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SOCIALIST CREDIT POLICY

by

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17, JOHN STREET, W.C.1

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CONTENTS

PART I

THE ECONOMIC BACKGROUND

PART II

POLICY

APPENDIX

Part I The Economic Background

1 CREDIT POLICY AND SOCIALISM

Credit policy and Socialism have, in one sense, nothing to do with each other. Socialism is fundamentally a demand for social justice. It is the expression of the desire which is alive in every free human being for economic freedom and social equality. The Labour Movement is not devoid of other political ends, but social justice is the peculiar property of its *Socialist* faith and it is in relation to this end that its other economic policies must be judged. It is plain that credit policy is not directly connected with the achievement of this organizing and controlling motive. The solution of the problem of credit policy and the discovery of the monetary methods by which full employment can be maintained, will not of itself advance the cause of equality by a single step. Indeed it is quite possible that too exclusive a devotion to the difficulties of monetary and employment policy will divert the attention of the Labour Movement from its central Socialist task.

While this is true and while it is important to bear it in mind, it would be absurd to deny the importance of credit policy in the general strategy of the campaign of Socialism. On the contrary —it is the common conviction of Socialists today that the equalitarian purpose of Socialism cannot be achieved within a system which is predominantly capitalistic in its economic structure. It is not possible, for example, to execute a levelling policy by taxation within a system which depends for its growth and plasticity upon the savings of the rich. Economic democracy cannot be secured in an economic system whose strategic points are controlled by propertied interests. Hence equality must be preceded by the social control of industry. Industrial nationalization is the necessary prelude to Socialism. All this is quite familiar reasoning. But it will be quite impossible to control the industrial system without nationalizing and controlling the sources of money and credit upon which the industrial system depends. Immediately the monetary system is nationalized the problem of credit policy must be faced. A supreme economic authority set up by a Socialist Government and responsible for the operation of the banks must lay down, in general form, the policy that is to be

pursued. Therefore since as Socialists we must have *some* credit policy it is essential that we should have the right credit policy.

This essential problem is not one which has as yet, I think, been considered in the right light within the Labour Movement as a whole. The problem of nationalizing the banks has been argued and debated with considerable feeling, but the more difficult problem of what to *do* with a banking system, however and whenever it may be nationalized, has not been properly discussed. There is a widespread belief, clearly expressed but not clearly defended, that the credit system should be operated so as to *stabilize prices*, and this is the official policy at the moment.* Now this conclusion is undoubtedly contrary to the present general trend of economic thought and it is the purpose of this pamphlet to examine this and certain other proposals for long period credit policy in the light of the most recent scientific thought on the matter; but before this can be done it is necessary to inquire into the general nature of the problem with which this pamphlet is concerned. The examination of the general problem is the purpose of the first part of this pamphlet and that of the particular problem of Socialist policy of the second part.

Money and Wealth

I must emphasize once more that this pamphlet is not concerned with the general purpose of the economic strategy of Socialism. It is not even concerned with the detailed *machinery* of its credit policy. I do not propose to consider whether the Bank of England alone, or the Bank of England *and* the Joint Stock Banks should be nationalized in the first instance; nor do I wish to discuss the constitution of the board by which the socialized system should be controlled. All these questions are discussed elsewhere in the literature of Socialism. I am only concerned to discuss the more limited problem of the general monetary policy which such a board, however constituted, should pursue. What quantity of credit should it seek to provide? Should it aim at stabilizing the price level of consumption goods or not? How should we expect prices to move in a Socialist community which is increasing the social stock of machinery and productive resources? How much money income should be provided for the consuming public in order that the full output of industry can be freely marketed? These and cognate problems, all centring round the relation between money and real goods, constitute the whole of my present subject matter.

There is one important sense at least in which the issue of money can do nothing to solve our economic problems. It is

* Labour Party Banking Policy Pamphlet.

common knowledge that the mere provision of more money is of no use to anyone. We cannot live upon treasury notes or clothe ourselves in bank credits. Money is finally a *means* to an end—and not an end in itself—the end in this case consisting of the real commodities, houses, food and clothes, which the economic system is capable of producing. These finished commodities can only be manufactured by real productive resources such as natural wealth, skilled and unskilled labour, and the instruments of production, with which labour must work, and which are termed real capital. Moreover, the production of finished commodities can only be increased and the general standard of living raised if the quantity of these basic resources is increased or the methods by which they are utilized are improved. Apart from an increase in the population, the chief way in which the available resources can be increased is through the process known as saving.*

Social saving consists in setting aside a part of the current net income of society in order that part of the existing resources may be directed to the production of new capital instead of devoting the whole of these resources to the production of goods to be consumed. The manufacture of consumption goods and the manufacture of new capital are the two fundamental processes in any economic society. What part does money play in the execution of these two central tasks? It is obvious that the part which money can play is ultimately a purely negative one. The creation of money in the absence of any increase in real productive resources will merely raise prices and no one will be any better off—consumers on the average will spend more money, but since prices are correspondingly higher, they will receive the same quantity of houses, food and clothes as they enjoyed before. The utmost which monetary policy can do is to keep all the existing real resources in full employment in order that the maximum output of finished goods and new capital may be maintained.

This, of course, is no small task, but it is possible to exaggerate the increase in the general standard of living which the successful execution of it would imply. It is estimated, for example, that during the last ten years the *average* percentage of unemployment has been 12½ per cent, and the percentage of unemployment of material resources could not have been much greater, while the consequent fall from the potential maximum of physical productivity due to this unemployment is less than this. It is therefore certain

* The methods by which production can be increased are really four: (*a*) an increase in the population, (*b*) an increase in the skill of the existing population, (*c*) inventions and discoveries, (*d*) saving: but it must be remembered that invention is of little use without saving to utilize the invention and new skill nearly always requires new machines. Hence saving is the most important source of increasing productivity.

that the execution of a successful monetary policy could only have raised our physical productivity at a rate which is of *the order of* 10–15 *per cent* over the whole period. The saving of human misery involved in this unemployment which could be eliminated by a correct credit policy is almost immeasurable, but it is clear that the increase in the general standard of living which would be secured is *not* incalculable but on the contrary is quite moderate.*

The Nature of the Problem

Our problem is now plain. We want to know what credit and price level policy will maintain full employment. If all the real resources are employed in the production of consumption goods or new capital goods, it is not possible to increase the standard of living by manipulating the supply of money. If the supply of money is increased prices will rise. This is true for Socialism and capitalism alike, for if a Socialist Government legislated to prevent a rise in prices it would merely mean that some of the new money would have to remain unspent and everywhere there would be queues as a result of the artificially low level of prices. Such was our economic policy in the war. A successful monetary policy could, however, maintain 100 per cent effective employment. The degree of unemployment all over the world today is a measure of the extent to which capitalism has, as yet, failed to solve this problem.

What then is the credit policy which will maintain full employment? How can full employment be maintained during a period in which part of the real resources of society are devoted to increasing the productive capacity of the whole economic system? To answer this question we must first explore the way in which the circulation of money controls the productive system, and afterwards examine the effect of saving.

2 THE NECESSARY STRUCTURE OF MONETARY CIRCULATION

It has been iterated again and again from Labour platforms that what is required is an "adequate flow of purchasing power

* (*a*) The actual increase might be somewhat greater than this, since part of the original increase of production might go to increased saving. In so far as this happened the increase would be cumulative, but it would remain of the order of 10–15 per cent. The calculation is only approximate and the increase of productivity which would be possible may be two or three times as great as this—the only purpose of this section is to emphasize that the possible increase in productivity under any system is not gigantic but moderate.

(*b*) Throughout I have assumed that capital corresponding to the labour is also available. This is a reasonable assumption, for cyclical unemployment affects both labour and capital.

to consumers". It is the purpose of this chapter to discover what that "adequate flow" really is. It is obvious that the flow of purchasing power to consumers is only adequate if it enables the whole output of the industrial system to be sold at prices which cover the costs of production and render producing units, whether capitalist firms or socialized trusts, solvent. But there is a great deal of dispute as to the size of this necessary quantity—whether it is the quantity of purchasing power which will stabilize prices in face of an increasing physical output or whether it is some quantity different from this—either larger or smaller. It is impossible to answer this question without understanding the way in which money actually circulates and must circulate in any advanced economic system.

I do not think there can be any better way of starting the inquiry than by examining the account of monetary circulation which is given by a very influential thinker and writer on monetary problems—Major Douglas. It is only fair to say at the very beginning that I do not agree with Major Douglas' final conclusions. But he has done so much to emphasize the importance of monetary problems and his proposals have featured so largely in popular controversies on this subject that an examination of his views makes a most pertinent introduction to the matter under consideration. As this is not the place in which to embark on a long examination of Major Douglas' various writings, I propose to examine one of the positions which he once formulated and in which some of his followers still believe. I do not here pretend to examine the position which Major Douglas now occupies or to refute any of the conclusions at which he has now arrived. I merely wish to examine the account of monetary circulation which he offers. A criticism of his particular views can be found elsewhere.*

Major Douglas and the Relation Between Consumers' Income and the Costs of Production

Major Douglas starts from the very sensible position that the economic system cannot work smoothly unless consumers possess sufficient purchasing power to purchase the whole product of industry at a price which will cover the cost of production including a normal return to the owners of capital. The costs of production, including normal profit surplus, are, however, made up of payments which pass directly or indirectly into the hands of the workers who are consumers. Rents pass into the hands of landlords, and all

* The best existing treatment of Major Douglas' opinions is to be found in *What Everyone Wants to Know about Money*, Chapter VIII, by Mr H. T. N. Gaitskell. Anyone interested in Major Douglas' views should read this brilliant critical essay on them.

salaries and profits are received by some person who is a consumer. Even when a payment is not made directly to a consumer, but to another producer, as for example when a baker buys his flour, it will come into the hands of a consumer in the end, since the second producer, or the third producer in the sequence, must pay the people whose labour or property *he* employs, and they are consumers. There is therefore a fundamental tendency for consumers' receipts to be equal to the payments involved in producing final products.*

But many of these payments are not made *directly* to consumers. Some of them must pass through a dozen hands before they reach final consumers. When a motor bicycle is bought, payment is made to cover the cost of mining the iron ore which was used for the cylinder of the car, but the payment will have to pass through the hands of the retail merchant, the wholesale merchant, the manufacturer of motor bicycles, the manufacturer of the finished steel, the smelter of the original ore and the owner of the mine which raised the ore, before it reaches the ultimate consumers who work in the mine or receive mining royalties.

In any advanced economic society there is bound to be a large number of payments between producers before the price of the final product accrues to consumers. Consumers, argues Major Douglas, or once argued, must have enough money to make all those payments if prices are not to fall short of costs. Here is a passage from one of Major Douglas' works :†

"In order to see that this is so it is necessary to restate in general terms an argument which has been dealt with elsewhere in detail (*Economic Democracy*). A factory or other productive organization has, besides its economic function as a producer of goods, a financial aspect—it may be regarded on one hand as a device for the distribution of purchasing power to individuals through the media of wages, salaries and dividends; and on the other hand as a manufactory of prices—financial values. From this standpoint its payments may be divided into two groups :

Group A. All payments made to individuals (wages, salaries and dividends).

Group B. All payments made to other organizations (raw materials, bank charges and other external costs).

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* Of course this is not so if producers hold or hoard part of the money they receive. This matter is dealt with fully in the Appendix.

† Credit Power and Democracy.

"Now *the rate of flow of purchasing power to individuals is represented by A, but since all payments go into prices, the rate of flow of prices cannot be less than A plus B. The product of any factory may be considered as something which the public ought to be able to buy, although in many cases it is an intermediate product of no use to individuals but to a subsequent manufacturer; but since A will not purchase A plus B, a proportion of the product at least equivalent to B must be distributed by a form of purchasing power which is not comprised in the description grouped under A.*"*

This is a critical argument. If it is true, as Major Douglas seems to suggest,† that the consumers' income must cover *all* the payments between producers, we have the solution to the problem of credit policy. But I claim that such a view is plainly wrong.

In the first place, we have only to imagine that it is true to see what an amazing conclusion would follow. Major Douglas used to imagine that his Group B payments—payments between producers—were only a small fraction of total payments, say one-half or one quarter; while in point of fact recent research has shown that they are an enormous proportion of them. It is calculated that payments between producers are roughly nine times as great as payments to consumers in Great Britain, and over eleven times as great in the United States of America. If what Major Douglas appears to say is true, consumers' income would be multiplied by nine times or 900 per cent. Everyone knows that this would seem a gigantic inflation, which would send prices shooting to the skies and disorganize the whole of production for the whole period in which the policy was pursued. And if any attempt were made to prevent the rise of prices by law, a corresponding amount of money would remain unspent and might just as well have never come into existence.

In the second place, it is not difficult to find the mistake which this view involves. Of course, it is *not* necessary that the consumers should have enough money to cover the payments between producers, because they are made at the earlier stages in the production of consumption goods and at a time when the money spent on finished products has had time to stream back from the last stage of production. *All that is necessary is that consumers should have enough money to pay for the immediate costs of producing consumption goods, and this they will have as long as the supply of money is fixed and none of it is held up in its movement through the economic system.*

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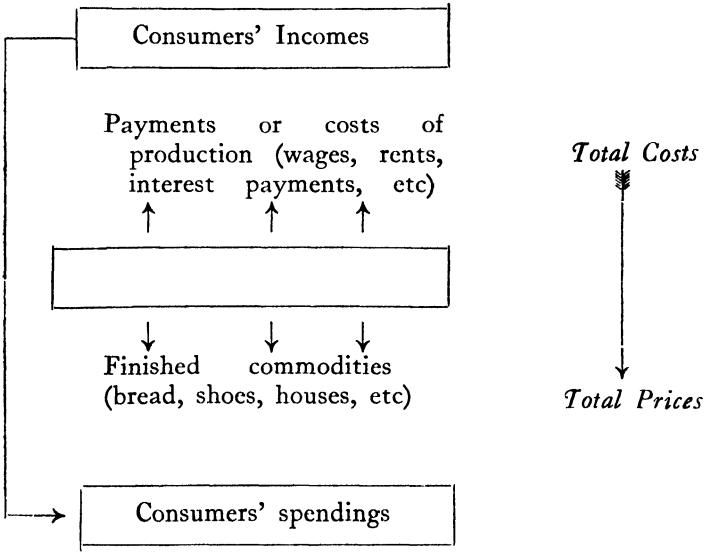
* *Op. cit.* pp. 21–22. The italics are Douglas'.

† Major Douglas now denies that he means to suggest this. See Mr Gaitskell's essay.

The Real Nature of Monetary Circulation

The mistake which Major Douglas certainly once made and the true position can best be explained by the aid of some diagrams. If the economic system were managed as one commercial unit in which there was only one financial control which employed all the factors of production and sold all the final products, then it would be perfectly plain that consumers' receipts were equal to the total payments necessitated by the course of production, since there would be no other payments than those which the single concern was making to people whose labour and property it employed. And it would naturally follow that if they spent all their money on the finished products of the single trust, the trust's receipts would be exactly equal to its total payments. Such a simple condition can be expressed in this diagram :

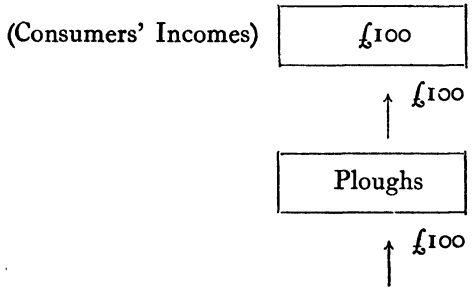


In such circumstances it is plain that the income of consumers is exactly equal to the total costs of production, since they are the same payments looked at from two different points of view; and as long as the consumers spend the whole of their receipts the producing system receives back in exchange for its products just as much as it paid out in costs. This simple monetary circulation can then continue for ever.*

* It must be understood that the receipts and payments of banks and banking institutions and the depreciation of real capital are included in this simple circulation, but that it is subject to the qualification stated in the footnote on p. 10.

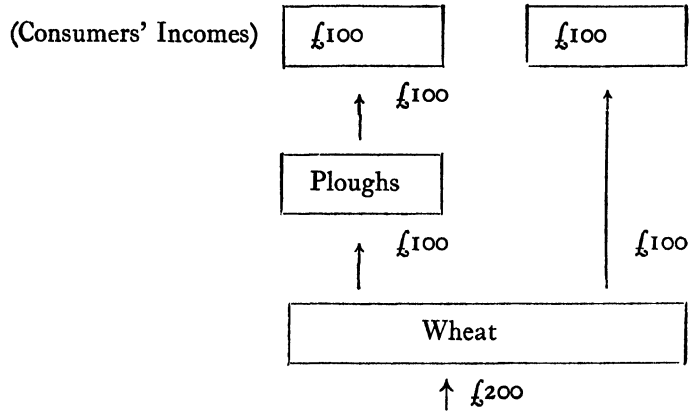
But, of course, the existing system is not as simple as this, and Major Douglas' argument is concerned with the more complex system of the real world. Now the important difference between this simple system and the real world is that in the real world the various technical stages in production are under different financial managements, so that a commodity in the course of its technical production is exchanged against money more than once. Let us take the production of bread as an example of this difference. Under the simple system in which the consumers' income provided by the production of bread is equal to the total costs in all stages of production, these stages, the production of flour, the production of wheat, and the production of all the necessary ovens, mills and ploughs, would all be under one management which would pay all the bakers, millers, farmers and all the wages, rents and interests, which were incurred in the complex course of production. It would then necessarily follow that the income which this one producer provided and his total outward payments would be equal, since there are no other payments in the system except those between producer and consumer. But in the real world, the production of bread is under the control of one producer, the production of flour under another, the production of wheat under a third, and that of ploughs under a fourth; and as a result there are entirely different types of payment—the payments between these producers which are necessary to bring the product of each stage into the next stage. Now what difference does this make to the relation between consumers' income and total payments? Let us assume that all six of these producers pay an equal sum of money per week in wages and capital charges to consumers and that each producer buys the product of the previous stage. The technical system of production can then be built up by the following diagrams:

(*a*) The producer of ploughs employs labour and capital directly and pays £100 a week, shall we say, directly to consumers, thus:

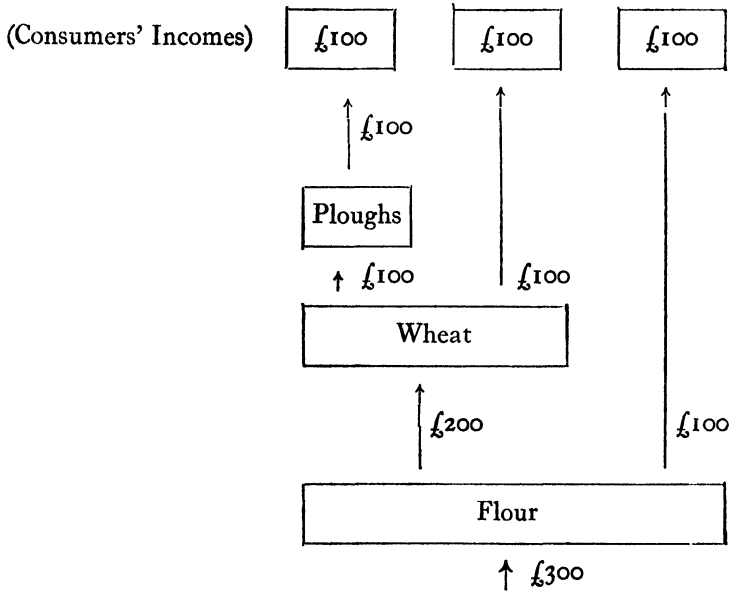


(*b*) The producer of wheat, who is the next producer in the sequence, buys the ploughs and also employs labour and capital to the

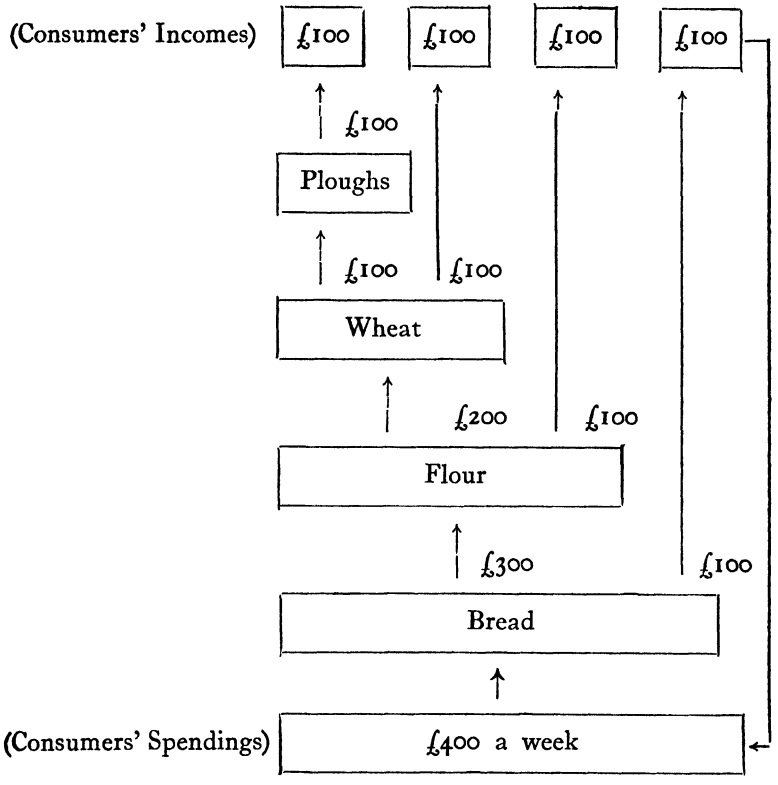
tune of £100 a week, so that his costs are £200 a week—which are met by the sale of wheat, thus :



(*c*) In the same way the miller buys the wheat at £200 and employs labour and capital to the tune of £100 a week, so that his total costs are £300 a week, which are made up as follows :



(*d*) Finally the baker buys the flour at £300 a week and employs labour and capital at £100 a week, so that his costs are £400, thus :



This is the last stage in production and the bread must be bought for £400. From where is the money to come? It can only come from the consumers. Can the consumers provide this sum? To do so, they must be able to spend £400 a week. But an inspection of the diagram, and the simple reflection that four producers are each paying consumers £100 a week, will serve to show that the consumers' income is just £400 a week. Hence if they spend all that they receive they will make the price of the finished product just equal to its cost of production and the system can maintain itself in a state of continuing production. What is true of the commodities taken here as an example is true of all commodities, so that in the system as a whole consumers' income tends to equal the cost of producing consumption goods.

The nature of the mistake that Major Douglas used to make should now become apparent. He is perfectly right in arguing that the consumers' income is necessarily less than the *total cost of producing everything*. In my example the total cost of producing

bread, flour, wheat and ploughs is £400+£300+£200+£100=£1,000 a week. But where Major Douglas was wrong was in going on to suggest that consumers' income ought to be equal to these *total* costs. It is quite impossible that it should be. If it were to become so for a moment, the most enormous inflation would have to take place. But it *is* necessary that consumers' income should be equal to the *cost of producing finished commodities*—the cost in the last stage of production. And this it necessarily is as long as no money is held up or hoarded in the general system of industry. In our particular example the cost of producing finished articles is £400 per week, and the consumers' income is £400 per week. As long as the consumers spend this income all will be well. In the last stage of production the costs will be £400 a week, of which £100 a week will go back to consumers and £300 a week to the purchase of flour. In the production of flour, £300 a week will be divided as to £100 a week to consumers and £200 a week for wheat, and finally the £200 a week will be divided between consumers and ploughs, and all the stages will be solvent and the circulation of money will continue. Major Douglas' proposals, *in so far as they depend on this view*, would merely involve a large, continuous and disastrous inflation.

Conclusion

It should now be apparent that money circulates in such a way that the purchasing power received by consumers could be sufficient to buy the whole product of the industrial system without the gigantic inflation which would be necessary to make it equal to the total costs of production. All that is necessary is that it should be equal to the costs of producing consumption goods, and this it will be as long as no money is held up in its movement through the system. The periodical breakdowns from which capitalism suffers are not therefore due to any inherent defect in the circulating system as such. They can only be due to the misuse to which the system is put and wrong ends to which it is directed. This is an important conclusion for Socialist policy, but it does not carry us very far.

In the first place we have not taken into account the process of saving. All that this chapter has attempted to show is that if no saving is going on, if no idle money exists, and if the production of consumption goods is not increasing, then consumers' purchasing power will be adequate without the continuous creation of new credit. But suppose these conditions do not exist? Suppose that saving is taking place and that the productive resources of society are increasing, or that some money which has been

earned is not spent but hoarded, what will happen then ? In the first place, what ought to happen to the volume of credit if the output of consumption goods is steadily increasing ? To answer this question we must understand the significance of saving.*

3 SOCIAL SAVING

From its earliest foundation there has been a suspicion of saving engrained in the Labour Movement. No doubt this is partly due to a fear of the machines in which saving becomes embodied. But it is also due to the belief that savings can frustrate the sale of finished commodities. Saving involves the withdrawal of some of the social income, which has been earned as part of the money costs of production, from the purchase of finished commodities. Does it not follow that saving will either reduce the prices of finished commodities below their costs of production, or reduce the quantity of commodities that can be profitably reproduced ? In either case loss and unemployment will result.

The basis of the view that saving is a dangerous process lies in the relation which it is supposed to set up between the total prices and the total money costs of producing consumption goods. In the last chapter we traced the source of all money income to money disbursed to the final consumer by the industrial system. These payments from the industrial system *are made possible because of the payments to the industrial system* arising from the sale of the finished product. Costs, in short, are paid out of receipts. In the case of the individual firm it is a mere truism to point out that if its receipts fall short of its costs production, it must choose between closing down or reducing the money costs. At first sight this also seems true of the industrial system as a whole. It receives money into itself from the sale of its finished products—bread and clothes. Will it not be true if those receipts are reduced by saving, it will either have to contract production or set in motion a vicious circle by reducing the volume of money which it pays over to the consuming public ? If saving reduces the total income of industry below the level of total current costs, how can the contraction of production be avoided ? Yet it is plain that unless a community continues to save in some form it will never be able to raise its standard of living and relieve the general burden of poverty. Unless a Socialist society can devise some process whereby it can devote part of its real resources to the production of new and better capital it will condemn itself for ever to the standard of living which it inherits from the last stage of capitalism. This would be a disastrous mistake, so that it is of the utmost importance

* The second question—that of hoarding—is dealt with in the Appendix.

that we should understand how saving becomes effective and how it can continue to take place without loss.

Income and Costs

We have already seen that in a society in which no new saving is taking place the total receipts of the industrial system will be equal to the costs of producing consumption goods, if there is no tendency to hoard. We saw that if there were only one trust which employed all types of labour, all material instruments, all existing sites; produced all kinds of commodities and sold them all upon the market for consumption goods, it would do two complementary things: it would sell total output at a certain price, and would pay out all the incomes of the productive resources as its money costs of production. It is plain, in such a simple case, that its payments must be equal to the total incomes of final consumers, and that if they save nothing the price of the total output will be equal to the cost of that output.

Nor, as we saw, will it radically alter the conclusion if we assume the far greater complexity of real life. Even if we assume not only that the different commodities are produced by different firms, but also that the different stages in the production of each commodity are in the hands of different firms, it will still be true that total consumers' income will be equal to the total payments incurred in the production of consumption goods, as long as no saving is taking place. Whatever payment is made to maintain the production of consumers' goods will accrue to some consumer in the end, even if it passed through a dozen hands before it does so.

It is therefore certain that when no new saving is taking place the income of the final consumer is equal to the necessary outlay of the producers of consumption goods. Such a condition can continue indefinitely, and in this condition these three quantities are equal:

(*a*) The total money costs of all finished goods (including an average return to capital).
(*b*) The total money incomes of all final consumers.
(*c*) The total money price of the output of finished goods.

But now let us impose upon such a system a certain degree of saving. Suppose that part of the social income is not spent upon consumption goods but is set aside to build up new capital. It would seem at first sight that the full output of consumption goods cannot be sold. If it is decided to save even a small fraction of the social income, then the total of prices will fall below the previous level of total costs by the quantity which is saved. Losses will follow and a contraction of production must begin. This is

the simple analysis and the simple conclusion at which many "theories of capitalist trade depression" arrive. And yet it is a conclusion repugnant to common sense. It is absurd to suppose that all saving, however small a fraction of the social income it may be, is necessarily a social evil and necessarily involves a reduction in the production of consumption goods, when the great capital accumulations of the past have been accompanied by great increases in contemporary consumption. What then is the error in this reasoning?

The Normal Mechanism of Saving

It is a fundamental mistake, in examining the process of social saving, to concentrate exclusively upon the initial and purely negative process of abstaining from spending money upon consumption goods. In order to understand the final effect of saving, we must consider the process of investment in real productive capital, to which this abstinence is the mere prelude, and examine, in particular, the effect of investment upon the money *costs* in the production of consumption goods.*

Let us therefore consider an economic system in which there has been a steady rate of new saving, instead of a society in which there has been none. In such a society the people have decided to save a certain fraction of their national income in order to secure the increased standard of living which new capital will make possible. The only sensible use to which these savings can be put is to spend them upon a certain type of industrial output. They must be used to increase or improve the quality of capital instruments with which consumption goods are ultimately to be made. By some mechanism the money savings of society must become embodied in the physical instruments of production with which labour works.

For this purpose labour and capital become organized into industries to meet the demand for the instruments of production arising from the social decision to save. It is scarcely necessary to point out that a large proportion of our English industrial resources, for example, are specialized to meet this demand for improvements in the general capital equipment of society; and that a considerable portion of our employment is provided by industries whose market arises from the purchase of machinery for the investment savings in this country and throughout the world. The flow of savings and investments is so regular in any advanced economic society that this specialization is desirable and inevitable. As far then, as the *direct* effect upon employment and the market

* The distinction between these two processes—saving and investment—is discussed at length in the Appendix.

for *all* types of industrial output is increased there is no net reduction as a result of saving. If we count in the output of capital instruments, and employment offered by these industries, the effect of saving will be simply to increase one type of finished product. The only effect of saving on production and employment will be a contraction in the employment offered by one group of industries, those concerned with the direct production of consumption goods, and an expansion in the employment offered by a different group of industries : the capital goods industries. There will be no net contraction in the market for all types of production, as a result of saving, so long as the savings are invested and spent upon the output of real capital goods.

While the foregoing analysis of saving is important, we have still neglected the most significant fact in the process of saving. We have only looked at the expansion of certain types of production taking place as a result of saving and investment. The output of capital goods increases. Yet it is useless, in itself, to increase this output. Tractor rather than horse plough, power looms rather than hand looms, are not wanted for their own sakes. Capital instruments are only useful, and will only be economically valuable, if their potentialities for the production of consumption goods are utilized. This is the paradox of saving. Saving, we have already seen, consists in the first place in abstaining from the purchase of consumption goods. How can a process, which reduces the purchasing power available for the buying of consumption goods, and yet increases the supply of the resources with which consumpsumption goods are to be made, continue for long ?

The reconciliation in fact lies in the effect which saving has upon the level of average costs. We have seen that unless the prices received for the output of consumption goods are equal to the costs of producing them, contraction and unemployment must follow. And it is inconceivable that the output of the instruments to be used in the production of consumption goods will be increased at a time when prices are falling below costs. Since it will reduce the total price of consumption goods saving can only proceed successfully *as long as it reduces costs as much as it reduces prices.* And that is precisely what it does do, as long as there are any opportunities for investment open within the economic system.

Saving and the Cost of Producing Consumers' Goods*

It is time that we examined more closely the nature of the rate of interest in a capitalist economy. The fact that interest

* The Argument of this section is expounded at much greater length in Chapter 2 of *Purchasing Power and the Trade Depression.*

is paid as a net addition to the original value of saving has always stimulated both scientific inquiry and social resentment, all that we need to understand is the immediate source of the funds out of which interest is, in fact, paid within the existing system.

Let us imagine the case in which there is a steady flow of new savings to the capital market, and a steady rate of interest being paid to secure the use of them; and there are many periods of history in which these conditions are substantially fulfilled. The competition in capitalist society to secure the current supply of savings is sufficient to cause them to possess a price—the rate of interest. Anyone who chooses to save £100 in the present, is certain to receive £5 added to the original value of the savings, year by year in perpetuity, as long as the rate of interest is 5 per cent or £3 10s. 0d. when it is 3½ per cent.

How does this demand for saving originate? In capitalist society, the demand for savings must originate from those who, conducting business, are prepared to pay the market rate of interest in the future, in exchange for the present use of other people's money. But why are they prepared to make these future interest payments, and from where do they obtain the sums, which enable them to pay the continuing market rate.* They can only obtain these sums as a result of the changes brought about by the uses to which they put the savings. They must spend the savings in such a way as to increase the margin between the prices which they receive for their new output and their new level of costs other than interest. This margin is the sole source from which they can meet their liabilities. If a car manufacturer raises a loan of £1 million and contracts to pay £50,000 in interest upon it every year in the future, he can only do this if the difference between the level of the payments he makes and the prices he receives is increased by £50,000. Otherwise he must make losses. *Since on the average new investment means a larger physical output, and since a larger physical output of a commodity always entails a lower price per unit, the only normal source of these interest amounts will be a still greater reduction in costs per unit. Unless costs per unit are reduced more than the prices there can be no interest payments.* Wherever there are interest payments, costs *are* being reduced more than prices.

The argument can be generalized. Wherever there is an effective rate of interest in the market there is an effective

* Of course some people who borrow will make investments that, in fact, return no rate of interest; but to compensate for them there must be some who make universally large profits in order to maintain the average rate paid upon the cost of production of the capital. It is imperative to realize that a market rate of interest over a period of time can only exist if net interest payments are actually made.

demand for savings. An effective demand for savings can only arise from producers who can utilize these savings to start new methods of production which will yield them a sufficiently greater margin between the total costs and the total prices of the new level of output.* When these sums are paid they must already have experienced the fall in the price of their product which the enlargement in the size of their output has already caused. In estimating their demand for savings they must calculate, and in paying the harder effective market rate they must have secured a reduction in money costs per unit of output sufficiently great, not only to meet the interest costs, but also to allow for any reduction in the price of their product upon the market.

This then is the explanation of the method by which saving can proceed without choking the market for consumption goods. It explains those periods of capitalist prosperity, associated with continuous saving, relatively stable interest rates, increasing physical production, and declining prices. It is possible for all these things to go on together, because the payment of interest proves that the current supply of savings can be utilized to lower the money costs of production (per unit) sufficiently to allow for both interest payments and lower prices. Unless money costs are reduced this way, there would be no demand for the new savings and the rate of interest would fall to nothing. The existence of any steady rate of interest with new savings in the capitalist system proves that they can be utilized to lower money costs.

In physical terms what is happening is that the increase of real capital enables the *same* primary factors of production to produce larger quantities of finished products. It therefore follows that throughout the structure of production, the same total of money costs will finance an increasing physical output of finished commodities, and secure a rise in the general standard of living through constant money incomes and falling prices.

Conclusions

The analysis of this chapter throws a great deal of light on the process of social saving and the alternative monetary policies

* It is scarcely necessary to point out that this reduction of costs will not necessarily be a reduction of total costs below the previous level. In the case of certain commodities the total price of growing output will increase, and then all that will be necessary will be a less than proportionate rise in total costs. For the whole community, if the amount of money and the rapidity of its circulation remain constant, total costs and total prices will never change. Larger physical quantities will be produced at lower costs per unit, and then interest and the rate of interest will fill up the difference. This will mean a greater relative share going to property, but only as long as the rate of interest remains constant. If the rate of interest falls more than proportionately as new savings increase, constant total costs will be maintained by a rise in total labour costs, and a fall in the costs of capital. It will still be true, however, that the interest payments on new savings will rise out of the reduction of costs per unit other than itself more rapidly than prices.

which it is possible to pursue while saving and investment are taking place. Social investment necessarily secures an all round increase in the output of finished commodities. This is its chief purpose and it is the only important method whereby the standard of living can be permanently raised. The process of social investment, the building up of new capital, must continue under a Socialist regime. The consequent increase in the production of consumption goods will tend to lower the price of all finished commodities, and at first sight this seems an undesirable and dangerous process—a process which has often accompanied the worst types of capitalist depression. But it must be remembered that depression is not a necessary result of a fall in prices due to increasing productive efficiency. Prices are falling because efficiency is increasing, and as efficiency increases the money costs of producing commodities within capitalist firms or socialized industries are reduced by the same proportion as final output is raised. The problem with which we are left is to consider what ought to happen to the supply of money as the supply of finished commodities continues to increase.

Part II Policy

4 THE CORRECT LONG TERM CREDIT POLICY

If a Socialist society is to enjoy any increase in its general standard of living it must accumulate more and better instruments of production. A growth of physical capital involves an increase in general productive efficiency and, as we have seen, a growth of physical efficiency is the same thing as a fall in the average costs of production. Without any change in the supply of money, prices will tend to fall. The problem of policy then becomes—is it desirable that this fall should take place ?

But there are really two questions at issue which must be clearly distinguished from each other. It is a matter of radical importance in the choice of an immediately practicable banking policy to know whether or not the industrial system is in a reasonable condition of productive activity or not. What is feasible during a period of prosperity becomes quite impossible, for purely monetary reasons, when there are two and a half millions out of employment. It would be ridiculous to seek either to stabilize prices or to let them remain at a level at which a large proportion of workers could not be re-employed without a considerable reduction in money wages.

We must therefore distinguish clearly between a monetary policy which it would be sensible for a Socialist Government to

pursue if it came to power at a time when capitalist depression was at its height, and the policy which is the answer to the theoretical question raised by the analysis of the conditions created by a long period of saving and investment. In the context of this pamphlet it is sensible to take the second and more theoretical question first. We have just examined in detail the nature of saving and investment and it is necessary to complete the argument by outlining the conclusions about credit policy to which that analysis leads. But it is essential to emphasize that this is only the solution of the long period problem and could only be suitably applied at a time when unemployment had been reduced to its lowest possible level. The method by which this condition of the industrial system can be secured constitutes the short period problem—to which the next chapter is devoted.

If then, in the first place, the output of consumption goods is rising *over the long period*, through the existence of a steady rate of saving and investment, there are at least two possible courses which the Socialist monetary authority can take. It can seek to *stabilize prices* or to *stabilize the general level of money incomes* and allow prices to fall as costs decline. We must examine the relative merits of these two proposals.

Stable Prices

At first sight it seems obvious that the stabilization of prices is the more sensible course. Stabilizing of prices as output increases involves a general and welcome increase in money incomes —an increase of which everyone will be directly aware and which will reconcile everyone to the otherwise unwelcome process of social saving. At the same time the industrial machine will be encouraged to maximum output by the knowledge that production can be expanded without any fall in prices. Stable prices would appear to guarantee satisfaction to society as a body of consumers and to society as a body of producers alike. In the light of these arguments it has been recommended again and again by capitalist business men and economists, drafted into the constitution of the Federal Reserve System of America, and finally adopted as the orthodox financial policy of the Labour Party in this country.

I should be the last person to argue that the execution of such a policy is quite impossible and its advantages are plain. But I think there are grave difficulties in execution *within the existing capitalist system*, or in any transitional stage before a completely planned economy can emerge. Whatever may be possible in a system in which production and saving can be controlled without regard to the level of money profits, it is,

in my opinion, exceedingly difficult to see how it will be possible by operating on the monetary factor alone to stabilize prices in a system in which the decisions about production are not yet within the control of the monetary authority itself.

Let us imagine, for example, that the policy of price stabilization is carried out by the issue to producers of new credit by the Bank of England and the Joint Stock Banks during a period in which saving and capital construction is going on, either in our present economic system, or in an intermediate period in which one third or one half of production is carried on by a number of separate socialized trusts which do not therefore embrace the whole of our productive work. We have seen that the result of capital accumulation is to increase the total production of finished commodities from the same set of primary productive resources and thus to reduce the average costs of production. But this fall of costs, by definition, is not accompanied by a corresponding fall in prices if the policy of price *stabilization* is being executed. Hence costs will fall further and further below prices as the policy of stabilizing prices is pursued, and the profits or surplus of prices over costs on every unit of product will grow greater and greater. Moreover as the level of money wages advances when the new credits pass from producers to consumers, the price level will itself pass out of control. Prices are continually tending to rise above the costs of production and there will be an inevitable expansion in the demand for money to expand production as the net profits on such production grow larger and larger. A general *inflationary* situation will therefore develop, although the price level does not rise by a single point. This is very much what happened in America between 1926 and 1929. Everywhere large profits were being made, not because prices were rising, but because industrial efficiency was increasing while prices were stable, and as a consequence all sorts of enterprises were undertaken which were only justified, and which could only be maintained if this high general level of profits was sustained by constant prices. It is this disguised inflation to which a policy of price stabilization is bound to lead in a period in which costs are falling, and it is a danger of which almost no one seems to be aware. But it is a real danger because such a inflationary structure cannot be long maintained.

If it were possible, as it would be in completely planned economy, to control production without any reference to the level of money profits, it might be possible to avoid the dilemma of disguised inflation. Even in this case it would not be easy to control the situation if the new credits required for price stabilization were issued to the producing trusts, as it is only in a later period

of time that these new credits are passed into the hands of consumers and begin to affect the price level of finished commodities. By the time the effects become noticeable an inflationary structure might have been built up. Nevertheless, it would be possible, in a fully planned economy, to prevent this later rise in prices from controlling the productive situation in the way that it does control the situation in a capitalist system or might control it in any transitional stage from full capitalism to full Socialism. But in any condition short of full planning it would not be possible to prevent an inflationary situation from developing if prices were maintained for any considerable period of time above the money costs of production, and it is essential for us to understand why an inflationary structure cannot be permanently maintained.*

In a period in which costs are falling below prices, business is everywhere profitable and all sorts of extensions and capital schemes are begun which are only justified on the assumption that this high general level of profits will be permanently sustained. Credits will therefore continue to stream out of the banks, rendering it still more difficult to control the course of prices. The banking system is soon faced with a dilemma. As the credits flow out the general volume of monetary business is increased, and the level of money incomes is raised. People will begin to draw upon the cash reserves of the banks, not because they distrust the banks, but simply because they need the same proportion of cash to their growing money incomes. Cash will therefore leave the banks in greater quantities, and be held permanently by the public in greater quantities. The banks are accustomed to think of a certain ratio of cash to their credit liabilities as the minimum consistent with safety. This limit is steadily approached and the banks will be ruined unless they can check the drain. They must do something to check the inflation and to damp down the rate at which they are creating new credit. But such a restrictive motive move on their part is bound to initiate a general credit crisis and begin a depression.

It may be asked why a Socialist Government in such a situation should not meet the drain by the simple expedient of creating more cash—printing more notes. There is no reason why in the short period they should not do this and such a measure will be effective in delaying the onset of the crisis. It can, however, only delay the final crash. The high level of profits is maintained by the continuing inflation. The demand for money will therefore

* I am not clear in my own mind whether it would be possible to stabilize prices in a fully planned economy and I do not believe that anyone has given a satisfactory account of how it could be done.

continue to increase. The cumulative tendency for the outflow of new credit to get greater and greater will receive no check and the hidden inflation will go on. After a certain time it will cease to be hidden. New money is flowing out at an increasing rate and the *rate* of growth of technical efficiency is most unlikely itself to increase. It is almost certain to decline. Hence after a period of time the rate of outflow of money is bound to become greater than the current rate of increase in physical production. Beyond that point prices are bound to rise and the later stages of inflation would set in. There is now no choice except that of allowing prices to rise to fantastic heights and to destroy the currency, or to check the rate of credit expansion. The check to credit expansion will have the same disturbing effect at this stage as it would have had before the new cash was created, and brings us back to the central dilemma of price stabilization.

But it may be asked: why should the contraction of credit necessary to stop prices from rising cause any general collapse? That is an important point. Now I do not believe that it is possible to check credit expansion and falsify the producing authorities' expectations as to the future course of profits, without creating a wide loss of confidence, bankruptcy of capital schemes and severe unemployment. Hundreds of individual concerns have embarked upon capital schemes which were only justified on the assumption that the outflow of money was going to continue and the high level of money profits would be preserved. A whole structure of productive enterprise has been built up not only upon the new credits as they issued from the banks and in relation to the level of profits created by stable prices, but also to meet the needs of all those to whom the credits have been accruing as they streamed through the system. The whole of this structure will come tumbling down. Some enterprises which are half completed will not be able to obtain the money which they need and will be forced to stop production. Much more important, certain other enterprises will make losses because the inflation of credit has stopped and prices fail to behave as they were originally expected to do. Such concerns are bound to cut down production. Both these primary contractions will involve a reduction in the demand for the products of other processes, whose previous expansions will thus become unprofitable and will therefore be stopped. Investment will everywhere be checked and expectations as to the course of prices and profits will everywhere be falsified. Step by step the inflationary structure will come tumbling down, causing unemployment to appear in all industries, but particularly in the heavy industries which were more involved in the original expansion of capital production. This is the inevitable result of attempting

to stabilize prices in the absence of planned production at a time when costs are falling.

Let me repeat that I am not arguing that price stabilization is impossible in a fully planned economy. What is not possible when production is controlled by the general level of monetary profits may be quite possible under complete Socialism. If it is possible to control not only the quantity of money but also its distribution between producers and consumers, and to see that individual producing units do not embark upon expansionist policies which taken collectively will lead to a cumulative expansion, it may be possible to stabilize prices and increase money incomes. But what I am arguing with conviction is that since it is increasingly plain that the monetary system will be one of the first elements in the economic structure which is likely to be socialized, there is bound to be a transitional period, perhaps lasting several years, between the period in which the monetary system is successfully socialized and the productive system itself is brought completely within our control. It is during this period that the arguments for a policy alternative to price stabilization seem to be so overwhelming. What then must be done ?

Stable Incomes

The right policy for a period in which complete planning is not achieved is, I am convinced, a policy of *stabilizing money incomes*. This does not mean refusing to expand credit at all, but it does mean abandoning any attempt to stabilize prices. As the accumulation of capital goes on it is very probable that the whole process of production will grow more and more complex and become divided into a larger number of separate processes. As a result of this process the amount of money required to finance the production of a physical unit of any given commodity will grow greater and the amount of money required to transact this series of exchanges will necessarily expand. Such an increase could safely be provided by the banks, but it would not lead to any increase in the level of money incomes because the money would only be provided in the cases in which it would remain held up in the course of production. Thus, although there would be an increase in the volume of money in the productive system—a lengthening of the series of monetary transactions shown in the figures of Chapter I—there would be no expansion in consumers' money income.

Meanwhile the production of consumption goods would be increasing, so that their price level would decline. But there would be nothing disastrous in such a fall. As we have seen in

Chapter 3, these prices would only fall after and because of a previous decline in money costs, and the full output of consumption goods could be marketed at these lower prices. Everywhere more would be produced for the same total cost. Everyone would receive the same, or approximately the same money income, but the real income would continuously rise as the prices of finished products continued to fall.

This policy has one great advantage and one great disadvantage. The great advantage is that it would plainly prevent the hidden inflation which we have seen to be the great weakness and ultimate end of any policy of price stabilization. If the general level of money incomes is constant it is impossible for falling costs to force up net returns, since money prices must fall as output increases. On the other hand, there is a psychological disadvantage in raising the standard of living by allowing prices to fall instead of allowing money incomes to rise. This is beyond question. No one really believes that the tiny reductions of pennies and halfpennies in the prices of the commodities which they buy actually aggregate to the totals which a corresponding change in their money incomes would represent. Those who have been in constant employment at a fixed money wage during the last three years do not really feel that they are just as well off as if their money wages had been raised by 10 or 15 per cent above their 1930 level. Yet prices—even allowing for the relative stationariness of rents—are down by something equivalent to this amount. This is a real disadvantage in the operation of a constant income policy, and yet I believe that it is the only way by which disguised inflations—and the subsequent crises and depressions—can be avoided in the interval between the socialization of the banking system and the socialization of the whole industrial system.

Hence I conclude that the solution of the long period problem is to be found in the policy of constant purchasing power per head of the population. The socialized banking system must be required to change the criterion of its policy over the long period. The banking corporation must not look to prices, nor to the total of their liabilities, nor even to the unemployment position, but to the general level money incomes which their credit policy is in large part determining. They must construct some suitable index of the income position and seek to stabilize that. By this method they will succeed in preventing the creation of unstable monetary profits, the building up of a top-heavy inflationary structure and the appearance of credit crises and waves of high unemployment. But such a policy does not represent a cure for the large volume of existing unemployment.

5 AN IMMEDIATE MONETARY PROGRAMME

It would be absurd for a Socialist Government to stabilize incomes and allow prices to fall, if it comes into office when there were two or two and a half million unemployed. By so doing it would be committed to a choice between an indefinite continuation of this high level of unemployment or the policy of reducing money wages. Either course would involve political suicide. Now it is quite possible—though by no means certain—that the next Labour Government will come into power when there is a larger volume of unemployment than at present, or else that a considerable amount may be created by its advent to power. Capitalism undergoes a continuous alternation between prosperity and depression—between periods of high money profits, high productivity and employment, and depressions or periods of falling prices, low profits and productivity and high unemployment. It is also possible that a Labour Government will come into power on the top of a wave of prosperity, in which case it might be sensible to embark on a policy of income stabilization. But if it does not come to power at such a time, or if its advent to power causes a deflationary situation to develop and unemployment to rise, what is to be done in these circumstances ? The stabilization of income would be absurd. An expansionist monetary policy is essential. Prices and money incomes must be forced up so as to increase the demand for labour and re-employ the idle workers at Trade Union rates. But how can such a policy escape the evils of disguised inflation which are set forth in the previous chapter ?

Let us assume that a Labour Government is returned at a time when there are two million unemployed and when the cure of unemployment is one of the central issues of immediate policy. It cannot be left until the full process of social control has been extended over the majority of industries. The government must initiate a policy within the period of the first three or four months of office. During such a period, apart from revolutionary developments, it will only be possible to acquire the banks and the main financial houses. The solution of the problem is therefore subject to three conditions—two political and one economic :

1 The solution must not depend upon the assumption that full control of industrial processes has been obtained by the government, *i.e.*, it must be based upon the necessity of making a large quantity of *private* industry expand its demand for labour, at the existing level of wages, and upon the demand of the Trade Unions for the maintenance of money wage rates.

2 But the policy which is pursued must also be consistent with the general political objectives of the Labour Movement,

the extension of social control over the important sources of industrial power and the achievement of economic and social equality. The policy must not be such as to entrench the interest and power of private capital during the transitional period.

3 The last and the least obvious of the conditions which the policy must fulfil is a purely economic one. The industrial system with which the Labour Government is concerned is of a certain technical kind—namely, one in which a series of disguised inflations or capitalist "booms" has influenced the distribution of the productive resources between different types of industry. The resources have been directed by the expenditure of the credits issued to producers in previous booms into the capital good industries. Those industries have therefore become larger than they should be—in the sense that the resources in them can only be fully employed at current money rates if a process of inflation, which is inherently unstable, is currently taking place. It therefore follows that when prices are made to equal costs in the consumption goods industries there will still be a large volume of unemployment in the capital goods industries and yet that inflation beyond this point will bring prices above costs in the consumption goods industries and render a future crisis inevitable. This is the most serious problem which Socialist monetary policy has to solve, for it means that the ordinary inflationary measures are not enough to cure the unemployment problem. If they stop short at the point when the full output of consumption goods can be marketed unemployment will not be fully cured; while if they continue, without any sort of check, to the point at which unemployment is fully cured, the monetary position will have become unstable. What then is the right "check" to inflation and how can it be applied in a form which is consistent with the general purposes of the Labour Party? This is the crux of the practical problem.

The Policy

To solve the problem of *controlled* expansion it is necessary for the Labour Government, in my view, to pursue three courses at one and the same time—to discover a number of reliable statistical indices and to watch their movements; to initiate a vigorous expansionist monetary policy; and to apply a brake upon that expansion by the use of the instruments of taxation. Let us set forth these steps in greater detail:

1. It is essential to secure a reliable set of indices which can be read at the shortest possible intervals and which will keep you informed as to what is happening to the consumers' income, to the market for consumption goods and to the quantity of

unemployment in various types of industry. The person or body responsible for monetary policy will therefore require:

i An index of *Consumers' Money Income*—that is of the total amount of money paid to the consuming public in the form of wages, rent and interest payments, returns on fixed capital and to management, and all other forms of net income received by persons and institutions.

ii An index of the *expenditure on finished consumption goods* made out of the total income—a measure of the volume of retail sales throughout the country. The difference between these two totals will give a measure of the saving voluntarily undertaken by individuals.

iii Finally an index of unemployment classified in a significant way, but above all resolvable into two figures:

(*a*) the volume of unemployment in the industries concerned predominantly with the later stages of commodity production—the consumption goods industries;

(*b*) the remainder, which will contain the unemployed resources which are attached to the industries making new capital.

2 It is now necessary to begin a vigorous expansionist monetary policy—consisting of a simultaneous application of all the known methods of encouraging investment. These measures fall into four divisions:

i Purely monetary expansion should be encouraged by orthodox methods of *low interest rates* at the Bank of England, in the money market, and, most important of all, upon the overdrafts issued by the commercial banks. Low rates should be accompanied by *open market operations* on the part of the banks to force more money into circulation.

It is essential that the new money created in this way should actually be used in productive enterprize and this can only be secured by pursuing active investment policies.

ii The familiar method of public works: increasing government expenditure on capital account can be pursued within reason, although it must be remembered that expenditure on capital should be expenditure of a predominantly productive kind, and public works must not be limited to houses and roads if the types of capital which are more necessary to industry itself will not be built as a result of the utilization of available funds for government schemes.

It is almost certain that these methods will not be sufficient and the process of encouraging investment must be carried still further.

iii In the third place it should be possible to encourage voluntary investment in the great body of industry which is still under private control. This can be done in three ways. First the Trade Facilities Act can be extended to cover all types of internal investments.* Secondly, it should not be impossible to reduce the rate of tax on reserves appropriated for capital construction. Thirdly, it would be reasonable to give a mild subsidy to the rate of interest on approved concerns by charging a lower rate of interest to schemes approved under the Trade Facilities Act than that paid to the subscribing public. By a vigorous use of these methods the amount of investment undertaken by the private industry could, I am convinced, be greatly increased.

iv Finally there is the method of *direct investment in socialized industries*. In the early stages of the execution of the government's programme few industries will be under its direct control, but after a time the number will increase and it will be possible to make use of the growing volume of money which is available for capital construction to carry out plans of reconstruction in them. This will become, after a year or so, one of the most important methods of stimulating and maintaining the volume of investment.

As a result of all these forms of expansionist activity it should be possible to increase by £150—£200 millions per year the volume of current investment. Not only will this increase the volume of employment, which is directly available, but the new active money will circulate through the system, and by extending the market for consumption goods, will stimulate investment still further, and so create large volumes of necessary employment.

The ordinary expansionist movement of the capitalist boom will now begin. Everywhere monetary streams will be expanding, employment increasing, plant coming back into use, and the consumers' money income will be rising. After a period, however, if the argument of the first section of this chapter is correct, a critical point will be reached. The new money will pass first into the hands of the producers of capital and from them to consumers, increasing employment in both groups of industries cumulatively. But a point will come at which unemployment in the consumption goods industries is fully cured and where prices are equal to costs at current wage rates, and yet there is still unemployment in the capital goods industries. Beyond this point the element of real inflation

* I am indebted to Dr Dalton for this suggestion.

begins. If the volume of investment is stimulated further and *nothing else is done*, the expenditure of this new money in the hands of those producing capital will raise prices above costs in the production of consumption goods. It is at this point that the government must embark upon the third part of my programme.

3 The government must, when the indices reach a certain position, *use the instrument of taxation to finance the further* schemes of capital investment. At the critical period the consumers' income will still be rising and so will the expenditure on consumption goods. The indices i and ii, measuring consumers' total income and the volume of retail sales, will both be moving upwards. But the unemployment in the consumption goods industries will have fallen to the level made inevitable by normal causes of illness and change of employment. The index I iii (a) will stand at 0. If the unemployment problem is to be fully cured, it is essential that consumers' income and the volume of monetary investment should continue to expand, but if an inflationary situation is to be prevented from developing, it is vital that the expenditure on consumption goods (index I ii) should be stabilized. The stabilization of expenditure on consumption goods can be secured by taxation—possibly of an equalitarian nature.

The government, or the supreme economic authority which will probably have been created by this time, must attempt to stabilize the volume of retail sales at the level which results in full employment in the finishing industries without preventing the further increase in the volume of money income itself. If it is to find a permanent cure for the unemployment problem it must secure the same proportional division of the money spent within the system, between consumption goods and capital goods as exists between the quantities of resources invested in these two types of industry. If the resources are invested in a ratio of 3 : 1 or 3 : 2, then the volume of money must be spent and invested in the same proportion as 3 : 1 or 3 : 2 as the case may be. As we have seen, the consuming public, if left to themselves will never spend money in this proportion, but will spend more than this quantity upon consumption goods. This they must be prevented from doing if permanent stability is to be secured. The purpose of restricting the communal expenditure on consumption goods is not in the least to reduce the volume of real consumption, which indeed will expand at a faster rate if the unemployment problem is permanently cured, but simply to prevent an inflationary situation from developing. If it does develop a later crisis and depression is inevitable.

Hence the policy of the government must be to hold down the expenditure on consumption goods as soon as unemployment in that group of industries has fallen to nothing. This it can do by imposing direct and indirect taxation with a view to preventing a further increase in the volume of retail sales. The funds so obtained by the government should then be used to finance more schemes of capital investment to expand still further the employment offered by the capital goods industries. In this way the government will secure the necessary volume of investment by a double process of taxation and investment which is not unstable and which can be prolonged indefinitely. It can cure the unemployment problem for ever and succeed as no capitalist policy could ever do, in stabilizing the capitalist boom indefinitely. But it is impossible to do this without at some point imposing taxation, not for the purpose of current expenditure, but in order to finance schemes of capital expansion.

The great advantages of this programme are obvious. If it is successful it will secure full employment without the wastage of resources which would be inevitable if the alternative policy of transferring labour and capital into the consumption goods industries were chosen instead. Moreover, there is no part of the policy which is not consonant with the broader Socialist purposes of the Labour Movement. The forms of licensed and subsidized investment could be made conditional upon the surrender of autonomy on the part of the private industry to the controlling central authority and would therefore be an integral part of the general programme of social control. The necessary taxation could be of an equalitarian character and would establish the essential Socialist precedent that taxation is to be based, not only upon the financial needs of the government, but also upon the requirements of complex economic plans and fundamental social changes. Finally the policy, if completely successful, not only enables the government to make a short period onslaught on the unemployment problem, but also perpetuates indefinitely the ultimate regime of full employment. These advantages constitute an almost overwhelming argument in favour of this policy or some variant of it.

At the same time it would be silly to deny that it has no great disadvantage. It does involve the decision at a certain moment to check the increase in consumption expenditure. It means that the government must *appear* to prevent the expansion in consumption. In fact the government will do nothing of the kind. It will only change the form in which the increment in real consumption accrues to the consumer—a change from the form of rising money incomes to the form of falling prices. But it will be an

unpopular move. Moreover at a later period (when full employment is obtained everywhere) the government will be involved in the attempt to stabilize money incomes instead of allowing them to rise still further. No one can pretend that this is a pleasant task. At the same time unless the government does succeed in holding down the volume of retail sales it is virtually certain that the " reflation " will get out of hand and the plan for monetary stability be completely ruined. The success of the later stages of the plan depend upon the courage and skill of the government in making plain to its supporters in the Trade Union Movement that a period of stable money income is necessary to the maintenance of prosperity. If this is impossible, then the cure of unemployment in a comparatively short period is also impossible, because there is no alternative to a plan of this kind.

When the whole industrial order is brought under social control and all decisions about prices, rates of expansion and volumes of investment can be made by one central economic authority the position is quite different. It may then be very easy to allow money wages to rise as productive efficiency increases and so to stabilize prices. But that is not a condition that is likely to obtain, apart from a revolutionary development, in a period of three or four years. It is with that short period that this chapter is exclusively concerned, and given one element of realism in the outlook and policy of the Trade Unions I believe that it would be possible to solve the unemployment problem by a vigorous and balanced monetary policy.

Appendix

CAPITALIST TRADE DEPRESSION AND THE RELATION BETWEEN SAVINGS AND INVESTMENT*

Throughout the first part of this pamphlet I have neglected the problem of capitalist depression. It may be felt by some readers that the existence of general depression invalidates my argument. This is not true. It is true that capitalist development is accompanied by " booms " and " slumps ", but I do not believe that general development cannot proceed without them—nor even that capitalism itself could not greatly diminish the severity of these crises if it pursued a more sensible credit policy. It may therefore be of interest to say something in this appendix about the nature of capitalist depression itself.

There are at least six main text books, each ten times the

* This is a reprint of certain sections of my book, *Purchasing Power and Trade Depression*—for the permission to print which I have to thank the publishers, Jonathan Cape & Co.

length of this work, setting forth different explanations of how the system works, and why it fluctuates. It would be ridiculous to attempt to examine them all here, and unnecessary. On the whole the post-war tendency has been to trace the source of disturbance to the intricate relationship which exists between the supply of the means of payment on the one hand, and the processes of saving and consuming on the other; and in the last year or so a new stream of monetary theory coming from Vienna has made it increasingly probable that depression can only be avoided by controlling the period of recovery and enforcing a more severe restriction on the issue of credit toward the end which I have already described. This is quite an old-fashioned conclusion, but it is based on a more detailed analysis of the processes of monetary circulation. If this is the truth, it is probably beyond the power of capitalist society to force such a policy upon the banks, and hence the need for general social control is greater.

In the meantime, I wish to relate the analysis of the first three chapters of this pamphlet to the conditions of general depression that so often appear. How can the depression arise, if the general relationships between total prices and total costs which I have described in these chapters continues to exist, even when saving takes place? What are the sources of divergence between them? They arise, I think, from two general sources, corresponding to two of the assumptions contained in those chapters which are not fulfilled in the real world. In Chapter 3, I made the assumption that the whole of savings is made directly available for industrial purposes —*i.e.* that they are automatically invested. And, in the second place, I assumed that the available supply of savings constituted a fairly constant proportion of the total average income and were accompanied by a corresponding series of technical inventions, such that the effective market rate of interest was uniform over the period in question. Neither of these conditions is fulfilled in fact.

Inequality of Savings and Investment*

In Chapter 3, I attempted to prove that the process of saving did not, in certain circumstances, reduce the total market for industrial output. This is true, in the first instance, because the expenditure of the savings increases the market for certain types of production; and in the second instance because the capital improvements which the savings have made possible reduce the money-costs of the larger output, and keep them equal to the smaller monetary expenditure. Throughout the process, the

* I am indebted for the whole of the subject matter of this section to the unpublished writing of J. E. Meade.

preservation of prosperity depends upon an equality between total prices and total costs. If the money paid for the output of industry as a whole, capital goods and consumption goods taken together, falls short of the amount paid away as costs to the factors of production, then somewhere in the industrial system there will be a net loss, and contraction and unemployment will result.* This is a purely monetary cause of disequilibrium and no advantage can come from it. Such a condition will be brought about if any of the money paid out by the industrial system to the factors of production is saved (*i.e.* not spent on consumption goods) by the consumer to whom it ultimately accrues; and is not returned, either by him or by someone else, to the industrial system through the purchase of capital goods. It does not matter whether the money is returned in this way by the person who saves it, or by someone else after a whole series of monetary exchanges have intervened. What does matter is that the money spent by the group of individuals who buy capital goods should be equal to the money saved by the different group of individuals who refrain from buying consumption goods. It does not matter, for example, whether Mr Smith, who saves £100, should buy £100 of Government loan from Mr Brown, who buys a South American State loan from Mr Jones, who buys an existing Railway debenture from Mr Robinson, although none of these purchases increases the market for capital goods, as long as Mr Robinson at the end of the series does buy a security which represents *new* investment, or spends the money himself on capital improvements or consumption goods. As long as the money saved by Mr Smith is ultimately spent upon the output of some industrial concern, the conditions of equilibrium are fulfilled. As long as the stream of money pouring out of the investment market for the purchase of industrial products is equal to the stream pouring into it from the pockets of individual savers, the market for total output is constant. If we designate all monies not spent on consumption goods as "savings"; and all the money spent on individual output other than consumption goods as "investment"; then the condition of full employment without losses can be maintained only as long as investment is equal to saving.

A great deal of time has been spent by economists in England† since the war in analyzing the circumstances under which this condition of equilibrium will not be fulfilled. I must content myself with a short catalogue of the causes which they have discovered for divergences between savings and investment:

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* Mr Abbatti has put this as definitely as anyone in the *Final Buyer.*

† Particularly Mr Robertson and Mr Keynes.

1 INCREASING PRODUCTION AND THE VELOCITY OF CIRCULATION

If there is a good harvest, or an invention in the production of certain commodities, the consequent increase in physical output may cause saving to exceed investment.* This may happen if the commodities are of such a type that less is spent upon a greater physical quantity than upon a smaller—*i.e.* that the price falls by a greater percentage than the physical output increases. When the output increases consumers spend less upon this particular commodity, and unless they spend more upon some other commodity the total receipts of the industrial system will fall short of its previous costs by the amount that they fail to spend. In our terminology, saving has increased. If such saving causes an immediate fall in the rate of interest, and an immediate increase in the volume of investment, nothing more serious than a transfer from one kind of production to another is necessary to restore equilibrium. But suppose instead of this that consumers are only aware of a relatively small reduction in their expenditure, and therefore allow a small increase in their bank deposits or in their cash balances to take place. A very small change in the balances held by a large number of individual consumers may represent a very considerable reduction in the market for a single industry.

In circumstances such as these the public are really depositing more with the banks. They are leaving deposits with them for a longer period of time, and all that is necessary is that the banks should lend these increased savings to producers who will invest them. Unfortunately the banks are not necessarily aware of what is happening. The total of their customers' deposits remain unchanged. One set of individuals—the consumers—are holding larger balances, while another set—the traders—are of necessity holding smaller balances. But the public does not, and cannot change the total. Moreover the banks may either have to lower their rate of interest or the security of their loans in a way that may not be immediately profitable to them in order to restore the value of money borrowed for productive purposes. Any cause which may lead to an increase in saving through the banks does not therefore necessarily lead to an increase in investment by the banks, and from this cause alone investment may fall short of savings and general unemployment appear.

Reasoning of this type has been familiar since Mr Robertson first analyzed this cause of disequilibrium in 1926.† There are,

* This is the general view held by all business men and some economists, when they speak of "over production".

† *Banking Policy and the Price Level.* Passim.

however, some difficulties in believing that the disequilibrium is very grave. It is a disequilibrium arises because some people spend their bank balances less rapidly, and because there is no mechanism which makes the banks aware that such a fall is taking place. It is difficult to see, however, why the increase in physical output should be predominantly of the type which reduces the velocity of circulation, or that there are no mechanisms which inform the banks of the situation. In the first place a tendency to transfer from current to deposit account, and the banks will be faced by an expansion in that part of their business which actually costs them money. At the same time the losses made by traders will bring about a contraction in the volume of loans which they make, and therefore an increase in the disposition of the public to hold bank deposits will contract loan business of the banks and expand their customers' interest bearing assets. The banks are not likely to be unaware for long of this tendency. But at the same time it is no doubt true that the banks are unwilling or unable to reduce their rate of interest sufficiently rapidly to offset the fall in profits which the tendency to hold bank deposits has caused, and if this is so, savings will exceed investment, and cumulative losses will be made in industry at large.

2 Sale of Securities

The source of disequilibrium discussed in the last section can be expressed in terms of the rate of interest. An increase in the desire to hold bank deposits is really an increase in the supply of savings ; and equilibrium required that the rate of interest should fall far enough to increase the sums borrowed from the bank despite the fall in the prices of consumption goods due to increased saving. Mr Robertson has suggested that there are reasons why the *banks'* rate of interest will not fall in this necessary fashion if the increased saving is done through the banks. This may be true or not, but Mr Keynes has gone on to suggest that even if the saving goes to the ordinary security market and not to the banks, the rate of interest may still fail to move downwards to the necessary extent.* The only way in which the rate of interest in the ordinary security market can fall is if the price level of existing securities rises, while the dividends upon these remain stable or actually decrease. As soon as the relationship between the price of existing securities and the dividends upon them changes, the terms upon which new loans can be raised will change also. If the price of securities rises relatively to the

* *Treatise on Money* and *Economic Journal*, 1931.

level of dividends the rate of interest at which new loans can be raised will fall.

It has been the usual view that an increase of saving, directed to the security market, will raise the price level of existing securities, lower the rate of interest to new investment, and so bring about an increase in investment equal to the increase in saving. Mr Keynes now suggests that if the producers of consumption goods meet the losses they sustain through an increase in saving, by the sale of securities or a reduction in the rate at which they buy them, then the supply of securities will increase at the same time as the demand for them increases. There will therefore be no necessary change in their price level and no necessary reduction in the rate of interest. Once more the rate of interest is above the rate which would make investment equal to saving, and net losses will result. The same argument may be put in an alternative form, by arguing that if the person who saves those savings to buy a capital asset held by the producer of consumption goods, who makes a loss equal to the quantity of new savings, there will be no tendency for the original loss to be offset and a condition of insolvency will creep in general paralysis over the production of consumption goods, spreading out from them through the whole industrial system.

It may be that such movements as these will hold up the rate of interest. At the same time it is important to realize that the cause of the trouble is the failure of the rate of interest to fall, and that it is not easy to see why it should be maintained for long. For equilibrium to exist the market rate of interest should be equal to the current rate of profits on new investment. As a result of saving the latter has fallen, while the rate of interest is maintained. But why, in general, should it be maintained? How can the market rate of interest be above the rate of profits for long? The movement to withdraw funds from productive enterprize of all kinds, in order to earn the higher money return offered in the security market, must soon restore the equality of the rate of return in industry and in financial speculation. But as soon as this equality is restored the market rate of interest will be equal to the rate of return on the cost of new investment, as equilibrium requires. It is, therefore, difficult to see how this cause can be a serious or *permanent* cause for losses and unemployment, unless there are very grave rigidities which no doubt there are.

3 A Decline of Investment

It is finally suggested that the rate of savings is inherently more stable than the rate of investment. Saving is so much a

matter of habit and of the maintenance of conventional standards of living, while investment, on the other hand, is the uncertain fruit of confidence, technical invention and business enterprize—all unstable and subject of wide fluctuations. If, then, a group of profitable inventions is fully exploited, after a period of active investment and high interest rates, the rate of interest will fall sharply while saving continues at very much the old level. At once the condition of equilibrium is destroyed. Saving exceeds investment.

There can be no doubt that this *could* happen. It is more doubtful whether technical invention does proceed in this fitful fashion, or whether it is sufficiently concentrated in one part of the industrial system for the exploitation of one set of inventions to cause any general collapse. It would seem more probable that in the period in which invention is exhausted in one direction, it is active in another, and that on the average the technical opportunities for investment are maintained. At the same time periods of capitalist depression are patently periods in which investment contracts sharply, without reason to believe that saving contracts first. The problem is really to understand *why* investment falls off, however true it may be that the decline is the proximate cause of disaster.

We need scarcely pursue the subject any further. I have said enough to show that the argument of the preceding chapters is not inconsistent with the existence of general depression. If investment fall short of saving, then general losses and unemployment are inevitable. There are large fluctuations in investment and these are undoubtedly the immediate source of depression and unemployment. I have tried to suggest that none of the explanations that I have examined for the decline of investment is really adequate. None of them explain the source of periodical impulses to a rate of investment that cannot be maintained, and all of them assume a change in the relation between saving and investment without showing why that change is inevitable. I have suggested elsewhere the direction in which I think such a explanation may be found.*

4 Changes in the Rate of Saving

There is another group of theories which seem to trace the cause of depression not to divergencies between saving and investment, but to the variations of saving themselves. In Chapter 3 I outlined the main case against this group of pure under consumption theories. They cannot possibly be accepted in the

* *Purchasing Power and Trade Depression*, Chs. IV and V.

crude and inconsistent form in which they are normally expressed, but there remains a certain peculiar difficulty associated with changes in the rate of saving which they have not succeeded in stating with precision, but which we must consider. In Chapter 3 I explicitly assumed that there was a relatively constant rate of saving and a relatively constant rate of investment maintaining the demand for new capital; so that the current supply of savings was constantly absorbed in the reduction of money costs per unit of output throughout the industrial system at a relatively steady rate of interest. In such circumstances the rate at which the money costs of production are falling is constant, and keeps pace with the steady fall in prices brought about by constant saving and the constant expansion of physical output. The maintenance of a stable relation between falling prices and falling costs results in a maintenance of a steady rate of interest. This condition is realized because, and only because, prices fall at the same rate as the economies of capital improvements are realized, so that money prices never fall at a greater rate than do money costs. If, for example, a certain rate of saving, combined with a certain series of inventions, causes an increase of physical output of 10 per cent a year, and with a constant rate of saving, prices will fall by 10 per cent per year. Equilibrium between prices and costs will be maintained.

But suppose now, that there is a considerable rise in the rate of saving, while the rate of invention remains constant. In the *long run* the consequential fall in the rate of interest will enable the increased savings to be absorbed over a wider field of investment, and since the rate of interest expresses the effectiveness of savings in reducing costs, there will be a final equilibrium between prices and costs. But in the *short run* this condition is not fulfilled, however rapidly the rate of interest responds to the changing conditions. In the short run the prices of consumption goods fall at once as the result of saving, while costs cannot fall immediately. Not only will it take time, in practice, to reduce the market rate of interest, but the reduction in the rate of interest will not bring down the money costs of production *until after the new processes made possible by the lower rate of interest have been brought into operation.* The financing and mobilization of these new processes may take months or even years. In the meantime a disequilibrium between prices and costs is bound to exist. Prices will start falling at once at a rate greater than 10 per cent per year—say 15 per cent per year—while costs will continue for a time to fall only at a rate of 10 per cent a year. Costs will therefore exceed prices for a period determined by the length of time required to make the new and lower rate of interest effective. In the

meantime the output of consumption goods will be contracted and the demand for the instruments of production sympathetically reduced, until such time as the volume of new processes started with the purpose of utilizing the lower rate of interest has caught up the original contraction due to the losses following immediately upon the increase in the rate of saving.

It is not my business to examine the theory of this type of disequilibrium any further. It is only my purpose to demonstrate that there are grave difficulties within the capitalist system arising from fluctuation in the rate of investment, and in the rate of saving. Disharmony is bound to result from any change which tends to a divergence between saving and investment, and as far as I can understand the matter, also from any considerable fluctuations in the rate of saving or the rate of interest.

London, December, 1933

Printed by The Hereford Times Ltd. (T.U. all Depts.),
London and Hereford.

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