulteration of food and much besides.

Nor is this all. Drastic changes of the kind usually proposed to achieve such an objective will inevitably interfere with our whole pattern of living: indeed, those who advocate new ideologies always stress the social changes they will bring about. Naturally our readiness to adopt them will be influenced by our attitude to these non-economic aims.

Clearly it would be futile and misleading to discuss such sweeping proposals at any length simply in the narrow context of unemployment policy. To be of value, we require to re-open the subject on an altogether broader basis. This I have attempted to do in a study which forms the logical sequel to this volume, and which I have called *The Conditions of Happiness*. However, in order that the present book shall be, as far as possible, complete in itself I shall devote the remaining pages to a brief outline of the principles involved in such proposals (as far as economics is concerned) and to indicating what seems to me the most hopeful line of development.

ALTERNATIVES: COMMUNISM [1]

Recognizing that the human entrepreneur is often anti-social, a large and apparently growing body of opinion proposes the expedient of replacing him by a non-human owner—the state.

In many respects, this proposal is very effectively conceived for solving *economic* ills. All receipts are paid to the state, which sets aside whatever is required for investment and distributes the remainder as wages. The state is not tempted to save too much; if anything, it might be tempted to seek popularity by distributing an unduly large proportion as wages. Equally the state can solve the structural problem. It need have no qualms in closing an obsolescent factory since it is simultaneously receiving profits from newly launched enterprises in other fields. Its only interest is to maximize the national income as a whole. Moreover, as in the case of a big monopoly, it can co-ordinate the activity of its parts more effectively than when they are competing units; it can

[1] I am here referring to the general principle known as communism, not to the specific variation practised in the U.S.S.R.

'spread its overheads'; and it can make full use of the principle of division of labour.

True, it will need a considerable planning and administrative staff to carry out the initiation and regulation of enterprise, but in compensation it will be able to dispense with the elaborate mechanism of adjustment needed by capitalism (dealers, wholesalers, stock markets) and much of the apparatus of capitalist management (boards of directors, holding companies, etc.) and much of the minor impedimenta of business (bankruptcy courts, debt collection and many legal expenses).

However, to say that the state replaces the entrepreneur, though sometimes a convenient simplification, conceals the true issue. What is this omniscient, impartial 'state' on which we rely to behave so magnanimously? It consists of human beings. It is human beings who have to regulate wages and start new enterprises. What the communist really asserts is this: (*a*) that the most suitable persons to occupy administrative posts in business can be *selected* better by deliberate choice than by the hurly-burly of competition, and (*b*) that the state employee is in a more suitable *environment* in which to take administrative decisions than the ordinary entrepreneur, because he is not tempted by considerations of personal profit nor is he committed to serve the interests of any minority group.

The principles on which this case is based are undoubtedly sound. It is obviously desirable that industry should be operated impartially in the public interest by men who combine uprightness of character with commercial and administrative capacity; and it is also obvious that such impartiality can, as a general rule, only be achieved when the administrator's interests are not too adversely affected by his being impartial—it will be still better if they are actually enhanced. The principle is not even new: we use it in staffing the government service, in appointing judges and in running the armed forces. Despite this, opponents of communism declare, not without justification, that the bureaucratic method of management does not realize the aims just set forth.

To the best of my knowledge, no really exhaustive, scientific analysis of the defects of bureaucracy has yet been made. The authors of such books as attempt the task are usually so beclouded by emotional bias that they spoil their own case. Great play has been made with the difficulty of devising administrative and planning machinery capable of handling such a formidable task as the regulation of industry on a national scale. After the experience of the recent war it is doubtful whether this objection still carries much weight, especially when we remember that war-time administration had to be improvised in the space of a few months whereas in civil life it could be perfected over a period of years.

The opposition is on firmer ground when it turns to examine the human being on whom the system depends. For instance, it is pointed out that the salaried official may still have an interest in the outcome of a decision even if his salary is not affected by it. When money ceases to be the criterion, prestige is often substituted. The salaried official may obstruct the work of other departments in order to further the work of his own (*e.g.* by withholding information) or may undertake work for which his department is not fitted in order to enhance his own prestige—and if he succeeds he may be able to justify a higher rate of salary for himself. Again, the paid official gains no commensurate reward if he is successful in a new enterprise, while he may be heavily blamed if the scheme fails. Bureaucracy thus tends to be timid and unenterprising.

Such examples can readily be multiplied, and gallons of ink have been spilt doing it. That each system has defects needs no proving. The issue which matters is: which system, taking it all in all, has fewest? On the whole, bureaucracy is most likely to misuse resources, producing goods which are not wanted or failing to produce those that are, since it is not so strongly impelled to study the public whim. Capitalism is most likely to make errors of discrimination, spoiling beauty spots or permitting ribbon development. It must be borne in mind, too, that efficiency

is only valuable when the purpose to which it is devoted is socially desirable. A government department controlling the location of industry might make many absurd errors and still produce a better industrial distribution than the most 'efficient' of private enterprises interpreting efficiency solely in terms of profits and costs.

It is probably unnecessary to try and answer the riddle, since the general fear of communism is in reality based on subtler grounds. People feel, not always explicitly, that state monopoly does not and cannot provide a fully satisfactory environment for human beings to live in. It is bound to be more or less frustrating. Chief among the bases for this belief is the fact that state monopoly is bound to exhibit all the normal disadvantages of monopoly in their acutest form. It will tend to foster an excessive uniformity to the impoverishment of the culture as a whole; it can flout the wishes of considerable sections of the public; if it makes an error it will be on a titanic scale; if it chooses to make an enemy of any person he has little chance of standing out against it. Under competitive private enterprise, a customer who is dissatisfied with one firm can go to another. A man who is discharged by one firm can seek a job elsewhere. Under state socialism, it is claimed, this would not be possible. Already we have the situation that a radio artiste or engineer or technician who falls out with the B.B.C. is virtually obliged to abandon radio as a profession. Already we have a state of affairs in which one government department will sometimes refuse to take on a man who has resigned from another. And inside these huge organizations the danger is intensified. Employees must accept arbitrary conditions such as small-scale entrepreneurs could never succeed in imposing and even regulate their private lives to suit. In the last resort, the employee who does not like a private employer's methods can walk out. If there is only one employer he is deprived of this essential retort.

If the objections to state monopoly can be summed up in a single phrase, perhaps it is 'no second chance'.

Monopoly gives the state absolute power, and that is dangerous. It is dangerous not so much because the state may misuse its power, but because it is part of the function of every human being to learn to exercise a certain degree of power: if we take

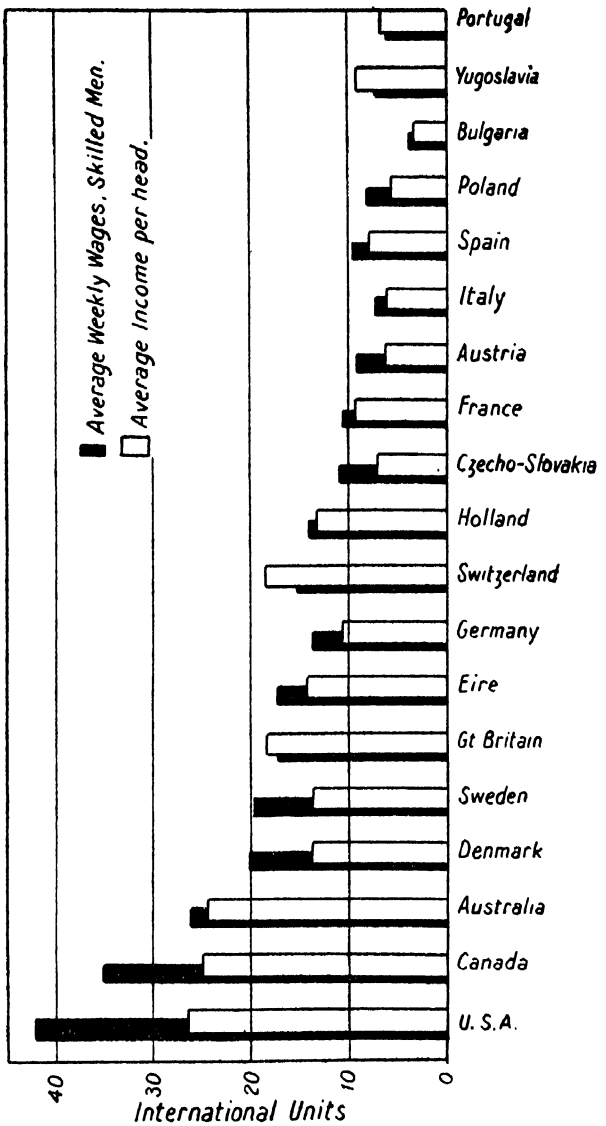


FIG. 37.—INCOME REDISTRIBUTION: EQUAL PAY FOR ALL?

The black columns represent average wages in a selection of comparatively skilled occupations for which figures are collected by the International Labour Office.

The diagram shows that in most countries skilled workers are getting more than the average income per head of the whole country. If the national income were divided absolutely equally, as Mr. Bernard Shaw has advocated, skilled workers would, except in a few countries, get less than they do at present. Non-skilled workers—particularly the rural population—would get much more.

all power from the people and deposit it in the hands of a dictator, then we have made ourselves into slaves, however benevolent the dictator may be. It is perhaps as well to make the point, since recent writers have tried to popularize Lord Acton's showy, shallow phrase: 'All power corrupts. Absolute power corrupts absolutely.' If that were true, the only way to avoid corruption would be to render everyone powerless: then we *should* all be slaves, and damned too.

VARIANTS ON COMMUNISM

Communism presents the managerial solution in its simplest, most clear-cut form. Socialism aims at the same objective, but differs from communism in that it hopes to bring the desired state of affairs into being by the gradual extension of the 'socialized sector' over the face of capitalism, whereas the communists believe that capitalism can only be ousted by a sudden coup. Hence socialist institutions are created by the making-over of capitalist undertakings.

As with communism, socialism also puts its faith in the impartiality of the salaried official, but seeks to avoid the dangers of too highly centralized a monopoly by leaving the control of industry in the hands of public corporations, administered by officials appointed by the government and answerable, through a minister, to the representatives of the people. Socialism differs, however, from communism in not advocating a general pooling of the receipts of industry. Instead, the great corporations would, presumably, adjust their wage-rates in accordance with government directives; similarly they would be prepared to expand or contract operations and locate their plants as advised by the appropriate government departments.

The objections raised against communism apply with weakened force to socialism. Since it is somewhat decentralized, the dangers incident on monopoly, though present, are less acute. By proceeding gradually and democratically, socialism can adapt the various parts of its plan to suit local conditions or opinions. And it need not go all the way: it can leave certain fields open to private enterprise, provided it retains control of the location of

industry and the volume of investment. (The possibility that an entrepreneurs' strike might force its hand, however, has already been mentioned). What life would, or will, be like under socialism depends greatly on how far it is pushed and on the care and ingenuity with which it is decentralized. One thing is certain: those who set a high value on economic independence will not like it.

Since fascism successfully conquered unemployment in Germany, a few words on its economics may be in order. Instead of substituting new institutions, as do socialism and communism, the National Socialists were cunning enough to leave the façade of private ownership in position while introducing control from within. Each firm nominally retained its private and independent status, but, since wages and prices were fixed for it, as also the amount it might distribute in dividends, and since its books were open to inspection, its freedom was more apparent than real. Furthermore the state, by a system of licences, could cut off its supplies of raw materials and thus bring pressure on it to locate new plants wherever the state desired as well as controlling the volume of production.

If by socialism we mean a controlled economy, fascism is undoubtedly a form of socialism, indeed of communism. The difference between them is the purpose for which control was used. As it happens, the Germans used their power to make war, while the socialists use it to raise the standard of living of wage-earners. It is not inconceivable that a dictatorial communist ruler might use his power to hold down wages and raise the rewards of party officials or other favoured persons, or to arm the country for aggression. The truth is, fascism, socialism and communism are primarily labels for systems of value and only accidentally names for modes of economic control, which happen to have been employed in the hope of realizing those values.

These three systems represent the only alternatives to modern capitalism which have ever gained any considerable measure of support. Each involves a rather rigid control over the men who are to conduct the processes of industry. Every executive is bound to adhere closely to directives from above and to conform to numerous regulations. Such men will undoubtedly suffer a

definite reduction of liberty—though the position of wage-earners and the salariat remains in this respect almost unchanged. The question arises: can any further alternative be found?

THE ROAD FROM SERFDOM

Now that we have established the fact that the primary task is to induce human beings to behave in a co-operative and responsible manner—that is, to behave socially and not anti-socially—we are in a position to answer the question: can we conquer economic ills without losing our liberty? A moment's reflection will show that there is one, and only one, set of circumstances in which people can be relied upon to serve the public interest without compulsion and that is *when they want to.* In certain cases, perhaps, we may be able to wangle matters so that producers' profit coincides with public interest—as, for instance, when we subsidize an industry which we want to expand—but as a rule they will conflict. Hence only if the individual, be he producer, investor or worker, is genuinely anxious to serve the public weal, only if he is fundamentally unselfcentred, can compulsion be avoided.

The dictator is a man who, too cynical or too impatient to wait on the slow course of human self-development, attempts to forestall it by violent methods. 'Be my brother or I'll knock your block off!' he says. And so he seeks to create an economy in which everyone can be happy by means of establishing a polity in which no one can be happy.

Thus the first line of attack against economic ills must be manned by the parents, the teachers, the psychologists, the propagandists, the moralists and religious instructors who help to make us what we are. But—and the point is crucial—we must recognize that the production of unselfish people is not the whole of the story; and that is where the moralists and religious teachers so often go wrong. Two other things are necessary for economic salvation. We must have efficient methods of selecting responsible people for posts of economic power, and we must provide them with a favourable environment in which to operate. Let us speculate broadly how this may be done.

A MANAGERIAL REVOLUTION?

Who is to occupy the posts of power in the economic sphere? Who is to control the numerous industrial and financial enterprises which determine so many of the conditions of life of the ordinary man?

To-day nearly everyone sees this question as a choice between salaried state officials (dubbed 'managers') and supposedly independent entrepreneurs rewarded by whatever profits they can earn; the former public-spirited but inefficient, the latter the reverse; the former slaves, the latter free. If this is a correct view we shall no doubt leave the bulk of such jobs in the hands of entrepreneurs: for once it is granted that no one shall reach such a post unless he is adequately endowed with a sense of public responsibility, there can be no inherent objection to the entrepreneur.

However, is it a correct view? For my part, when the time comes, I shall expect to see the majority of those who are eligible plumping for the role of manager. They will be attracted not so much by the desire for security as an end in itself as by the fact that, with income secured, they will be freer to concentrate their efforts on the job in hand. On the other hand, those who opt for private enterprise will not do so in expectation of greater personal gain, for there will be little chance of it. Rather will it be those who welcome hard work and danger and despise personal reward who will venture to sail their own small craft on the economic ocean instead of serving in the crew of some industrial leviathan.

And is it true that the salaried manager is necessarily less efficient than the entrepreneur? The case rests largely on instances of delay, misjudgment and lack of imagination in the permanent civil service, or its war-time outgrowths. Certainly the technique of civil service administration needs drastic overhauling. But the civil service is hardly the only instance of management at work. The planning that landed half a million men on the shores of Normandy must have been fairly efficient. Nor does one hear an undue number of complaints about such bodies as the Port of London Authority, London Transport or the coastguard

service, all of them run by salaried officials. The truth is that, for hundreds of years, a great part of human enterprise has been successfully operated by salaried officials. Every large industrial enterprise appoints a general manager to supervise operation. Every club and every society is managed by a salaried official. Not only are there few complaints about such managers, but the managers themselves do not complain that they are frustrated. If frustration and inefficiency occur, it is when unduly large and rigid organizations are built up, and that is equally true of public institutions and of private profit-making concerns. To this point I shall shortly recur.

As absurd to pretend that the paid manager has not played a large part in every major civilization as to deny that in the complex pattern of a machine age his rôle is growing. Belatedly perceiving the existence of this trend, Burnham in his widely-read book *The Managerial Revolution* has leaped to the conclusion that the trend must continue until society becomes wholly 'managerialized'—and has offered the blood-curdling prediction that these managers will come to form a new privileged class which will exploit the public just as ruthlessly as the ruling classes of earlier epochs. Maybe they will. But it is certainly not the only possible outcome, and it depends on us whether or not we let it come about.

If managers are not subjected to democratic control, as happens equally in pure capitalism and in dictatorship, they may indeed be tempted to secure special privileges for themselves at the public expense. But there is no reason why they should be free of such control, unless we choose; and if we do not choose, it only remains to make that control as effective as possible.

POWER AND RESPONSIBILITY

The people for whom the economic machine is conducted are the consumers, a class in which both wage-earners and entrepreneurs are included. So it seems reasonable to conclude that consumers are the proper people to supervise the activities of managers and entrepreneurs with a view to ensuring that they observe the public interest.

At present we seek to achieve this by the indirect process of electing popular representatives (M.P.'s) who criticize the proposals of a committee ('the government') the members of which are individually responsible for various departments of the economic machine. Under this scheme the channel between complaining customer and erring manager is so long, and the minister forms such a narrow bottleneck, that none but the most serious abuses are effectively remedied, and then only after great delay. We certainly need to devise some much less centralized, much more direct and personal system of supervision.

I imagine the solution will turn out to be something like this. Panels of specially selected consumers will sit-in permanently on the thousands of directorial boards and managerial committees which operate industry, together, of course, with representatives of the central administration and other interested bodies. Naturally these panels must not consist of a few retired family men, idle wives or public busybodies. They must be serious and representative. So I fancy it will be made an obligation for everyone of either sex to devote three months of their time every ten years (or some such period) to serving, with adequate remuneration, on properly-constituted consumer panels. Doubtless people will be asked to indicate in advance what industry would interest them and when they could most conveniently serve. And, in order that their comments shall be governed by a sense of what is practicable, they will take a short 'orientation course' before starting work. And if, occasionally, a panel should attempt to exceed its powers, the representative of the central government will be there to see fair play.

Only by some such device as this, I think, can we achieve a control of industry which will be flexible, enterprising and democratic. Furthermore, active participation in the task will help to give the citizen a sense of his rôle in the community and a knowledge of the circumstances of those in other walks of life, which should help him to appreciate the community as a whole.

Finally there is the question of selection. The salaried manager, naturally, is selected on the strength of his personality and qualifications. But what of the profit-making entrepreneur? In

present conditions, any producer who attempts to pay high wages, to provide the best working conditions, or to locate his factory where it will do most good handicaps himself as against less scrupulous competitors and is liable to be forced out of business. Thus we have a form of selection of dysgenic type, eliminating the most public-spirited individuals and favouring the most ruthless and self-centred.

It is evident that we should submit the aspiring entrepreneur to some kind of examination before we license him to proceed. The entrepreneur is in a position of power. His decisions affect the happiness of thousands of people. There can be no power without responsibility. We do not permit a child to drive a car and we permit adults only after they have shown their fitness to hold a licence. But a reckless entrepreneur can do far more harm than a reckless driver. So, like the reckless driver, he should be liable to penal servitude if he causes harm to others, even if only through negligence.

One more thing we can conclude with a considerable degree of certainty. In our complex civilization the manufacturer, however well-meaning, cannot know unaided where he should locate his new factory. The worker cannot tell for what industry he should train himself. The investor cannot tell how much to save. Therefore we require a finely integrated planning body fed with every essential statistic and with continuous access to public taste. But this body must be only advisory, and its proposals must be open to continuous public discussion and modification. In addition it should be open for consultation on specific problems by all interested parties. By keeping it advisory we leave the individual entrepreneur or administrator free to adapt its suggestions in the light of local knowledge or ignore them if he knows a better plan. Any errors of judgment occurring as a result of this freedom are part of the inevitable costs of personal development and must be written off against the gain in personal freedom and general flexibility.

Doubtless such a planning body should be decentralized on a regional and sub-regional basis and there should be provisions for passing schemes from the bottom of the pyramid towards the top for integration in wider plans.

THE PLACE OF VALUES

The realization that unemployment, like other economic ills, is primarily the result of imperfect behaviour and only secondarily the result of ineffective organization is a conclusion of major importance. It points the way to a solution but makes it clear that the path is not an easy one.

Cynics, perhaps, will say that it is an impossible one. Man will always be predominantly selfish and acquisitive. Anthropology contradicts this assertion. Man has shown sundry vices at different periods, he has been intolerant, aggressive, lecherous and cruel, but he has *not* always been acquisitive. Primitive capitalism has often in the past—and in certain parts of the world still does at this moment—work better than modern capitalism precisely because the entrepreneur subordinates the earning of profits to other motives. In particular he desires to retain the respect of his friends and neighbours, and he knows that he cannot do this if mistreats his employees or damages public amenities. Modern capitalism has failed partly because the dysgenic evolution we have just considered selects those who are ruthless and impervious to criticism and rejects the rest, partly because its much greater size tends to render public sanctions ineffective. The employer can live far from the people he is harming. The investor can remain ignorant of the evil nature of the activities he is financing. Direct consumer control of the type we have foreshadowed would do much to reduce this isolation.

A more serious trouble is that public sanctions have weakened in themselves. We have grown so habituated to the abuse of entrepreneurial power that we no longer react to it with any indignation. We would do the same ourselves if we could. Occasionally there may be found an old-fashioned craftsman who, framing a picture for us or hanging a door, does not shrewdly estimate how much we can be induced to pay, but charges 'a fair price for the job'. He is a man who values independence and his own self-respect more highly than money.

'Values' is the operative word. Sociologists know that values are the ultimate determinants of conduct. A man may pay good

wages for the selfish reason that he values the respect of his fellow-men—but the reason his fellow-men respect him is that they value generous behaviour. If they set a higher value on personal possessions they will accord their respect to the man who manages to acquire possessions and thus will determine his behaviour in regard to wages. The problem of ensuring right action is thus primarily a problem of reconstructing our system of values. Values, however, are the product of what the majority of people hold good. Thus in the end the problem comes home to the doorsteps of us all. Politicians and economists can help by providing the environment for right action, but the kernel of the problem is the human being—that is to say, *you*.

In the last analysis, the conquest of unemployment takes its place as a single facet of the vast task of human self-development.

FURTHER READING

The reader may like the names of a few books in which he can follow up in more detail some of the subjects we have dealt with all too briefly.

Quite the best book for the non-technical reader on the intricacies of monetary mechanism—exchange rates, the gold standard, central banking, and that ilk—is Geoffrey Crowther's *Outline of Money* (Nelson). Something on the monetary machine should certainly be read, for it is very complex and I have simplified fairly drastically in the present volume. There is a clear description in G. D. H. Cole's *Intelligent Man's Guide through World Chaos* (Gollancz); though now out of date in its treatment of unemployment theory, this former best-seller is still the best source for vivid, human treatment of manifold aspects of economics. It should be available at most public libraries.

The standard work on unemployment theory is the late Lord Keynes' *General Theory of Employment, Interest and Money* (Macmillan); but this is definitely heavy going. You could taste the subject by reading Mrs. Joan Robinson's *Introduction to the Theory of Unemployment* (Macmillan), a short book which will give you the general idea.

In the present book, I have not touched at all on the theories of value and of rent, which constitute such a large part of formal economic teaching. There is an admirable short outline in Professor Henry Clay's *Economics for the General Reader* (Macmillan) which is the best simple text-book I know.

The history of the slump can be got where I got it, from H. G. Wells' *Work, Wealth and Happiness* or from Cole's *The Intelligent Man's Guide*; but the slump is ancient history now. The time would be better spent in reading H. W. Arndt's detailed but absorbing study, made for the Royal Institute of International Affairs, *Economic Lessons of the 1930's* (O.U.P.).

Lastly, don't fail to read Mrs. Barbara Wootton's *Plan or No Plan* (Gollancz) for vivid discussions of the pros and cons of economic control. For the rest, all the books referred to in the text or in footnotes are recommended reading on the points in question. One more might be added: Jarvie's *The Old Lad Unveiled*, a study of the Bank of England.

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