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THE CONQUEST OF UNEMPLOYMENT

THE CONQUEST OF UNEMPLOYMENT

By

E. VICTOR MORGAN

Under the general editorship of

HUGH MOLSON, M.P.

1947

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FOREWORD

by

Rt. Hon. Sir John Anderson, G.C.B., F.R.S., M.P.

NO TIME could be more opportune than the present for the appearance of a book of this kind.

At this moment economic theories and policies are being subjected to the most searching practical tests.

Moreover, the country is for the first time in its history confronting a major crisis under the conditions of a managed economy. On every previous occasion under the operation of a gold standard the national economy was self-regulating, except, of course, for the discharge on well recognised traditional lines of the functions of the central bank and the exchange houses. Now, by contrast, all this is under the ultimate control of Ministers—not themselves necessarily skilled in such matters and liable to be impelled along dangerous courses by an electorate entirely unskilled.

We may, perhaps, usefully pause here to reflect for a moment upon the essential difference between a self-regulating and a managed currency.

The great merit of a metallic standard of currency—and though other standards for a self-regulating currency are theoretically possible none has been tried in practice—is that it excludes the uncertain factor of human psychology. It can be relied upon to exhibit the danger signal in good time. I say that despite what happened in 1931, for then the red light was plainly visible for months before the crisis broke but was ignored by those in power.

The outstanding defect, on the other hand, of such a currency is one which is inherent not in the system itself but in the nature of the standard. Gold—and the same holds for any other metallic substitute—is itself a commodity subject to influences prevailing in the countries in which it is produced, and therefore liable to import an element of caprice into the economy of other countries which accept it as a standard of value.

Moreover, any self-regulating currency by its very nature must be ruthless in its operation. The processes of cure follow automatically upon the manifestation of disease and may be more drastic than the body politic can bear.

For better or worse, however, we in this country stand committed to a system of managed currency: it becomes of extreme importance, therefore, on the assumption that we shall preserve the essential elements of democracy, that knowledge of how the system works in detail should be spread as widely as possible. The great merit of this work—apart from a number of debatable arguments and conclusions upon which readers will be in a position to form their own judgment if the book fulfils its clear educational purpose—is that it does provide a most painstaking and detailed analysis of our economic system in all its practical aspects. I have no hesitation in saying that it well merits study by all who wish to prove themselves worthy of the responsibilities of citizenship. I venture, however, to think that it can be studied with greatest profit by those who have already grasped the broad features of our economic system. These can be quite simply stated and that is my purpose in this foreword.

Unemployment is unquestionably the chief malaise to which our economy is subject, and is one which is always liable to degenerate into a debilitating and even mortal

disease. By means of an analysis such as the book provides we can elucidate the working of our economic system, and should be able to determine how far unemployment can be cured without abandoning any of the essential principles of democracy.

It is necessary to distinguish clearly at the outset various kinds of unemployment.

There is what is called frictional unemployment, which represents nothing more than the cumulative effect of innumerable small delays in passing from job to job.

Then there is structural unemployment—to use another technical term—which is the outcome of permanent changes in the national economy arising from one or other of a variety of causes. The exhaustion of mineral reserves, the loss of important overseas markets, changes in public taste at home, the supersession of established processes by new scientific discoveries, are among the main sources of such unemployment, characteristic of what were known as “depressed areas” during the inter-war period and are now more optimistically termed “development areas”.

These forms of unemployment are due to specific and often purely local causes and call for remedies by way of improved organisation. Inasmuch as they do not result from general economic factors, they should not concern us here.

What we have to examine is nothing more nor less than the phenomenon known to Victorian economists as the trade cycle—the alternation of phases of boom and slump, of high and low prices, of brisk trade with good employment and slack trade with much unemployment.

This cyclic phenomenon, of which recurring periods of unemployment are a well marked feature, is in truth a normal characteristic of an inherently stable economic

system. The ebb and flow is the result of a natural and spontaneous effort at readjustment.

How does that inherent stability arise ? It arises because as individual members of the community we are all engaged in the economic process of buying and selling whatever it may be—goods, services or purchasing power. The interaction of our individual efforts settles prices, wages, and money rates. If buying and selling pressure produced a perfect balance then, apart from outside interference, conditions would be static. In human affairs, however, such perfect balance can never be achieved. At one moment the selling pressure, at another the buying pressure, will gain the mastery, but only for a time because the price mechanism, whether in relation to commodity values, wage rates or interest rates, will come into play and tend to restore the balance. Keen demand, putting up prices, stimulates supply and sets a reverse tendency into operation under which demand yields until falling prices again provide the necessary stimulus under which the cycle repeats itself.

This rhythmic process in our economic life should not be regarded as unhealthy. On the contrary it is essentially salutary. It reflects, as already stated, an inherent stability. In effect it represents in one particular aspect the working of the most universal of all natural laws—the law which in physical science is known as Newton's third law of motion: "to every action there is an equal and opposite reaction." It is this law that keeps a ship on an even keel and holds humanity back from the abyss.

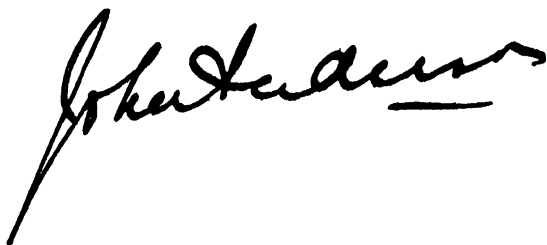
Having grasped this fundamental principle we shall, I think, be much better able to profit by a detailed study of economic phenomena and to appreciate the limits within which it may be practicable by appropriate and well-considered measures to moderate the violence of the upward

and downward swing without sacrificing the advantage of the inherent stability of what physicists call harmonic motion.

The characteristic curve illustrating such motion is of the type shown on p. 100 of the text. It can undoubtedly be modified by outside agencies—by the force of custom or tradition, by the conscious influence of trade organisations, or by action of those in authority. It is not dependent upon the nature of the accepted medium of exchange or standard of values, but because its most conspicuous feature is an alternating rise and fall in money values it has sometimes been regarded as essentially a monetary phenomenon. This is in fact true only in so far as the contraction of credit which normally accompanies an incipient slump tends to accentuate the mischief until other factors overcome the tendency.

If this general picture is accepted it needs no effort of imagination to see that any attempt to maintain a continuous high level of employment must be directed to two objects—first to identifying in good time the movements that are taking place and then to counteracting them by positive measures in such a way as to reduce to the smallest dimensions the amplitude of the oscillations while, of course, encouraging any general long-term upward trend. As the book shows, there is a whole range of measures which may be taken for this purpose. They need not be recapitulated here. Their efficacy can be judged in the light of experience. They can be applied without risk so long as the standard by which values are measured remains under control. That standard need not be static. It may be adjusted from time to time, but let it get out of control and the capacity for self-adjustment inherent, as I have tried to show, in a stable economy is at once lost. This is the true significance of run-away inflation.

One question which the book leaves unanswered is whether even in theory it is practicable to iron out the curve of trade fluctuations completely. Undoubtedly the range of periodic movement can be narrowed very greatly but the mechanical analogy I have drawn, in the validity of which I have great faith, strongly suggests that the inherent stability of rhythmic movement, within limits however narrow, is something which is worth preserving.

A handwritten signature in black ink, likely belonging to John Maynard Keynes, written in a cursive style. The signature is positioned below the main text of the foreword.

SEPTEMBER 1947.

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PREFACE

THIS BOOK does not claim to introduce any new or startling discoveries; it is an attempt to set out in straightforward terms conclusions and methods of thought which are now accepted by a very large number of economists. It is written in the hope that it may be helpful to a few of the many citizens who have had no intensive training in economics, but who find some knowledge of the subject essential to an understanding of politics. The central chapters of the book are based very largely on the work of Lord Keynes to whom I, in common with all other workers in this field, owe an immeasurable debt.

I should like to thank Mr. Lewis C. Ord for permission to quote from his book *Secrets of Industry*, Mr. Hugh Molson, M.P., the editor of this series, for a great deal of help and encouragement, and Messrs. Leslie H. Robinson and Innes Smith for reading my manuscript and for very many helpful suggestions.

E. VICTOR MORGAN.

THE CONQUEST OF UNEMPLOYMENT

CHAPTER ONE

INTRODUCTION

THIS BOOK, like all the work of economists, is concerned with the production of wealth and with the use of wealth to promote human happiness. One thing about wealth which can be said without fear of contradiction is that we have not enough of it. Nearly all the materials which nature provides are of very little use in their original form; in order to convert coal into warmth, iron ore into pots and pans, seed corn into bread, and so on, it is necessary to work; the amount of work we can do is limited, and so we can produce only a limited amount of wealth. Hence the need to do all we can to increase productive efficiency on the one hand and, on the other, to see that whatever wealth is produced pays the greatest possible dividend in human welfare. These two aims were summed up by Jeremy Bentham in one of the best slogans of all time, "The greatest happiness of the greatest number".

The past two hundred and fifty years have brought more progress in this direction than any similar period in history. In 1696 Gregory King made one of the first thorough statistical enquiries into the economic life of England and Wales. The population was less than one seventh of its present size; the death rate was more than twice as high as it is now; the average life of man was only twenty-seven and

a half years, and of each thousand babies born 160 died before they were a year old. Brick-built houses were a luxury and the poor lived in huts of wood, clay and thatch; streets were unlit, undrained and often unpaved, and refuse was thrown from the window and left rotting in the roadway. The average labourer earned about £15 a year (perhaps equal to £40 in modern money); he ate bread of rye and barley with meat (salt in winter) once a week, if he was lucky; he wore clothes of rough homespun wool, worked from dawn till dusk and travelled no farther than he could walk. These ill-housed ill-clothed and ill-fed ancestors of ours were an easy prey to disease; and plague, cholera, smallpox and scurvy killed them off by the thousand. These are the hard facts about "Merrie England", though sentimental historians sometimes paint a different picture.

For many centuries before Gregory King's time the rate of economic progress had been very slow; indeed the standard of life of the masses was very little better at the end of the seventeenth century than at the end of the thirteenth. Throughout this long period work and trade had been closely regulated by the guilds, the towns and the state, but about the beginning of the eighteenth century the old restrictions fell into disuse and, at the same time, there began that great burst of creative activity which has brought the wealth we enjoy today. First there were improvements in agriculture which brought wheaten bread and fresh meat all the year round for all; then the growth of factory production, bringing cheap textiles and household goods, as well as comforts hitherto undreamed of, within the reach of the average wage-earner. These great benefits were the result not only of new inventions and the discovery of new techniques, but of the new economic freedom, which enabled men to spend their money and the money they could borrow in developing

the industries where capital was most needed and could be most profitably employed. During the nineteenth century the advance was amazingly rapid, and in 1913 income per occupied person in Britain was more than two and a half times what it had been (allowing for the difference in prices) in 1837.¹ The great losses of the first world war had been made good by 1924, and the efficiency of production was still increasing. The growth of real wages since 1914 can be seen in Diagram 1. By 1938 the industrial worker worked at least six hours a week less than in 1913, but his wages would buy 17 per cent more.

These benefits were not achieved without cost. Improvements in the technique of production were by no means fully matched by improvements in distribution; our wealth therefore paid less dividend in happiness than it might have done and, worse still, we suffered from increasing unemployment and violent swings between prosperity and depression. Unemployment and the fear of unemployment has afflicted at least half the working population, and the insecurity which it brings has largely offset for them the higher standard of living that they enjoy when in work.

Moreover, in spite of all this progress, the world is still a very poor place. Britain is one of the richest countries in the world, yet when Mr. Seebohm Rowntree carried out a survey of York, a typical British town, in 1936, he found that more than one person in six fell below a none too generous poverty line.² So great is the disparity in wealth between different countries that even the families below Mr. Rowntree's poverty line were living in comfort compared to many Eastern Europeans and in luxury compared to the average Indian or Chinese peasant. That this poverty is

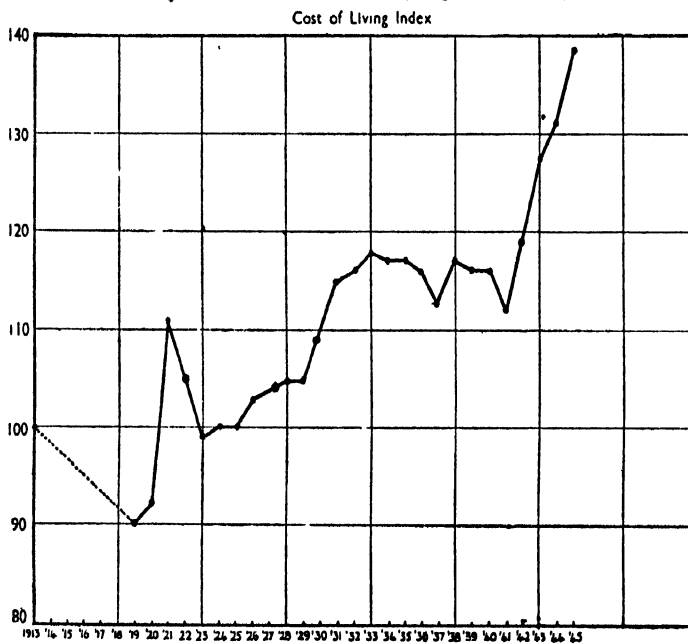
¹ Colin Clark, *National Income and Outlay*, Macmillan, 1938, p. 233.

² B. Seebohm Rowntree, *Poverty and Progress*, Longmans Green & Co., 1941.

Diagram 1

THE COURSE OF REAL WAGES 1913-1945

(London and Cambridge Economic Service Index of Weekly Wage Rates divided by Ministry of Labour)



due to a real lack of goods and not merely to the maldistribution of wealth can be seen from the fact that, even in Britain the production of wealth in 1938, if distributed with absolute equality among the whole population, would have provided barely £2 per head per week.

There are some who speak and write as if scientific discovery and particularly the release of atomic energy were about to make a summary end of scarcity, and usher in an age of boundless plenty. Such statements are often coupled with the suggestion that "reactionary elements" are keeping the benefits of science from hungry humanity, and that all that is necessary to solve the world's economic problems is to get rid of those features of society of which the speaker disapproves. This is perverse nonsense. Atomic energy may eventually yield great new sources of power, but power is of no use unless harnessed and applied. The chief cause of scarcity in the modern world is not lack of power but lack of the means of applying it. Nearly half the work done in modern Britain is in the upkeep of private homes and gardens, the preparation of food and the care and education of children; a further large part is in distributive and administrative services, none of which is easily mechanised. Less than a third of the working age population is engaged in manufacturing industry, and this branch of production is already highly mechanised. We shall no doubt see many new advances in the application of power, but they will depend on much new invention and a further great accumulation of capital, and can only come gradually. If we use our resources fully and wisely, we in Britain have the means of abolishing extreme poverty, but we are a long way from abundance, and vast areas of the world are living far below present British standards.

So long as goods continue scarce the improvement of

productive efficiency must be one of our foremost aims, and our economic system must be judged largely by its success in stimulating such improvement. The system of free enterprise has, as we have seen, such a good record in increasing production that there would be little case for making any drastic change if it were not for the disastrous failure to provide stable employment. It is the memory of the suffering and the loss of output that have resulted from unemployment, and the fear of their recurrence that influence men to sweep away the system of free enterprise and replace it by socialist planning.

But one does not dismiss a general with a long series of victories to his credit and put an inexperienced young officer in his place merely because the general has lost one important battle. Neither should one lightly scrap a proved economic system and put a new and untried one in its place merely because the old system has failed at one important point. Such action should be taken, if at all, only after careful consideration of the reasons for the failure and the possibility of avoiding it in the future. We therefore turn, in the next chapter, to see how the system of free enterprise works, and what are the reasons for the successes it has won in the past. The main part of the book will then be an analysis of the reasons for the failure to provide full employment. This is a field in which economists, inspired by the great work of Lord Keynes, have been very busy during the last ten years, and we shall try to present the most up-to-date results of that work. Having discussed the merits and shortcomings of free enterprise, we shall consider the socialist alternatives and finally, in the last two chapters, suggest a policy by which we may hope to enjoy the advantages of free enterprise without suffering from unstable employment in the future.

CHAPTER TWO

THE GREATEST HAPPINESS OF THE GREATEST NUMBER

IF WE ARE to get the greatest possible welfare from limited resources, our economic system must fulfil, as far as possible, five conditions:

Full employment of available labour.

Freedom of the worker to choose his employment.

Efficient production.

Fair distribution.

Making what the buyer wants.

These conditions are equally important for any type of economic system. In a later chapter we shall ask how far they are likely to be fulfilled by socialism; in the present one we shall put the system of free enterprise to the test.

By free enterprise we do not of course mean the exclusion of the government from all part in economic life. The only essential conditions of the system are that both the products of industry and the factors of production should be freely bought and sold; that those who control industry should make the type and the quantity of goods that will be most profitable at the ruling market prices; and that they should make these goods in the cheapest way open to them. The reasons for these conditions will become obvious as the argument proceeds. We should normally expect to find most production organised by private persons or privately owned companies, but there is plenty of room for public ownership in suitable cases. There would also be a wide field for government assistance to and regulation of industry in the

interests of the community, and some examples of this are given in a later chapter. Our conditions, however, rule out the arbitrary fixing by the government of the prices and output of each commodity, for this prevents the free operation of the market, through which the consumer expresses his own preferences.

Full employment of available labour. Labour applied either directly or indirectly to the gifts of nature is the source of all wealth. Hence the community has a right to the work of its citizens, and the citizen has a right to work, a right to the feeling of "pulling his weight" which his work gives him, and to the income which is its fair reward. Mass unemployment causes a serious loss of wealth to the community, but, even worse, it deprives the unemployed man of his income, and makes him feel that he has no part in the national life. For both these reasons a sound economic system must make the fullest possible use of its available labour.

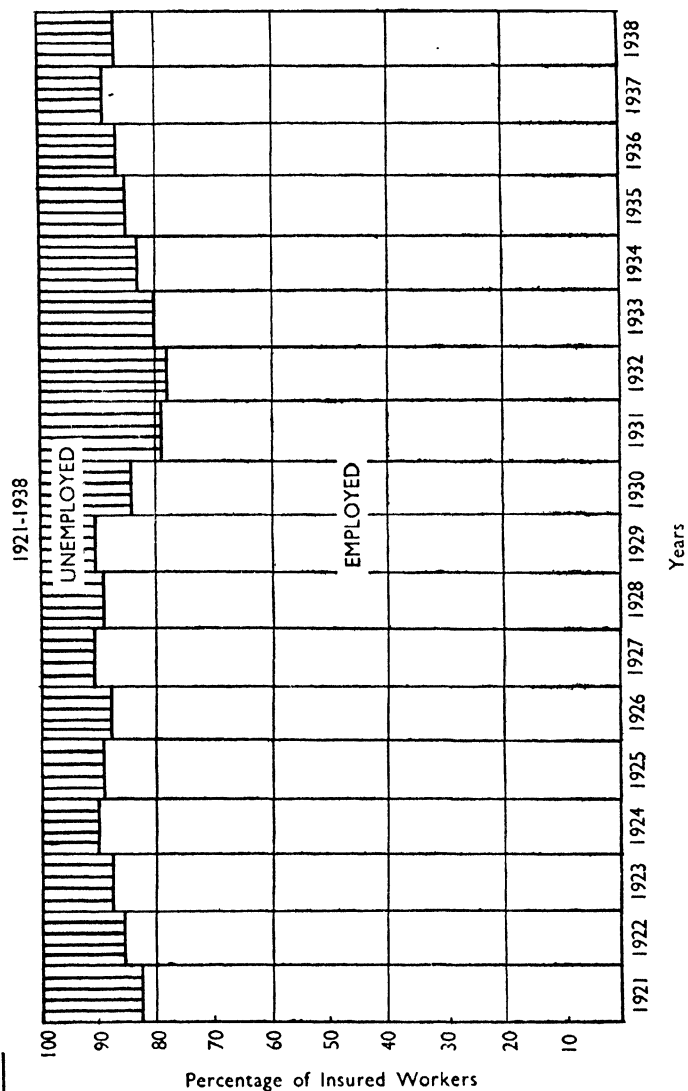
We can hardly expect every man and woman to be occupied every day on which they are able and willing to work. To achieve this we should need a quite intolerable degree of restriction. No man would be able to leave his job unless he had another to go to next day; no firm would be able to dismiss a man unless another firm was willing to take him on next day, and no firm could take on more men until it found another firm willing to release them. In fact men insist on their freedom to change their jobs; firms, especially those producing for export, find at times that their sales are falling off and they have to turn away men; others find their sales expanding and need more workers. To make these changes possible we must have a small "stock" of both unemployed labour and unfilled jobs, just as we have a stock of shirts in the shops, so that we can each choose one

the right size or, to use Lord Beveridge's analogy, a stock of empty houses in order that people may move from one place to another. Then again, some industries need to employ more labour at one season than at another and, though we may do a good deal to find alternative occupation for these workers, we can hardly hope to provide completely continuous employment. Lord Beveridge estimates that 3 per cent of unemployment would provide a big enough "stock" to allow for all these changes.¹ The essential point is that the "stock" of idle workers should be balanced by that of unfilled jobs; so long as this is so the number of unemployed will be small in relation to the total number of workers (which is the important thing from the point of view of the community); and no one person will be likely to remain unemployed for long (which is the important thing from the point of view of the individual). We shall, therefore, use the term "full employment" to describe the situation in which there are as many unfilled jobs as idle men.

We need only our own memories to tell how badly free enterprise met the full employment test during the inter-war period. The statistical evidence is shown in Diagram 2. In only one year did the proportion of insured persons unemployed fall below 10 per cent; in two years it was above 20 per cent, and for the whole period the average was over 14 per cent. Taking the practical "full employment" level at 97 per cent employed and 3 per cent unemployed, we were wasting on an average over 11 per cent of our available labour; the community was losing goods to an average value of £400 or £500 million a year and several million people were forced to undergo, at one time or another, the hardships and indignities of prolonged idleness. Test number

¹ Beveridge, *Full Employment in a Free Society*, Allen & Unwin, 1944.

Diagram 2. PERCENTAGE OF INSURED WORKERS EMPLOYED AND UNEMPLOYED IN GREAT BRITAIN.



one provides a very black mark for free enterprise; with our memories of the 1930's we are not likely to overlook it, but neither must we overrate its significance, for our other tests are very important, too.

Freedom of the worker to choose his employment. A system that sets out to gain the greatest happiness of the greatest number must allow freedom of choice between one job and another, for two good reasons. A man compelled to do a job against his will loses immeasurably in happiness and human dignity. Also he will most probably do the job badly, so that both he and society will be the losers. But that does not mean that a man should make his choice wholly uninfluenced by the views of society. There should be means of encouraging people to take up the most needed jobs and discouraging them from taking up the least needed ones. This, of course, is just what happens under free enterprise, and it is an example of the working of the market. If people in general want more motor-cars and less cotton goods, the wages of motor mechanics will go up and those of weavers down, and so people will be encouraged to go into the one occupation and warned off the other. Thus the labour force of one industry will grow while that of the other shrinks, but no one will have suffered any compulsion to become a motor mechanic against his will.

There are two big disadvantages to this way of doing things, but both can be overcome. A man who has trained for a skilled job finds it hard to switch to something quite different. Hence if an industry suffers a sudden depression, such as that which hit the British coal industry through fuel economy and the loss of export markets, the labour which has become redundant may cling to the industry for a long time, thus causing a long period of unduly low wages. The solution to this difficulty lies in providing plenty of

alternative jobs and training facilities so that the worker can fit himself for them.

Another more serious restriction upon freedom has been the fact that many jobs require a more or less expensive training and so have been open only to those with money behind them. This, however, can be and is being overcome by the extension of free education.

Provided that steps are taken to remedy these two defects the labour market under a system of free enterprise is a highly efficient way of distributing labour in bulk where it is most needed without interfering with the choice of any individual worker.

Efficient production. A large number of things go to the making of an efficient plant. Labour must have every incentive to do a fair day's work for a fair day's wage. Employees of all grades must work as a team and must be encouraged to contribute to efficiency, not only by doing their own job with a will, but by making suggestions for the improvement of the process. Work must be organised so that each worker finds his materials ready to hand without fetching or waiting. This is particularly important in modern mass production plant where the smooth flow of production makes a world of difference to efficiency. If the flow is too fast at one point, half-finished goods will pile up, wasting space and adding to overheads; if it is too slow, workers farther down the line will be held up and forced to waste precious time. And all this must be done with the minimum of administrative staff, for administrators are expensive. There are very great differences between firms in the ratio of supervisory and administrative staff to operative workers. A famous efficiency expert, Mr. Lewis C. Ord, quotes the case of a motor factory employing 130 supervisors and administrators per 100 operatives and which

by thorough reorganisation reduced this ratio to 10 per 100 and turned out a better product.¹

This brings us to another essential element in efficiency: the firm must employ all its different factors of production in the right proportions. We call factors of production all the different kinds of labour and materials, buildings, equipment and machinery and everything else which contributes in any way to the finished product. There are usually several different ways of getting the same result in industry. One can employ rather more workers and rather less foremen; more conveyer belts and less men with wheelbarrows; newer machinery and less fitters; more electricity and less coal; more of this material and less of that in endless variety. The well-managed firm will adjust its process very carefully so as to turn out its product in the most profitable manner, and its choice will be governed by the relative prices of the things it uses in the market. If the wages of labourers go up in relation to the price of conveyers, it may pay to put in a new conveyer and cut down on the wheelbarrows; if the price of coal goes up it may pay to install fuel-saving plant; if the price of pig iron goes up in relation to that of scrap, more scrap and less pig will be used, and so on. But these price changes are no arbitrary things; on the contrary, the market is a very sensitive instrument for measuring the value to society as a whole of each of the goods in question. For in the market the available supply is weighed against the demand, not only of one particular firm but of all firms in all sorts of industries. Suppose, for example, that a new process enables coal to be converted economically into petrol; the demand for coal will rise, the price of coal will go up; firms in all sorts of industries will find that it pays to install fuel-saving appliances; and so coal will be

¹ Lewis C. Ord, *Secrets of Industry*, Allen & Unwin, 1944, pp. 102-3.

set free for the new use. Thus, through the operation of the market in factors of production, the available supply of each finds its way into those uses in which it will best satisfy our general needs. The individual firm benefits by getting its output on the cheapest terms, but that is incidental; the real gain in efficiency is a gain to society in having its scarce supplies of goods each used in the most productive way.

The general manager of an efficient firm must be an organiser, but he must also be a leader of men. Good leadership has been proved over and over again to make a tremendous difference to the spirit of a factory, to the happiness and output of the workers. Mr. Ord estimates that really good leadership can raise output 10 per cent or more above normal, while bad leadership may cause it to go down 10 per cent or more below normal. We can probably look to improved leadership almost as much as improvements in machinery for increased industrial output.

The degree of efficiency which we attain in production can make at least as much difference to economic welfare as the extent to which we keep our labour fully employed. Unfortunately there is no simple statistical test of efficiency, but the system of free enterprise has two very powerful instruments for promoting it. The working of the market in factors of production already described gives each firm a financial incentive to produce in the way required by society, while competition is always bringing the more efficient to the fore and compelling the less efficient to mend their ways on pain of bankruptcy. Bankruptcy is often criticised by socialists as an example of competitive waste, but it is not nearly so wasteful to write off an inefficient undertaking once and for all as to allow it to continue wasting good labour and materials year after year.

Unfortunately the spur of competition may be blunted

by the action of trade associations and monopolies, and the laggard firm protected from its prick by government restriction schemes and protective tariffs. This has happened far too often in modern Britain, and there is no doubt that the efficiency of industry has suffered as a result. To quote Mr. Ord: "The experts gave it as their opinion that the differences in efficiency and structure of British and American industry is the result of the difference in the policy followed by the two countries. American efficiency they believe to be due almost entirely to the sharp competition enforced by law and the sharp supervision by the American government. Cartels, trade associations, price rings, suppression of competition, fixing of prices, allocation of work and territory, high profits and a pleasant live-and-let-live attitude, these things which British industry itself has introduced are, in the opinion of these experts, the real, the tangible handicaps of British industry compared with its only American counterpart."¹ This is a most depressing state of affairs, but it is a condemnation not so much of free enterprise as of our recent departures from it.

Fair Distribution. As soon as these two words are written we ask: "What is to be the standard of fairness?" And we come up against the two opposing principles of reward according to need and reward according to deserts.

If the annual production of wealth were fixed and unalterable, whether we slaved or lazed, whether we were clever or stupid, efficient or muddling, we should have to consider only how to get the most happiness from a fixed amount of goods, and reward according to need would be the correct principle. No man can assess another's needs exactly, but there is a strong presumption that the more wealth we have the less satisfaction we get from a little bit more, and the

¹ Op. cit., p. 91.

less satisfaction we lose if we have to put up with a little bit less. Hence a perfectly equal distribution of wealth would be the most likely way of producing the greatest welfare.

But our output of wealth is not fixed; it depends enormously on our own industry and efficiency. If income were equally divided there would be no incentive to anyone to work in the occupation where he was most needed; no stimulus to energy or discouragement of idleness, no reward for successful enterprise, no inducement to take a chance, and no encouragement to invention. There can be no reasonable doubt that such a society would produce very little wealth indeed. This belief is strikingly confirmed by the experience of Russia. The Revolution started on equalitarian principles, but its leaders soon found that complete equality gave no incentive to work, and they swung abruptly to the principle of reward according to desert. Now piece-work is almost universal in Russia; there are bonuses for fast work, premiums for inventions, and, of course, high salaries for successful executives.

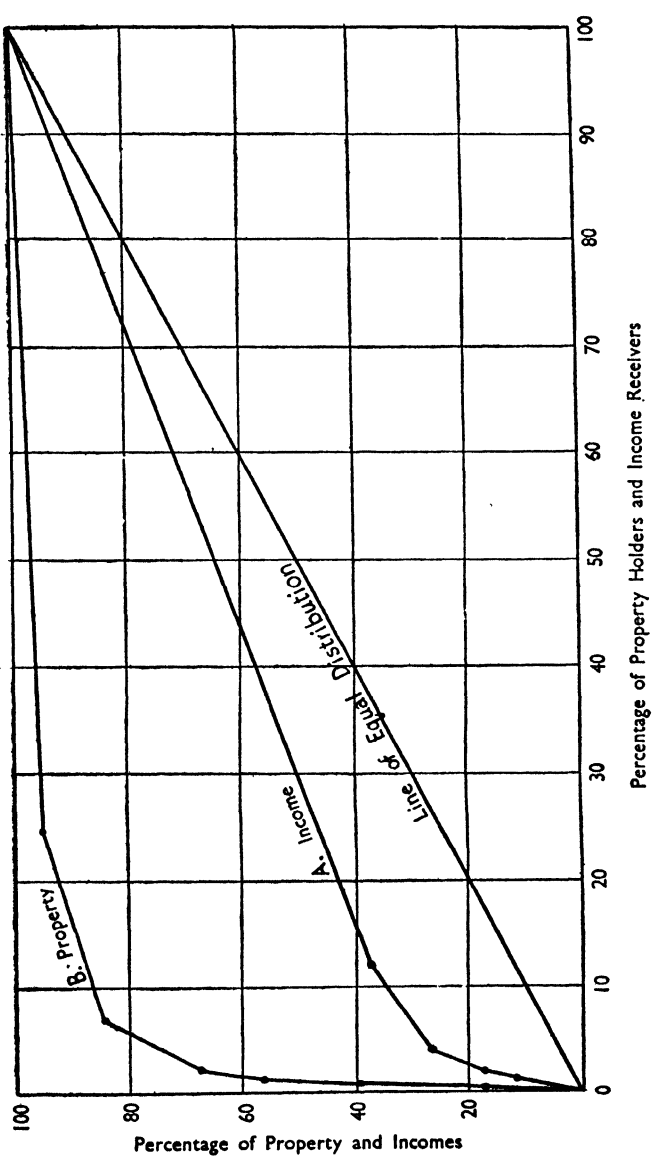
This then is the social justification for inequality: that it does more good by increasing production than it does harm by less economical distribution. Even the person who has an income below the average will probably be better off than he would if everyone were brought to common level; it is better to have a small share of a large cake than a slightly bigger share of a much smaller one.

This argument, of course, applies only to inequalities that increase the size of the cake either by encouraging hard work and efficiency or by helping to direct that work into the most useful channels. Much of the inequality of earnings under free enterprise can be justified in this way, though in fact it has been made greater than is necessary by the restriction of opportunity.

Diagram 3.

DISTRIBUTION OF INCOME AND PROPERTY

(for explanation see overleaf)



This justification is not nearly so valid for inequalities which arise from the unequal distribution of property. It has been estimated that roughly 70 per cent of incomes over £10,000 a year and over half of incomes over £2,000 a year is derived from property.¹ Property is much more unequally divided than income as can be seen in Diagram 3. There, the available information is calculated in percentages and plotted on a graph. The diagonal line shows equal distribution, and the way in which the curves of income and property run away into the top left-hand corner is a rough indication of the degree of inequality. It will be observed that this tendency is much stronger in the property line than in the income line. One of the chief causes of this greater inequality in the distribution of property is inheritance, and so inheritance, through its effect on the distribution of property, is a powerful cause of inequality in incomes. This form of inequality has very little economic justification and could be greatly reduced without weakening the incentives to efficiency.

Making what the buyer wants. There is an old saying: "One man's meat is another man's poison." No two of us have the same tastes, and if we are to get anything like the best out of our income we must be able to choose freely how we spend it. But this does not mean that each of us must choose regardless of the interests of society. We must have some means by which the buyer can be told the facts about the choice before society as a whole, and then given his own say in how that choice shall be made. This is done under free enterprise by another very sensitive bit of mechanism, the consumers' goods market. When our resources are fully employed as they should be we can only

¹ H. Campion, *Public and Private Property in Great Britain*, Oxford University Press, 1939, pp. 117-18.

make more of one thing if we go without something else. This fact is expressed in the relative prices of different goods; in the jargon of economists the price of each article should, and usually does, represent marginal cost to society. If for every five bananas fewer we can have a pint of beer the more, the price of a pint of beer will normally equal that of five bananas. Each of us can then buy either bananas or beer in the ratio of five to one pint in whatever quantity pleases us. If there is not enough beer to satisfy everyone the price will tend to rise, and the brewers will brew more. They will need more barley, more hops, more barrels and bottles and more workers, all factors of production the distribution of which is regulated by the factor market. The price of these things will tend to rise, firms in other industries will try to economise in their use while suppliers try to add to the amount available, and so the quantities needed by the brewers will come from where they can best be spared. As the output of one thing is increased relatively to others, the real cost of producing it usually rises, so we may expect the price of beer to settle down at a point rather higher than before, say six bananas to the pint; as a result some drinkers will consume less than they would otherwise have done, and this will help to equate demand to supply. Thus the working of the consumer goods market does two things: it regulates the total output of each kind of goods according to the preferences of consumers as a whole and it allows each single consumer to buy as much or as little of each kind of goods as he chooses according to his tastes and means.

The consumer goods market is easily the most effective device known for getting industry to make what the buyer wants, but even it is not perfect. Prices do not always reflect accurately the choice before society, especially if one

article is produced by a monopoly, and this is one of the strongest reasons for discouraging monopolies.

We have now completed our five tests, so let us sum up the results. To make our scarce resources yield the greatest happiness of the greatest number we must put all the energy and efficiency possible into production, and we must also make correctly a very complicated series of choices. Free enterprise relies for this on the working of the market. The market provides rewards and penalties, encouraging hard work and efficiency, uprooting idleness and muddle. The market in consumer goods distributes the supply of each to those who want it most and gives the buyer his say as to how much of each shall be turned out. The market in factors of production distributes the supply of each to uses in which it will do most to satisfy the demands of the buyer, and, while leaving workers their freedom of choice, gives them an incentive to go into occupations where their product will be most valued by society. The market system has done all these jobs exceedingly well and this is the great merit of free enterprise, the reason why it has added so much to human welfare.

On the debit side of the balance sheet the working of the market is sometimes obstructed by monopoly; inherited property creates arbitrary inequalities of income, and the inequality of opportunity limits the free choice of the worker. These are serious defects, but each has its remedy, which will be discussed in a later chapter. But for the present we shall concentrate on the outstanding defect, the failure of free enterprise to make full use of its resources.

CHAPTER THREE

MATERIAL INCOME

SO FAR, when we have spoken of wealth, we have not distinguished between capital and income. A man may be rich because he has a lot of property or because he receives a large income. The two things are, of course, connected, because the ownership of property is itself a source of income, but it is important to keep them separate. In the same way, when talking of a nation, we must distinguish between its accumulated stock of wealth and its current output. A little of this stock of wealth will be in the hands of consumers—food in the larder, clothes in the wardrobe and so on—but by far the greater part will be held either by public bodies or private firms for use in future production and trade. There will be land and buildings; roads, railways, canals, docks and shipping, mines, factories, and industrial plant; raw materials and goods in course of manufacture; finished products in the warehouses of the merchants and on the shelves of the retailer. These goods are described as “capital”, and the process of adding to them as “investment”. These words “investment” and “capital” are used by economists in a rather special sense. In common speech we should say that both the factory a man owned and the shares he held were part of his capital, and we should speak of investing both in a machine and in war loan. This is confusing and so, in this book, we shall use the words “capital” and “capital goods” to mean goods to be used in future production and “investment” for the act of adding to such goods. The purchase of stocks

and shares merely transfers titles to existing capital goods without in any way affecting the quantity of them in existence.

We may liken this stock of capital to a reservoir, into which flows a stream of goods from current production and out of which goods are constantly being drawn for current consumption. The stream of current production we call gross national income. In producing this income, however, stocks of materials are used up, and buildings, plant, etc., are subjected to wear and tear. In order to maintain our stock of capital we must set aside a depreciation allowance to cover these things; what is left of gross national income after providing for depreciation is known as net national income. Net national income thus measures the volume of goods available out of current production either for consumption or for adding to capital.

The technique of measuring the volume of current production has made great progress in recent years. The government now employs a team of economists at the Central Statistical Office, and they present us each year with a White Paper entitled *National Income and Expenditure of the United Kingdom*.¹ This is one of the most important of government publications, but unfortunately the facts it contains are put in a manner very difficult for anyone but a trained statistician to follow.

We have, therefore, picked out a few of the salient facts and displayed them in Diagram 4, pp. 27-8. The figures refer to 1938, and any reader who cares to take the trouble can make a similar diagram from the most up-to-date figures at the time of reading and compare the two.

First we add up the value of all the economic activities

¹ The latest issue at the time of writing is Cmd. 6784, covering the years 1938-45.

performed by the people of Great Britain during the year—of all the goods which have been made and the services which have been performed in return for money. The only way in which we can add up pine-apples, pianos and Punch-and-Judy shows and all the thousands of diverse things we make and do for one another is in their one common denominator, the money that is paid for them.

So national income has to be measured in money, and only those things which are bought and sold can be counted—this is unfortunate as it means we cannot count such important things as the work done by a housewife in her own home, but it simply cannot be helped. The only exception to this rule is that we count the estimated rent of owner-occupied houses. This is possible because the owner is assessed on his house for income tax, and so we have a fairly accurate measure of its value.

When we buy an article or pay for a service the cost is distributed as income among the various people who have had a hand in producing it. To find net national income, we add up all the incomes received by residents in the country,¹ and exclude those which are not received in return for any economic activity, e.g. old age pensions and interest on war loan. This gives us the value of all the goods and services turned out, as measured by the incomes received by those who produce them, and the result is usually called net national income *at factor cost*, i.e. at the cost which is distributed in wages, salaries, rent, interest and profits among the various “factors” of production. It is shown in the first line of our chart, and it will be noticed that this sum accrues almost wholly to private persons and privately owned

¹ This gives net national income, not gross national income, because the figures are based on income-tax returns and depreciation allowances are set aside before calculating income for tax purposes. If we wanted to find gross income, we should have to add depreciation allowances.

companies, and only in very small part to public authorities. It should hardly be necessary at this stage to issue a warning against confusing national income with government income, yet this confusion happens surprisingly often.

Net national income at factor cost is a measure of the flow of riches out of which we have to meet all the needs of the community for private spending, for public spending and for adding to capital. As such, it is the best measure we have of the economic well-being of the country. If net national income at factor cost goes up from one year to another, there is a *prima facie* case that we are becoming better off, either because we are working harder or more efficiently or because we are making fuller use of our available labour. We must not, however, be too eager to jump to this conclusion. If we are comparing two years some little distance apart, we must make allowance for changes in the size of population, and even when we compare two years close together we must be on our guard against changes in the value of money, which is the yard-stick by which we measure income. Thus between 1938 and 1945 net material income at factor cost rose from £4,610 millions to £8,483 millions, but a large part of this increase was illusory, for prices, excluding taxes, had risen by nearly 50 per cent.¹ It was not only that income itself had grown, but that the tape-measure had shrunk. We must allow for both these things before we can decide definitely that we are better off as a result of an increase in net national income.

Let us now consider how national income is shared out among various public and private uses—always remembering that, though we talk of money, what we really have in

¹ The only part of national income for which we have an accurate measure of price is personal consumption. Here the rise was 47 per cent excluding indirect taxes and subsidies. Cmd. 6784.

mind is money's worth, the real things that the money will purchase.

For this purpose, it is convenient to measure the value of our annual output of goods not at factor cost but at market value. The difference between the two lies in certain operations of the government. When we buy a packet of cigarettes we pay something to the shopkeeper, the manufacturer, the tobacco grower and so on, but on top of this we pay a heavy tax to the government; the government has played no direct part in the production of the cigarettes, and so the tax is not, of course, included in the value of the packet at factor cost. When we buy a loaf of bread the process is reversed; the government gives a subsidy so that the baker, the miller, the farmer and the other "factors" which produce bread get more than we actually pay. Indirect taxes, i.e. taxes on goods, raise market value above factor cost, while subsidies reduce market value below factor cost. Hence, in line one of the diagram, we add indirect taxes and take away subsidies in order to arrive at net national income at market value.

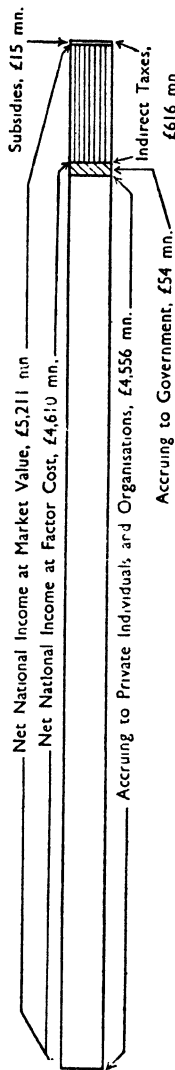
Line two of the diagram shows the income of the government, including the local authorities. A small amount comes directly from economic activities performed by public bodies. A large amount is derived from indirect taxes, and a further large amount from direct taxes, i.e. taxes on persons as distinct from taxes on goods. If these sources of income do not suffice, the rest has to be raised by borrowing. In one or other of these ways, the power to purchase roughly a quarter of the net national output was taken, in 1938, from those who originally received it and transferred to the government.

Line three shows the government making use of its income. Nearly two thirds was spent by public authorities,

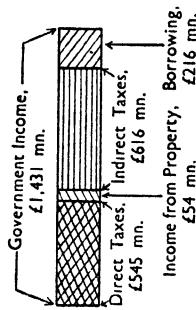
Diagram 4

NATIONAL INCOME AND EXPENDITURE OF THE UNITED KINGDOM, 1938.

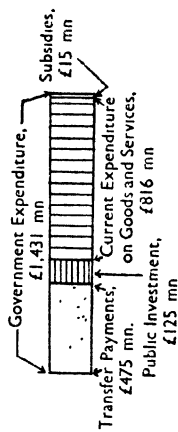
1. NET NATIONAL INCOME



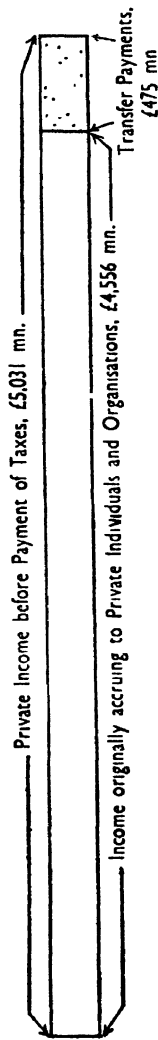
2. GOVERNMENT INCOME



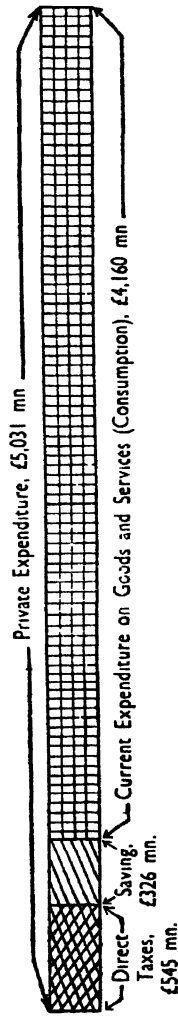
3. GOVERNMENT EXPENDITURE



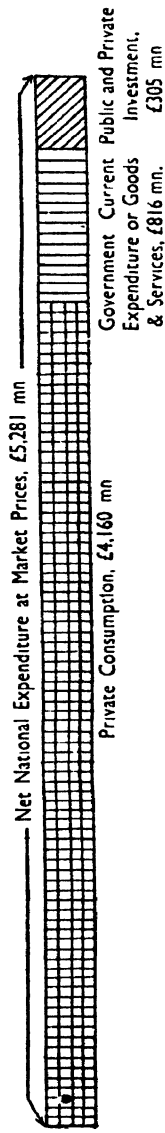
4. PRIVATE INCOME



5. PRIVATE EXPENDITURE



6. NET NATIONAL EXPENDITURE AT MARKET PRICES



central and local, on goods and services—the armed forces, the police, the civil service, education, roads and so on. This we may call social spending as distinct from private spending. The remainder, amounting to rather more than one third, was not really spent by the government at all, but was handed back to private persons in the form of interest on war loan, pensions, unemployment and health insurance payments, unemployment assistance and public assistance. These are known as transfer payments; the income derived from them is not earned by any contribution to current production, but is transferred by the government from those who originally earn it to those who ultimately receive it. As we have mentioned before, these incomes are excluded when we are reckoning net national income at factor cost for the simple reason that they are not paid to factors of production.

In line four we turn to consider the effect of these government operations on the incomes of private persons. To the income originally accruing to private persons as factors of production we add transfer payments, and this gives the total of private incomes before paying taxes. Out of this direct taxes, as their name implies, are paid directly to the government; indirect taxes are, of course, paid as we spend our income on taxed goods. What is left of private income after the payment of direct taxes is, therefore, at the free disposal of those who receive it, of you and me and over twenty million others. We may spend our income in any way we please, or we may save it. By far the greater part of private income after paying taxes is spent on satisfying our immediate requirements in necessities, comforts and luxuries, that is on consumers' goods; a much smaller but economically very important part is saved.

These savings may be borrowed and spent either by the

government (the deficit shown in line two) or by private persons. A private person who wants to borrow merely in order to live above his income is not likely to find any very willing lenders, and so practically the whole of private borrowing is for the purchase of capital, i.e. stocks of goods for future sale and instruments of production.

In the last line of the diagram we look at the picture from the spending point of view, and see national income split up between private spending on consumers' goods, social spending and private investment. It will be noticed that the total spending shown here is slightly larger than the total production shown in line one. The reason for this is that our payments abroad amounted to about £70 million more than the payments due to us from foreigners. This, of course, caused a net decline of that amount in the value of British foreign investments.

All these items in the national account are of great importance to the economist, and we shall have to come back to most of them later on. One thing which we must always bear in mind is that the different figures refer not to separate things but to the same thing, or parts of it, viewed from different angles. The great central fact with which we are concerned is the stream of goods and services which we produce each year to meet all our various needs. We measure the size of that stream by the money that is paid to all those who have a hand in producing it; we note that this money is not only a measure of what we have contributed to their stream, but is also a ticket entitling us to take out of the reservoir an equivalent value in the products of others; we trace how these claims have been transferred between private persons and the government and finally we see what has been done with the tickets by their ultimate holders, what sort of goods they have taken out and in what quantities.

The streams of national income and expenditure are both constantly flowing. In order to measure the flow we have to erect dams at various points, which we call years, and examine the contents of each section as if it were fixed and stationary. Actually, of course, it is changing day by day and hour by hour; at each moment when work and trade are going on goods are being taken out and fresh ones put in. We can all choose what we take out, and what we take out determines what others will put in; the more of any one thing we take out, the more incentive will there be for someone else to replace and more than replace it. This is only another way of saying, as we said in the last chapter, that it is the buyer who decides, through the operation of the market, what shall be made. But it is not only for single articles that what we take out governs what is put in; the same relationship holds good for consumption and production as a whole. If the outflow of goods for consumption is strong, the sluice gates are opened and the stream of production flows fast; if consumption dwindles the sluice gates are closed and the flow of production is slowed down.

In conclusion, let us look at the idea of national income in relation to that of the greatest happiness of the greatest number outlined in the last chapter. Since national income is nothing else but the flow of goods which form the material foundation of happiness, we obviously want to make it as large as we reasonably can. This involves the first two of our tests from chapter two, making full use of our resources and efficient production. A large national income is essential to a high degree of human welfare, but it is not enough in itself; we must not only produce the goods but we must distribute them fairly, that is we must remove those inequalities which have not the justification of adding to output. Then, also, it is not enough merely to be producing a lot of

goods unless we are making what the consumer wants. Even after allowing for the rise in prices which had taken place, national income was considerably higher in 1945 than in 1938, yet no one could believe that we were better off in the latter year than in the former. The volume of output was greater because we were using labour that had formerly been unemployed, and most of us were working longer hours and, in some cases, more efficiently. But this great volume of production included the tanks, guns, aeroplanes, bombs and shells, the services of soldiers and sailors and airmen, and all the other sinews of war, all measured by the price which the government paid for them. These things were being produced not because they added to anyone's happiness but because we were driven to it by force of circumstances. In time of war it is necessary that consumers' preferences should be subordinated to military necessity, but the same thing can happen unnecessarily in time of peace, though on a less spectacular scale, whenever the freedom of choice of the buyer is restricted. This is our fourth test of chapter two. Lastly, to fulfil our fifth test, we must accomplish all these ends without restricting the right of the individual citizen to choose his job.

If we fail in any of these things we shall not get the best out of our national income. But the most important failure in the inter-war period was the failure to make national income big enough, through the failure to use available man-power to the full.

CHAPTER FOUR

EARNING, SPENDING AND SAVING

WE MUST now look rather more closely into this business of national earning and spending. We will leave aside transactions with foreign countries to a later chapter; for the moment we assume that our buying and selling abroad just cancel one another out. It is then easy to see that one man's earning is another man's spending and vice versa. Every act of producing and selling anything, whether it is a motor-car or the services of a window cleaner, is really two twin actions, one of earning on the part of the seller and one of spending on the part of the buyer, and it is impossible for one to take place without the other. I cannot earn anything for writing this book unless someone spends on buying it, and everyone who spends on buying it must provide me (and the bookseller, the publisher, the printer and all the others who have had a hand in the job) with earnings.

To go into this a little further let us consider what happens when I spend a portion of my income on a suit of clothes. I pay my tailor, and part of the price stays with him as his earnings; but most of what I pay is only repaying him for what he has already spent in the wages of his assistants, the rent of his premises, light and fuel, chalk and scissors, and, of course, the cloth that goes into the suit. But this is only the first of many stages. The rent of the shop, for example, partly stays with the landlord as his earnings, but part of it we can trace back to the contracting firm who put up the building, to the bricklayers, plasterers, plumbers and carpenters whom they employed, to the timber importer who

brought in the wood, to the lumberjack who felled the trees in a Canadian forest. With the cloth again, part of the price the tailor paid supplied the earnings of the merchant, but the rest we can trace back to the weavers, the spinners, the dyers, the carders, the wool merchants, the sheep farmers, to the people who built the mills and made the machines, to the man that made the drill that helped the miner cut the coal that made the dye that dyed the wool, etc. We could go on with this game until we got to the House that Jack built, making a list of literally thousands of people who either did a job of work or owned a piece of property which helped in some way or another to make me a suit of clothes, and out of my act of spending they all get their bit of earnings.

It is, of course, true that most of these people will actually have received their earnings *before* I buy the suit. Only the tailor and possibly his landlord and the merchant who supplies him with cloth on credit are likely to get their earnings after I get my suit. But the point is that all these transactions have been entered into in the expectation of supplying me and others like me with suits; the tailor will only buy because he expects to sell so many suits, and he will only go on buying so long as he is able to go on selling. So my purchase is the necessary condition on which all the earnings depend.

My act of spending is sometimes said to constitute an "effective demand" for a suit. The word "effective" is used to signify that the demand is backed by the ability and willingness to pay the market price. I might demand a Rolls Royce and a steam yacht, but that demand would not be effective (and would therefore be of no interest to an economist) because I could not pay for them, and no one would be likely to supply them without payment. Total

effective demand for all goods is made up of the spending of private persons out of their income, the spending of the government, and the sums which private persons and companies borrow and spend voluntarily on the purchase of capital goods.¹ The greater the rate of spending, the greater will be effective demand, and the stronger inducement will there be to produce more goods.

By way of contrast let us consider what would have happened if I had decided to make my old suits do for a bit longer, and, instead of buying a new one, had saved that portion of my income. My tailor would now have sold one less suit than he expected, his own earnings would be reduced and he would need to buy less cloth; if other customers behaved in the same way he would be forced to reduce the number of his assistants and perhaps to move to a smaller shop, while if all his customers were bitten with the saving bug he would be driven out of business, his own earnings would cease and with them all that sequence of activities and earnings of which he was the culmination. All this because the effective demand for suits had fallen. Spending creates effective demand, saving does not and so when someone decides to save instead of spending, effective demand is reduced, the mainspring of production runs down.

It is now plain that saving is responsible for a good deal of trouble in the economic system. If there were no saving, if everybody had to spend all their income as they received it, we should have the happy state of affairs described by the famous Say's Law—that supply creates its own demand. Each act of production would give rise to an income which

¹ Sometimes firms have to borrow in order to hold stocks of goods which they are unable to sell. We do not count this involuntary borrowing-and-spending as part of effective demand. See below, p. 45, seq.

would be duly spent and so would add an exactly equivalent amount to total effective demand. There would always be enough spending to buy up current production and we should never meet the danger of a falling off in production through a failure of demand.

But we should be wrong if we concluded from this that saving is in itself an evil. If there were no saving we could never increase our capacity to produce by adding to our stock of capital goods, neither could the government ever spend more than it raised by taxation. The sums spent in the creation of new capital goods and the deficit expenditure of the government are, of course, borrowed. Usually they are borrowed by the spender from the saver either directly or through the banks. Quite often, however, the spender, instead of borrowing from others, draws on his past savings, by running down his bank deposit or selling securities or property. When this happens, however, the bank deposits, securities or property which change hands are bought by new savers. Thus the two processes come to very nearly the same thing, and we shall stretch the term "Borrowing-and-Spending" to cover both. The essential thing about borrowed spending is that it does not come out of the spender's current income. It is therefore an addition to total effective demand just as saving is a subtraction from it. Borrowing-and-spending in fact revitalises our savings and puts them back into the stream of effective demand, though the demand will take a different form, usually for capital goods instead of consumer's goods.

If what the savers wished to save were just equal to what others wanted to borrow and spend, the rate of effective demand would be maintained just as if there was no saving, and all would be well. We may guess, therefore, that the real reason why effective demand is not always sufficient to

maintain production at the level of full employment is not in saving itself but in some maladjustment of the saving and borrowing-and-spending processes.

Saving and borrowing-and-spending are, of course, done by different sets of people and from quite different motives, and, since the two processes play such a very important part in economic life, we had better look into this a little more closely.

First, we must remember that we are dealing with *net* income, after allowance has been made for repairs and replacements. We are not, therefore, counting as saving the depreciation allowances set aside for repairs and replacements to existing capital. Of course no one firm spends these allowances at exactly the same rate as they are accumulated, but for the country as a whole expenditure under this head will normally just about equal accumulation. When this happens, the two cancel one another out and we can ignore them. Sometimes, however, more is set aside in depreciation allowances than is actually spent, and this, like new saving, causes a decline in spending and a reduction in the rate of effective demand. If, on the other hand, spending on replacements during any period exceeds the sums set aside in depreciation accounts this, like new borrowing, will cause an increase in the rate of effective demand.

In 1938, out of a total of £326 million of savings, £140 million was made by individual persons and £170 million by companies and institutions, the remaining £16 million being sums set aside to meet increased tax liabilities. During the war, and the post-war shortage period, the situation has been very different; on the one hand, the Excess Profits Tax prevented companies from increasing their savings to any appreciable extent; on the other, the growth of money incomes, combined with

rationing, and the difficulty or impossibility of obtaining many goods, practically forced an increase in private saving. By 1943 personal savings had grown to no less than £1,400 million, while company savings had risen to only £210 million. As conditions come back to normal, however, we can expect a reversal of this tendency; when there are more goods to buy people will save less; when there is no E.P.T. to pay companies will save more. In the long run, we can expect at least half of our saving to be done by companies.

When talking of normal conditions we need not worry about the saving which we do because we cannot find anything to buy. Neither need we worry much about the temporary "saving up" which we do when we want to buy a motor-car, a radio set or a piece of furniture; these savings are soon spent again and make very little difference.

The saving which is done by private persons in order to acquire and keep property in some form or another proceeds from two motives; the desire for security and the desire for income. If we own a bank balance, or some stocks and shares, or a house or two, we have something to fall back upon in case of emergency.

The security and independence gained from holding a little property is a very great advantage. It can provide those few extra comforts which make so much difference in case of illness, disablement or unemployment. If the man who owns a bit of property doesn't like his job, he can afford to leave it and look for a better; if he wishes, he can learn another trade or start a small business of his own; if prospects in his area are bad he can move house and go somewhere else. Quite a small amount of property can give quite a lot of security; the man with £100 is immeasurably better off in this respect than a man with only £5. The income derived from a few hundred pounds' worth of property is

very small, and it is likely that small savers are interested chiefly in the security which they get from their property. With larger properties, however, the position is reversed. The difference in security between, say £50,000 and £100,000 is not great—the owner of either sum, by spending it gradually, could keep himself comfortably for a lifetime—but the difference in income is considerable. The large saver may, therefore, be assumed to be more interested in income than in security.

To those who save for the sake of security, the rate of interest which they earn on their property will make little difference; for those who save in order to enjoy income, however, it will be very important. It might be thought that a high rate would give a strong incentive to the savers, and that this type of saving would increase when the rate of interest went up and decline when it went down. There are, no doubt, some savers who behave in this manner, but there are others, possibly the majority, who have in mind a certain income which they wish to enjoy in retirement, and who save in order to be able to enjoy the sort of standard of life which they expect in old age. The lower the rate of interest, the more property a man must own and the more he must save in order to get any particular income. These people, therefore, will probably save more at a lower rate of interest than at a higher one. Whether total saving from the income motive will increase or decrease as the rate of interest goes down depends therefore on which of the two groups we have distinguished predominates. In the short run it is quite likely that low rates will produce more saving; in the long run, however, another influence comes into effect. As rates drop, people who have saved in the past will find it increasingly difficult to maintain the standard of living they expect without realising some of their property.

There will thus be increased "dis-saving" to offset against the new saving which is going on. In the long run, therefore, we may expect that net saving for the community as a whole will be less if interest rates are low than if they are higher.

But there are other influences which affect saving to a greater extent than the rate of interest. A rich man will normally save a larger proportion of his income than a poor man. The very poor cannot satisfy even their barest needs by spending the whole of their income. As we go up the income scale the margin left over after buying the necessities of life increases; much of it will be spent on comforts and luxuries, but the bigger the margin, the more will probably be saved. At the very top of the scale, the multi-millionaire is almost bound to save a large proportion of his income if only because it would be too much trouble to spend it.¹ From this simple common-sense argument there follow two important conclusions. So long as the distribution of incomes remains the same, a community will save a larger proportion of its national income as that income grows. If national income remains the same, the more unequally that income is distributed, the larger will be the proportion saved. It is natural, therefore, and it is a confirmation of this argument, that the curse of unemployment is one which affects chiefly nations which are relatively rich and in which income is very unequally divided.

The saving which is done by companies comes from rather different motives. The income motive is not likely to be important, but the security motive crops up in several forms. Directors like to have a reserve in case of some unforeseen misfortune. They like, also, to maintain a fairly constant level of dividends, and for this purpose the reserve

¹ This problem is, of course, now solved for him by the tax collector.

is often allowed to grow in good times and drawn upon in bad times. But probably the most important reason why companies accumulate undistributed profits is in order to have control of funds for the expansion of the business when opportunity offers. It is true that money can usually be borrowed for this purpose, but many firms prefer to avoid new borrowing if possible. This ploughing back of profits has always been a very important element in the finance of British industry.

Company saving will normally be little affected by the rate of interest, since directors will not be greatly concerned with the income which their reserve funds yield. It will, however, be greatly affected by the earnings of the companies concerned. A company cannot save unless it is making a profit, and the higher the profit the more likely are directors to set aside a large sum to reserves. If national income increases company profits will share in the increase, and company saving will go up. If the proportion of profits to the national income rises, as is often the case at a time of rising prices, that too will cause an increase in company saving.

We can now sum up our conclusions with regard to saving. We have distinguished four separate influences which govern the proportion of its income which a community will save. First the desire of its members for the advantages which come from the ownership of property; this we will call their thrift, secondly the rate of interest, thirdly the level of national income, and fourthly the distribution of that income.

It remains to ask which of these influences is likely to cause variations in the amount of saving, since it is these variations that are at the root of our problem. Thrift is unlikely to change rapidly in normal times, though radical

changes in the social system, in social habits, or in the structure of industry may make a big difference. The rate of interest may vary a good deal, but its influence on savings as a whole will be slight. The distribution of income changes little unless modified by drastic changes in taxation, though there may also be significant changes at times of fluctuating prices. The thing which both varies very greatly and has a very important effect on saving is the level of national income, and there is no doubt that changes in national income are the principal causes of changes in saving.

We turn now to the borrowing-and-spending side of the picture. In Great Britain the greater part of peacetime borrowing-and-spending has, hitherto, been done by privately owned companies and private persons for the purpose of buying new capital goods. The motive here is, of course, simply the prospect of a profit. The piece of capital which is bought is expected to yield during its life more than its cost plus interest, and if that expectation is fulfilled the balance will remain as a net gain to the person or company making the investment. Here we have two influences on the decision to borrow and spend—the rate of interest appearing again, and expectations as to the yield of capital goods. This matter of expected profits raises some difficult questions with which we must deal in a later chapter.

Public bodies, such as local authorities, the Central Electricity Board and the London Passenger Transport Board have also borrowed large sums in the past, and such borrowing will be increased by the needs of nationalised industries, and by the extension of local authority housing programmes. When these undertakings are producing goods for sale, their decision as to whether or not to borrow should be made in just the same way as that of a private firm. Often, however, public property such as roads and bridges, public

buildings, drainage and water systems and so on, renders services which cannot be sold in the ordinary way. Then the profit test cannot be made with accuracy, but the borrowing authority must still be guided by the general consideration of whether the benefit to be expected from the new capital is worth its cost plus interest on the loan.

Public borrowing for the acquisition of capital has long been recognised as "sound finance", but borrowing to meet the current expenditure of the government has been held to be justified only in an emergency. To raise by taxation all that the government must spend in time of war would be theoretically possible, but the taxes would have to be so heavy that they would cause great hardship, destroy most of the incentive to effort and so seriously reduce the efficiency of the country at a time when efficiency is most needed. Hence, governments have always borrowed on a large scale in time of war. In peacetime, however, "sound finance" has dictated that budgets must be balanced. Most modern economists now follow Keynes in holding that this view was wrong and that, in time of unemployment, the government should add to the total of borrowing-and-spending by running a budget deficit.

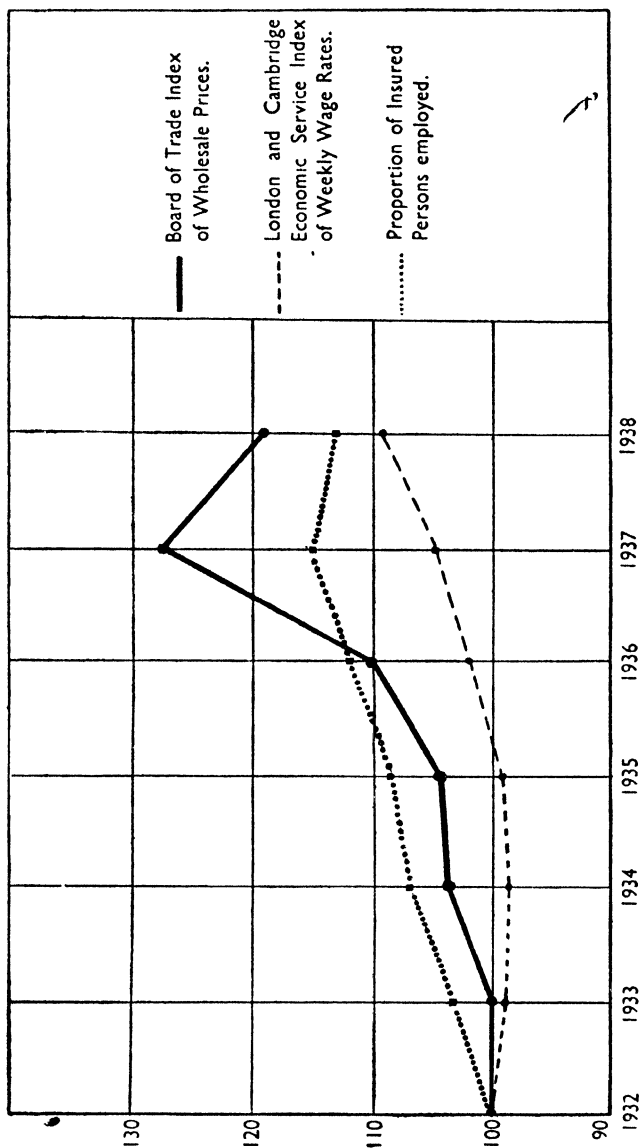
We have, therefore, to consider three forms of borrowing-and-spending, by private undertakings for capital goods, by public bodies for the same purpose, and by the government for ordinary expenditure.

We conclude this chapter with a paradox. Saving on the one hand and borrowing-and-spending on the other, depend on quite separate decisions made by quite different sets of people from quite distinct motives, yet in total quantity the two must be equal. We have seen that one man's earning is another's spending. Looking at national income from the point of view of the spender, it is composed of spending out

of earnings plus saving. Looking at it from the earning side income is derived from what other people spend out of earnings plus borrowing-and-spending. The item "spending out of earnings" is the same in both equations, so this cancels out, leaving us with $\text{saving} = \text{borrowing-and-spending}$. The formal proof, however, tells us little; the explanation of how this equality comes about is the subject of the next chapter.

Diagram 5.

PRICES, WAGES AND EMPLOYMENT, 1932-1938 AS PERCENTAGES OF 1932.



CHAPTER FIVE

HOW SAVING AFFECTS EMPLOYMENT

THE NECESSARY equality between saving and borrowing-and-spending comes about through changes in the amount and the distribution of the national income. For the first part of this chapter we will assume that wages, prices and the productivity of labour remain unchanged as employment and output vary, so that additions to the national income will be distributed between different classes in the same proportion as was previous income. This is approximately what happens in the early stages of recovery after a trade depression, as a glance at Diagram 5 will show.

Let us suppose that, at a time of heavy unemployment, we have an increase in borrowing-and-spending without any change in people's desire to save. In Britain during the nineteen-thirties roughly half of each addition to national income was saved.¹ Diagram 6 overleaf, shows what would happen in these circumstances as a result of a decision to borrow and spend an extra million pounds. The result is a sort of turbine effect.

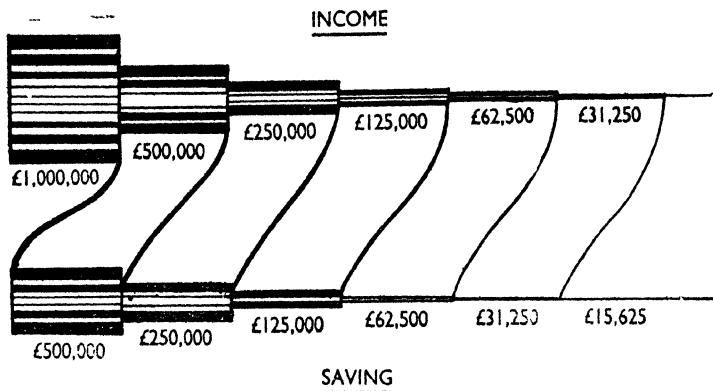
The new borrowing-and-spending adds a million pounds to the total of effective demand, but there is no immediate addition to the total supply of goods. The extra spending, therefore, can only take place by a reduction in stocks. Dealers will thus be involuntarily cutting down their own borrowing-and-spending on stocks, but this will be only temporary for, with an increase in demand, they will want

¹ This, of course, is not the same as saying that half of total income was saved.

Diagram 6.

THE MULTIPLIER EFFECT

Result of an initial expenditure of £1,000,000 on the assumption that half of each addition to National Income is saved.



not less but more goods in stock. So dealers will replace their stocks by placing £1,000,000 of new orders, more people will be employed and £1,000,000 of new incomes will be created. Of this million pounds of new income, £500,000 will be saved; this is drawn out of circulation and we have no further interest in it. The other half million, however, will be spent by those who receive it on consumer's goods of all kinds. Again dealers will find their stocks reduced, orders will be increased and new employment will be provided. Thus we have a further half million of income, again half of which will be saved and half spent, and so on indefinitely.

Thus, as a result of our original borrowing-and-spending of £1,000,000, we have additional incomes of—

£1,000,000 plus £500,000 plus £250,000 plus £125,000
plus £62,500 . . .

and additional saving of—

£500,000 plus £250,000 plus £125,000 plus £62,500
plus £31,250 . . .

If we add up the first series, continued indefinitely, it would come to £2,000,000, signifying that £1,000,000 of secondary income had resulted from our original £1,000,000 of borrowing-and-spending and, on our present assumptions, that for each man who received employment as a result of the initial spending another received employment from the secondary spending which ensued. This "turbine" process is usually known as the "Multiplier Effect", the Multiplier being the figure by which one must multiply the initial spending in order to get the total increase in income which results. The multiplier is always the reciprocal of the proportion of additional income which is saved. If half of any

addition to national income is saved the multiplier will be two; if one third is saved the multiplier will be three, ~~and~~ so on.

If we add up the savings series we find the total comes to £1,000,000, the amount of the original borrowing-and-spending. This initial act of borrowing-and-spending has created new saving equal to itself through an increase in the level of national income.

The process, of course, works backwards as well as forwards. A reduction in borrowing-and-spending will reduce effective demand and lead to an accumulation of dealers' stocks, a reduction in orders, and a decline in employment and national income, and out of a lower income less will be saved.

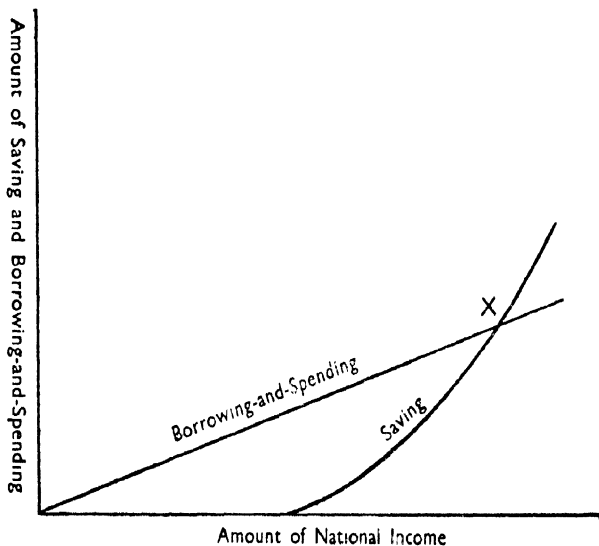
Borrowing-and-spending has thus the power to create its own saving, but unfortunately increased saving cannot create its own borrowing-and-spending. If a community were to be seized by a sudden increase in thrift, we should all try to save more, and the immediate result would be that as goods continued to flow in from the factories, stocks would pile up unsold in shops and warehouses. The unfortunate shopkeeper and merchant would have to pay for these and, with their usual receipts not coming in, they would have to borrow. We should thus have, for the moment, an *involuntary* borrowing-and-spending to balance our increased saving. But traders will not tolerate such a situation; if trade is falling off they will want not more but less stocks, and they will cut down their orders until stocks drop back to the level they want. This will mean less employment and traders, manufacturers and workers will suffer a loss of income. Out of lower incomes less will be saved, and income will continue to go down until the reduction in income offsets the increase in thrift, and saving is no more than before. Even this would not be the end, because the reduced spending on consumer's

goods would reduce the incentive to buy capital goods and so we should have a secondary depression which would still further cut down borrowing and saving. We can have no such thing as an actual increase in saving without an increase in borrowing-and-spending, the *attempt* to save more, so far from creating new borrowing, only chokes itself off through a reduction in income.

Saving and borrowing-and-spending remain equal in total amount all the time, in spite of these changes, but the balance is sometimes preserved only by the involuntary actions of traders. When new borrowing-and-spending exceeds what people wish to save, traders find their stocks running down—that is they are forced to reduce their own borrowing-and-spending; when the amount people wish to save exceeds new borrowing-and-spending, traders find they cannot sell their goods and they are forced to increase their own borrowing-and-spending. But neither of these situations are stable because, as soon as traders realise what is happening, they will take steps to alter it. When their stocks are running down, they will increase their orders to manufacturers; this will give more employment and increase national income, and out of this increased income will come increased saving. When stocks are piling up, traders will cut down their orders, and this will reduce employment and reduce the amount of the national income and, out of this lower income, less will be saved. We can only have a stable situation so long as saving equals the amount of *voluntary* borrowing-and-spending. Whenever there is a divergence between these two there is a change in total effective demand, and traders are forced into an *involuntary* increase or decrease in stocks, and this starts the sequence of events which ultimately brings about the required change in saving through changes in employment and national income.

Diagram 7.

HOW SAVING AND VOLUNTARY BORROWING-AND-SPENDING CHANGE
WITH VARIATIONS IN THE SIZE OF THE NATIONAL INCOME



We can now give an explanation of the chief reason for chronic unemployment. The size of national income and the extent of employment depends on total effective demand. Total effective demand is made up of spending out of earnings plus voluntary borrowing-and-spending. Saving is the amount by which spending out of earnings falls short of total earnings, and it must, therefore, be equalled by borrowing-and-spending. If people *wish* to borrow and spend less than the amount of saving available, employment will be reduced; if they wish to borrow and spend more, employment will be increased.

Diagram 7 illustrates the amount which people would save and the amount which they would wish to borrow and spend at different levels of national income. The borrowing-and-spending line is drawn sloping up gently from the corner; it is probable that however low national income there would still be some projects on which it was worth while to borrow and spend. The higher the national income the greater incentive will there be to borrow and spend but, as we shall see later, the borrowing-and-spending process is influenced by many other things than the mere size of national income. We must suppose, therefore, that the amount of borrowing-and-spending would not be greatly affected by changes in national income alone; hence the gentle slope of the line.

Our saving line is rather more curiously shaped. Saving depends on the margin of income available after meeting bare needs. If national income falls to a low level, saving may cease altogether for the community as a whole. If there is only a small margin most of it will be spent on minor comforts and only a little saved, but as the margin widens saving will increase rapidly. Hence our saving line is shown leaving the national income scale at a point well above zero,

rising slowly at first, but then with increasing steepness, showing that, the higher the national income the greater the proportion of that income which will be saved.

As national income increases, saving lags behind the amount which people wish to borrow and spend at first, but then increases much more rapidly. Our two lines cut one another at the point X and this is the point of stability at which the amount of saving is equal to the amount of voluntary borrowing-and-spending. If income were lower there would be "too little" saving, and income would rise, if income were higher there would be "too much" saving and a reduction in employment and income would ensue.

We cannot raise national income beyond the level at which savings equals voluntary borrowing-and-spending. If this happened to coincide with the level of income produced by full employment, all would be well, but there is no reason at all why it should. The exact level of national income at which saving and voluntary borrowing-and-spending would equal one another depends on many different things, and is constantly changing. In peacetime in modern industrial countries, however, it has always been well below the income which would result from full employment. This is what is meant when unemployment is said to be caused by a deficiency of demand. Strictly speaking, we should say that demand would be insufficient to maintain the higher level of income that would result from full employment.

So far we have assumed that prices, wages and productivity remain unchanged, and that a change in the amount of borrowing-and-spending generates the required change in saving solely through a change in the amount of national income. This fits the facts so long as there are large supplies of idle resources in men, materials and machines. It is roughly true, in fact, of a period of bad trade.

When trade is bad some comparatively inefficient firms may close down altogether; others, which work to only part capacity, will leave idle their older plant and concentrate production on their newest and most efficient machinery. As trade improves and output goes up, this low grade plant will have to be brought back into use, and its operating costs will be higher than those of the better plant. When trade is bad and firms are turning away men they will naturally try to dismiss the less good workers and keep the best; as trade improves some of these unemployed workers will be brought back and they will probably be, on the average, rather less efficient than their fellows. The use of less efficient plant and labour will cause production costs, and therefore prices, to rise. Statistical enquiries suggest that the rise in costs due to this cause is not great, but it is certainly present to some extent.

A more serious cause of rising prices is, however, temporary shortages. As demand in general increases, the demand for some commodities will outrun the supply, and producers will find that they need more machinery, that they have not enough skilled men, or that they are short of some essential material. In the long run these needs would be met by the attraction of resources from other industries where demand was less pressing. The machines could be made, the materials either made or drawn off through the operation of the market from other less urgent uses, the labour recruited and trained. But all this takes time, and meanwhile the producers of the scarce commodities are in a position to charge high prices and make abnormal profits. If these goods enter into the production of others, the cost of these will be raised, and the rise in prices will spread.

Thus, a time of expanding employment and income is marked by a rise of prices in general, but with some commodities going up very much more than others. As prices go

up workers will want higher wages, and as employment increases, the bargaining position of trade unions will improve. Rising prices will be accompanied by rising wages, but wages usually change less than prices, rising less in a boom and falling less in a depression, and there is naturally a time lag. A glance at diagram 5 on p. 44 will show how prices outstripped wages during the years 1935-7.

The fact that prices outstrip wages in time of expanding trade means that there is a redistribution of the national income, profits taking a somewhat larger share. This shift to profit will bring about an increase in saving. It will mean increased dividends and, since dividend receivers are in general, richer than wage earners, they will presumably save a larger proportion of their extra income. But, more important, larger profits will mean an increase in company saving.

Thus, except at a time of extreme depression, a change in borrowing-and-spending will produce a corresponding change in saving partly by a change in the amount of the national income and partly by a change in its distribution, but usually the increase in the amount of income is much the more important. If the expansion of income were pushed to the point of full employment, and there were still an unsatisfied desire to borrow and spend, then by definition, it would be impossible to increase the size of the national income any more, and further saving would have to be brought about entirely by a change in distribution. This is the condition known as inflation, which is discussed in chapter eight.

Changes in the distribution of the national income only slightly modify the argument of the first part of this chapter. In terms of the diagram 7 on p. 50 they simply mean that the saving curve rises rather more quickly and cuts the borrowing and spending curve at a lower level of income

than it otherwise would. In other words the shift to profit makes it somewhat more difficult to attain full employment.

The fundamental cause of chronic unemployment is in this relationship between saving and borrowing-and-spending, which causes effective demand to fall short of the amount needed to keep up the level of national income which full employment would produce.

There are, of course, secondary causes of unemployment which are quite separate from this principal cause. They are, however, of a subordinate nature, and affect particular occupations rather than the economic system as a whole. Most of them can be summed up under the general heading of "immobility of labour". However brisk is demand in general, there will always be fluctuations in the demand for particular goods, especially in the export trades, and when demand for any good contracts there will be unemployment among those who make it. There will also be unemployment when a new process or a new machine displaces labour and performs the same job with less effort than before. If the workers concerned could change to another type of job without any difficulty, this sort of unemployment would present few problems, but most jobs require a certain amount of special skill, and a worker who is highly skilled at one may be quite useless at another until he has undergone a lengthy training. Thus, even though there is no deficiency of demand and the labour force of the country is, in general, fully employed, we may still have patches of unemployment in some occupations.

Similar patches of unemployment may result from the difficulty of moving from one area to another. In the course of time the balance of industry between one part of the country and another changes, and one area may have heavy unemployment while another is short of workers. It might

seem fairly easy for a man who is unemployed in South Wales to pack up and go to London, but in fact there are many difficulties. There is the expense of travelling, which may be more than an unemployed man can afford. If he has a family, he must find a house and go to the further expense of moving furniture. Other members of the family may be in jobs, and either they must give up these and look for new ones, or else the family must split up. Old friendships will be broken off and new contacts must be made in strange surroundings. Experience shows that, while a short move may be made fairly readily, most people are very reluctant to leave their own area and travel to a quite different part of the country. In fact, surprising as it may seem, the average worker is more reluctant to change his place of living than to change his job.

Sometimes it may be necessary to do both, and then things are doubly difficult. This was the situation in the depressed areas of the inter-war period. These areas had concentrated almost exclusively on a few industries, and when these were depressed there was nothing else for a man to do. If the miner from South Wales or Durham was to have much hope of a new job in the nineteen-thirties he had both to learn a new trade and to move to a more prosperous part of the country. To do both at once is too much to ask of any man, yet thousands did it.

These are serious causes of unemployment, but they are secondary. The better is employment generally, the easier it will be to solve these special difficulties. If, as we have defined full employment, there are as many unfilled jobs as idle men, then if one industry has a lot of unemployed, another is sure to be short of labour; if one area is depressed, another will be booming. If the man who is unemployed in one trade knows that there are plenty of jobs going in

another, he will have every incentive to learn it; if he sees unemployment all around with other trades only a bit better off than his own, he is unlikely to bother. And it is the same, of course, with moving from one place to another.

When employment in general is good the state can help greatly in removing patches of unemployment due to immobility. Employment Exchanges can give advice as to which trades have most jobs to offer. Training centres can assist a man to learn a new trade. New industries can be encouraged to go to depressed areas or men helped to move to where there are jobs. All these things were, of course, tried in the inter-war period, and with only very limited success. This was partly because they were done on too small a scale, and with too little financial backing, but chiefly because there was chronic unemployment in all sections of industry. Total demand was insufficient to maintain full employment. Since this was so, workers had little incentive to co-operate and the schemes were handicapped from the start. But however successful they had been, they could not have produced full employment, or even any significant increase in the amount of employment. All they could have done would have been to spread unemployment evenly between different industries and different areas. It is only when we have solved the general problem of creating sufficient effective demand to maintain full employment for the country as a whole that we can cope with the special difficulties of depressed industries and depressed areas.

CHAPTER SIX

WHERE MONEY COMES IN

ANY READER who has been taught that unemployment is something to do with money, with the machinations of bankers and the schemes of high finance, will be surprised that we have gone so far with barely a mention of the part played by money in the economic system. Until recently it was very generally believed that money had a direct influence on prices. When the amount of money in existence increased, prices were supposed to rise and vice versa; rising prices were regarded as a stimulus to trade and employment, falling prices as a depressing influence. The question that was never adequately answered was how an increase in the number of banknotes could cause a rise in prices. The argument of the previous chapter leads to a rather different approach.

Banknotes cannot walk into shops and bid up prices; they begin to have that effect only when someone spends them. Thus we come back to the idea of total effective demand explained in chapter four. An increase in the rate of spending stimulates productions and an increase in production is often accompanied by a rise in prices, but the rise in prices is due, as we saw in the last chapter, to difficulties in the way of a quick increase in production and, like the increase in production itself, it is a consequence of the increased rate of spending.

A change in the quantity of money influences prices only if it causes a change in the rate of spending; the same

quantity of money may do duty for many different rates of spending, while one rate of spending may continue in spite of considerable changes in the quantity of money.

When new money is created and spent, e.g. when banknotes are printed and spent by the government, there is an addition to demand, but it is the spending not the printing which causes it. This is in fact only a special case of the borrowing-and-spending process. Like any other single act of borrowing-and-spending, it is done once and for all; the fact that there are more banknotes in existence as a result is no guarantee at all that there will be a permanent increase in the rate of spending when once the effects of the first action have been exhausted. The consequences of the creation of new money are, therefore, not very important in themselves.

The chief way in which the quantity of money affects economic life is through the rate of interest. Money performs two different sorts of function, it helps in the process of exchange, and it also serves as a means of holding property. As a medium of exchange money is unique; as a means of holding property it has many rivals. If we own wealth, whether as a result of past savings, of inheritance, or merely a successful gamble, we must decide in what form to hold it. This decision is quite separate from the decision as to whether or not to save; the to-save-or-spend decision must be made each week or month with regard to current income. The decision in what form to hold our wealth has to be made, and may at any time be revised, in regard to the whole of our accumulated property. We may keep it in banknotes in a box under the bed; leave it on deposit in a bank; buy government securities, either short or long term; buy the shares of an industrial company; buy a house or start a business.

Any one person in this country can choose freely how he will hold his property, and can always revise his choice by the simple process of buying or selling other forms of property in exchange for money or of selling one form and buying another. But for the community as a whole there is no such freedom of choice. The total amount of government bonds, stocks and shares, and capital goods in existence at any time is fixed, and changes take place in normal times only very slowly.¹ Only money (banknotes and bank deposits) can, if the controlling authorities desire it, be increased, or decreased in amount fairly quickly. There must, therefore, be some incentive by which property owners as a whole may be persuaded to hold just that amount of each form of property that is available for them. This incentive is provided by the rate of interest.

Each form of property has advantages and disadvantages of its own, which will appeal differently to different people; some will like to hold more of one sort, some of another. But money has unique advantages that make it preferable to any other form of property. The man who owns a banknote or a bank balance can spend it on the instant any time he likes on anything he likes. The man who owns a house or a factory, stocks and shares or war loan, if he wants to buy anything else must first go to the trouble of selling what he has. This would not matter much if he could count on always getting the price he expected, but the price of capital goods and securities fluctuates considerably, and anyone wanting to sell quickly may have to bear a heavy loss. The advantage which money thus enjoys over any other form of property is known as liquidity.

The advantage of liquidity is considerable and, unless

¹ Government bonds in wartime are, of course, an exception.

there was some compensation for giving it up, many people would not hold their property in any other form than money. The rate of interest is the compensation for sacrificing liquidity, a sort of bribe to induce people to hold property otherwise than in money.

If the general desire for liquidity increases up or if the quantity of money available declines, the rate of interest will rise. If the desire for liquidity decreases, or the quantity of money available increases the rate of interest will fall. This change takes place quite simply through the working of the market. The rate of interest yielded by a piece of property varies inversely with its price. £100 of $2\frac{1}{2}$ per cent Consols bought at par would yield $2\frac{1}{2}$ per cent; if its price fell to £62 10s., it would yield 4 per cent, while if its price rose to £125 it would yield only 2 per cent. If the desire of the public for liquidity diminishes this will mean that some people will wish to switch from money to other forms of property, e.g. Consols, and these people will bid up the price of Consols and drive down their yield. If the desire of the public for liquidity increases, the opposite will happen; people will try to switch from other forms of property to money, and this will create a selling pressure which will drive down the price of other forms of property and raise their yield.

A change in the quantity of money available produces its effect in a similar way. If the banks wish to increase the quantity of money they may buy securities themselves or make more loans to their customers. If they buy securities this will raise their price and depress their yield; if they make loans to their customers then the increased amount of money in the hands of the public will cause a similar buying pressure on securities and other forms of property. If the banks reduce the quantity of money by selling securities or

calling in loans, then there will be a selling pressure on other forms of property, which will drive down their price and raise their yield.

In Great Britain the principal forms of money are the notes of the Bank of England and the deposits of the big commercial banks. A creditor is bound by law to accept banknotes in settlement of a debt, but he is not bound to accept a cheque drawn on a bank deposit. The banks themselves are under obligation to repay their depositors in notes on demand, and so they have to keep a certain reserve either in notes or in deposit with the Bank of England. This reserve is kept fairly stable at about one twelfth of the banks' deposits. Hence, if the Bank of England alters the amount of its notes or deposits, the commercial banks will alter the amount of their deposits too, in order to maintain their cash ratio.

The Bank of England in its turn acts on the instructions of the Treasury, and so the government has a very effective control over the quantity of money in circulation. By changing the quantity of money the government can control the rate of interest. Good examples of this power are the way in which interest rates were reduced in 1932, and the way in which they have been kept down in face of the huge government borrowing of the recent war.

Government securities in this country are practically free from risk of default, either on the interest or the principal, and their yield represents "pure" interest; i.e. just the sum which is necessary to persuade property holders to give up liquidity. Industrial shares, however, contain also an element of risk—risk that the company may not be able to pay the dividends expected, and risk of bankruptcy. The yield of such shares, therefore, includes a risk premium. The size of this premium will depend on the view taken by the investing

public of the risk involved, and will be reflected in the price of the security on the stock exchange. During a depression, even though the pure rate of interest is low, the public may take a pessimistic view, in which case the price of industrials will remain low and it will be difficult for industry to borrow. During a stock exchange boom, even though the pure rate of interest may be high, investors take a very optimistic view, the price of industrials is high and firms find it easy to borrow. A high pure interest rate maintained for a fair time, however, will almost always break a stock exchange boom.

There is no doubt that the quantity of money in existence, in relation to the public desire to hold money, governs the rate of interest; the next stage in the argument, therefore, is to ask how the rate of interest affects the rate of spending.

The prospect of earning interest on one's property is one of the incentives to save, so high rates will probably cause people to save more and spend less, and vice versa. But most saving is done from motives which have little connection with the rate of interest, and some people may actually save less at a high rate than they would at a lower one. (See chapter four, pp. 37-40). On the balance, therefore, the effect of changes in the rate of interest upon saving will probably not be very large, and it will only be felt to the full after some time, as people who have retired draw upon their property (i.e. dis-save) to make up for the smallness of their incomes.

The rate of interest also affects the borrowing-and-spending process, for it is part of the price which the borrower must pay for the right to acquire capital goods. Government borrowing for a budget deficit will presumably be affected little by the cost, as a Chancellor has so far

borrowed only in grave emergency. The connection, so far as there is one, is likely to be the other way round, the Chancellor with a large debt to finance being likely to use his power to control the quantity of money in order to keep the rate of interest down and ease the burden on the taxpayer.

Borrowing for the purchase of capital equipment, whether by public or private undertakings, should ordinarily be done only if the goods are expected to yield more than their cost plus interest, and if the yield of capital could be known in advance and calculated accurately, then a very exact balance could be struck. Whenever an investment project would yield however little more than cost plus interest it would be undertaken, while any project yielding less would be left severely alone. Then the rate of interest would be very important; an appreciable fall would cause many projects to be taken up which were not previously worth while, and borrowing-and-spending would increase; an appreciable rise would considerably reduce the number of profitable projects and borrowing-and-spending would fall off. But unfortunately we cannot foretell the future with certainty, and our best calculations contain a large element of guess-work.

Considering capital goods from the point of view of their sensitiveness to changes in the rate of interest, we can divide them into four classes:

Stocks of commodities.

Instruments of production.

Buildings.

Public Works.

Stocks of commodities and materials are usually held only for a short time, and so the amount of interest which has

to be paid is not large. A difference of 2 per cent in the rate of interest would make a difference of only 10s. to the cost of holding £100 worth of stocks for three months. A change of only $\frac{1}{2}$ per cent in prices would thus be enough to wipe out the interest charge involved. A change of 2 per cent in the rate of interest is unusually large, but changes in prices of much more than $\frac{1}{2}$ per cent in three months are very common. Hence expected price movements are likely to be much more important than changes in the rate of interest in deciding the amount of stocks a trader or manufacturer will want to hold; if he expects prices to rise he will stock up, if he expects prices to fall he will delay purchases and reduce stocks as far as possible.

With instruments of production rather different considerations arise. The firm which installs a new piece of plant will have to make allowance for interest and also to set aside a depreciation allowance sufficient to cover the cost of the machine during its expected life. If the earnings of the plant exceed the cost of interest plus depreciation, then its installation will have been justified; otherwise not. Suppose a machine is expected to last ten years and costs £10,000, the rate of interest being 5 per cent. The interest charge would then be £500 a year, and in order to accumulate a fund of £10,000 in ten years at 5 per cent compound interest it would be necessary to set aside £795 a year depreciation allowance. In order to justify itself, the machine would have, therefore, to earn £1,295 a year. If the rate of interest fell to 3 per cent, interest charges would go down to £300, but depreciation would go up to roughly £875, so the total necessary earnings of the machine would drop only from £1,295 to £1,175 a year. On the other hand, with a rate of 5 per cent a reduction in the life of the machine to eight years would mean that it must earn £1,546 a year in order to

justify itself, while if its life were extended to twelve years, 'it need earn only £1,128.

From this illustration it appears that a moderate change in the expected life of the machine will make more difference than a moderate change in the rate of interest to the sum which it must earn each year in order to justify its purchase. The life of a machine is really very uncertain for, apart from the risk of mechanical breakdown, there is the far more serious risk that a new machine or a new process may be invented, which would make the old one obsolete long before it was really worn out. The business man has thus to estimate the life of his plant knowing that his estimate may be subject to a very wide degree of error.

The estimated cost of interest and depreciation must be balanced against the net earnings of the plant, and here again there is a lot of uncertainty. A firm with a good costing system could calculate accurately enough the earnings of a new piece of plant in the immediate future, but in making the calculation they would have to take into account the selling price of the product, the amount which could be sold and the cost of the other factors of production. As time goes on all these will change, and the further we look into the future, the more difficult it is to foretell how they will behave. A boom or a slump, a change in consumers' tastes, new inventions, the intrusion of new competitors into the industry, a change in the relative wages of different types of labour, all these things may upset the calculation and make the actual earnings of the plant a few years hence very different from those that were expected.

When a business man is considering whether or not to install new plant, he will be influenced in a general way by the amount of his interest charges, but he will not pay

nearly as much attention to them as he would if he could make his other calculations more exactly. In general, a high rate will check investment and low rates stimulate it, but we must not expect a moderate change to produce a very great effect.

Buildings are likely to be more sensitive to changes in the rate of interest; their life is longer than that of instruments of production, and so interest plays a larger, and depreciation a smaller part in the annual cost. The life of a building is more certain and so, also, is the return to be expected from it. We may, therefore, expect changes in the rate of interest to make a big difference to the volume of building, and there is no doubt that the building boom of the 1930s was largely due to the reduction in the rate of interest rates after 1932. For the next few years, however, this response of building to changes in the rate of interest will not operate. The provision of houses has become so urgent a matter of public policy that it is being undertaken largely by public authorities assisted by subsidies from the central government, and pursued more or less regardless of cost.

Lastly there are public works, about which we need say little. Usually their benefits are such as cannot be sold in the market, and it is thus quite impossible to calculate their earnings exactly. If the rate of interest is very high public authorities may be deterred from borrowing, if it is low they may be encouraged to undertake schemes which they would otherwise not have done, but we may expect the response to fairly small changes to be slight.

To these considerations we ought perhaps to add the psychological effect produced on business men by changes in the rate of interest. In the past, rates have always been high at the peak of a boom; but as booms have been followed

by slumps there is a general impression that a high *rate* brings bad trade. If business men take a rise in the rate of interest as a danger signal, a warning of bad times ahead, this of course will make them revise their estimates of the probable earnings of new investment and reduce their willingness to borrow and spend. Furthermore, borrowing is a two-sided transaction, and even if the borrower is sufficiently optimistic not to be put off by a very high rate, he may have difficulty in finding a lender with the confidence to trust him.

A very high rate will usually check borrowing-and-spending, but a low rate will not necessarily stimulate it. This is partly for the psychological reason just mentioned, and also because there is a lower limit but no upper limit to the rate of interest. The pure rate can be raised to any figure the monetary authorities think necessary, but it cannot be reduced below zero, and there is always the risk premium which a firm must pay on top of the pure rate. The most normal level for Bank Rate during the past hundred years has been between 3 per cent and 4 per cent; it has never fallen below 2 per cent, but it has risen to 7, 8, 9 and even 10 per cent. A sufficiently high rate will daunt even the most optimistic borrower, but a low rate will not necessarily stimulate a pessimistic one. At a time of extreme depression business men may feel that a new investment is unlikely even to repay its cost, let alone earn any interest. So long as they feel like this they will not borrow however cheaply they can do so; in order to induce them to borrow we should need a *negative* rate (i.e. the lender would have to pay the borrower for taking his money) which would be impossible under present conditions.

From this argument two important conclusions may be drawn:

(1) The rate of interest does influence the rate of spending both through people's willingness to save and their willingness to borrow, but in order to produce a big change in the rate of spending very large changes in the rate of interest would be necessary.

(2) A high rate is much more effective in checking the rate of spending than is a low rate in stimulating it. In other words, the rate of interest is a fairly effective safeguard against inflation, but a very poor remedy for unemployment.

Changes in the quantity of money work upon the economic system through the rate of interest, so a change in the quantity of money will influence spending, income and prices, but in a different and much less direct way than was once supposed. A change in the quantity of money in existence will first raise or lower the rate of interest; this will cause a change in the rate of spending which will cause a change in employment and national income, and lastly, as a consequence of all these things, there may come a change in prices. The power of money is exerted in a roundabout and not particularly effective way, and money is only one of the things which influence the rate of spending.

All the consequences we have described follow from the change in the rate of spending, and anything else which affects the rate of spending will produce exactly the same effects on employment, income and prices. Money is very far from being unique in its power to influence these things. The expectations of business men, the fiscal policy of the government, the balance of trade with foreign countries all play their part, and generally it is a much more active part than that of money.

The critics who attribute most of our employment

troubles to faults in the monetary system assume that the quantity of money is unique in its power to influence the rate of spending. The trouble lies not wholly, or even principally, with money, and we cannot hope to avoid a repetition of our difficulties in the inter-war period just by juggling with the monetary system.

CHAPTER SEVEN

OTHER INFLUENCES ON THE RATE OF SPENDING

WE MUST now look at the non-monetary factors which influence the total rate of spending and so help to determine the level of national income and employment. Anything which modifies either the desire of the public to save or the willingness to borrow and spend will change the total rate of spending, and so will change national income and employment.

The desire to save does not normally change very rapidly. The actual amount of saving, of course, does vary considerably as a result of variations in the amount and distribution of the national income, but people's desire to save out of a given income remains fairly stable.

Progressive taxation (i.e. taxation which takes a larger proportion of higher incomes than of lower ones) may be expected to reduce saving, for people with large incomes will pay their taxes largely by cutting down their saving. In the past there has been a steady though slow trend towards a more progressive system of taxation in peacetime, and the two world wars have each brought a drastic increase in the taxation of higher incomes.

These wartime increases have been so heavy that they have left little scope for using taxation as an instrument for diminishing savings in the future. Indeed, the present level of taxes on earned income is a serious discouragement to production.

Individual saving is undertaken largely to provide security

against misfortune and income for retirement, and the more of these things are provided out of public funds the less eager will individuals be to save for themselves. This argument applies less to social insurance schemes accumulating a surplus than to benefits provided directly out of current expenditure, as the surplus accumulated by the insurance fund is itself saving. But insurance schemes will effect an economy of saving, for by pooling risks, the fund of the insurance scheme can be much smaller than the total of individual savings would have to be in order to give the same degree of security.

It was pointed out in chapter four (see p. 36) that Company saving accounts for a large proportion of total saving. This saving varies very much from time to time with changes in the amount of profits, but the amount which companies would save out of a given income is unlikely to vary much. Companies might, however, be persuaded to vary the amount of their saving to some extent independently of their earnings if they could be shown that it was in the public interest for them to do so. In 1947, when we need to encourage as much saving as possible, directors are responding very well to the request of the Chancellor to keep down their dividend distribution. When times change and the opposite policy is required, there is no reason why they should not also respond within limits set by ordinary prudence to an invitation to make more generous distributions and put less to reserves. It might be possible to re-inforce such a request with a tax on undistributed profits, but there are considerable difficulties about this.

A form of disguised saving is the setting aside of depreciation allowances greater than the actual value of the depreciation which has occurred. The behaviour of private firms in this respect depends largely on their profits. When high

profits are being earned, the value of capital will probably be written down heavily; when profits are unduly low, the depreciation allowance may be allowed to fall below the loss of value which has occurred. For private firms as a whole there will probably be a tendency to over accumulation of depreciation funds in times of very good trade, and under accumulation in times of very bad trade; when firms are enjoying a fairly constant income, there will probably be little change in their attitude towards depreciation allowances. Some of the worst offenders in the setting aside of excessive allowances have been local authorities, acting on the instructions of the Ministry of Health. The Ministry often insisted on a sinking fund far larger than was necessary to write off the cost of the capital goods created during their expected life and during the nineteen-thirties the annual sum set aside in sinking funds by all local authorities amounted to roughly half their annual capital expenditure. When unemployment threatens again, there will be a strong case for extending the period over which local authorities write off their capital, and for encouraging private firms to do the same.

In the conditions that have prevailed in the past we have found very little reason for any large variation in the amount which would be saved out of a *given* income. Hence changes in the desire to save unless specially stimulated by social policy are not likely to be a cause of any large changes in income and employment. These changes in saving which have actually taken place have been a consequence of the changes in national income brought about by fluctuations in borrowing-and-spending or in foreign trade. (See chapter ten below.) If we desire, in the future, to alter the amount of saving which will be done out of a given national income, we have seen several possible ways of setting about it.

Altogether they add up to a quite appreciable force, but even so the volume of saving cannot be varied nearly so easily as the volume of borrowing-and-spending.

It is variations in the amount of borrowing-and-spending which have been chiefly responsible for past fluctuations in income and employment.

With any given rate of interest, the amount per year which private individuals will want to borrow and spend will depend on the number of investment projects which they expect to be worth while. A number of influences help to determine this. Some of them easily influenced by public policy, some not.

A rapidly increasing population will create new needs for all sorts of capital goods, and will thus stimulate borrowing-and-spending; an obvious example is the increased demand for houses arising from a growing number of families. Unfortunately the population of Great Britain has almost ceased to increase (though the number of families is still growing), and it may soon start to decline slightly. A declining population means, of course, that some capital will be redundant and that the opportunities for new investment will be fewer. This, therefore, is a factor adverse to an expansion of borrowing-and-spending, but fortunately there are others which work the opposite way.

The progress of scientific discovery and invention is always creating new forms of capital and new incentives to borrow and spend. The older British industries have lagged behind those of other countries in taking advantage of new inventions. They were first in the field with equipment which was the last word in efficiency when it was installed and, though new improvements have made it largely obsolete, firms have been reluctant to scrap it while still in working order. Recent surveys of the coal, iron and steel, and textile

industries have shown that a vast amount of new equipment is urgently needed. Besides this making up of leeway, new invention is going on at a pace faster than ever before, and it looks as if we may be on the threshold of an industrial revolution greater even than that of the early nineteenth century.

Here again public policy has its part to play. British industry has been handicapped in the past by lack of good research; partly because firms were unwilling to spend money, partly because there were not enough good men. Our educational system can be developed to provide an abundance of good men; our universities can be equipped for research on a much greater scale; the government can offer encouragement to industrial research, and conduct research work of its own; and the results can be diffused throughout industry. The more knowledge we can accumulate, and the more widely we spread it the more opportunities will there be for the accumulation of capital.

But business men will not be very willing to buy new capital goods unless they see a good prospect of being able to make full use of them. Of course there will always be risks in business; no one can tell when a new invention, the advent of a new competitor or a change in the tastes of consumers will upset calculations. It is part of the business man's job to accept such risks as this, and the readiness with which they are borne is one of the principal justifications of free enterprise. But there is the even more dangerous risk of a general depression in trade. We have had alternate booms and slumps in trade ever since the dawn of industrial society, so business men have naturally come to expect them. Slumps mean unemployment for machines as well as men, and if a business man expects to have a machine unemployed for a good part of its life he will not be very eager to buy it.

The expectation of trade depressions is a brake upon progress and, if we could only create confidence in a continuing state of full employment, this in itself would be a great stimulus to new investment.

By far the greatest single spender in the country is the government. In 1938 the central government and local authorities between them spent directly on goods and services more than one sixth of the national income, and collected and handed out a further 10 per cent in transfer payments. In the next few years, these proportions are likely to be even higher.

So far as government spending is financed out of taxes, its effect on total effective demand will be slight. If these taxes are paid out of private spending there is only a transfer of spending from private to public spenders, or from one set of spenders to another with no increase in total demand at all. In fact, however, part of tax payments are made out of income which would otherwise have been saved, and to this extent government expenditure financed by taxation does add to the total rate of spending provided that the taxes are not raised in a way which discourages the borrowing-and-spending of private industry.

But the government is not confined to spending what it raises out of taxation. It can itself borrow and spend, and government borrowing-and-spending, like that of private persons, is a net addition to total effective demand. The government can, therefore, use its power of borrowing-and-spending deliberately to add to effective demand and increase employment.

There is a hoary old fallacy that government borrowing is no net addition to demand because it "diverts savings from industry" and therefore industry must borrow less because the government borrows more. But savings do not get

themselves borrowed and spent automatically. On the contrary, the initiative lies with the borrowers and spenders; borrowing will always create its own saving, and so long as we have idle resources there will be an addition to income and employment in the process.

It is this power of borrowing-and-spending to create an increase in income and employment which has formed the basis of the arguments in favour of public works as a remedy for depression. Yet this fallacy was put forward in a famous Treasury memorandum of 1929 on the effects of a Development Loan, which contained the following passage: "The large loans involved, if they are not to involve inflation, *must draw on existing capital resources*. These resources are on the whole utilised at present in varying degrees of active employment; and the great bulk is utilised for home industrial and commercial purposes. The extent to which additional employment could be given by *altering the direction of investment* is at best strictly limited. Seeing that the national savings are less, allowing for the altered level of prices, than before the war, and capital is therefore relatively scarce and dear, it follows that we cannot afford investments that give only an uneconomic or a very distant return, or are of a purely luxury nature."¹ Here there is not the faintest suggestion that government borrowing-and-spending could add to investment or employment; government borrowing is regarded purely as a diversion of resources from other forms of investment. No doubt the persistence of this view is largely responsible for the aversion for government borrowing in time of peace, which has been so strongly marked in our Chancellors.

It was recognised that public works (roads, bridges,

¹ Memoranda on certain proposals relating to unemployment. Cmd. 3331, 1929. Author's italics.

drainage and water systems, public buildings and similar items of social capital) could be legitimately financed by borrowing. However little the works were desired in themselves, it was argued, the community would benefit by the secondary employment and production to which the initial borrowing would give rise (see chapter five). Thus even if the works in question turned out to be quite useless, the community as a whole would still be better off, would still have more of the useful goods it really wanted than if the works had never been undertaken. From the point of view of the Exchequer, there would be a substantial saving of unemployment benefit to set off against the expenditure, and the public would thus get its new capital at well below cost. Unfortunately, there are considerable difficulties in varying the amount of useful public works so as to counteract variations in employment due to fluctuations in other forms of borrowing-and-spending. The amount of labour suitable for this type of job is limited, plans take a long time to draw up and, once a big scheme has been started, it is not always possible to abandon it as employment improves and take it up again when employment falls off. Nevertheless, there is a strong case for pressing ahead with all the useful works possible in time of serious unemployment, and for varying the tempo of the work, so far as technical considerations allow, so as to counteract other changes in borrowing-and-spending.

But public works expenditure is not the only form of borrowing-and-spending. The government could borrow to meet its ordinary expenditure and raise correspondingly less taxes, or it could even borrow in order to hand round special bounties in consumers' goods to its citizens. From the point of view of giving employment it is only the fact of borrowing-and-spending that matters, the fact that the

government is spending more while none of its citizens are spending less, and so there is an increase in the total rate of spending. It hardly matters at all what the object of this spending is, whether it is to build a monument, to pay the policeman, or even to purchase tickets entitling each of us to a free visit to the cinema on Saturday nights. There is a lot of difference between the three forms of spending in other ways, but so long as there are idle men with suitable qualifications to be employed, either form will give employment and increase production.

Yet government borrowing for ordinary expenditure has until recently been regarded as "unsound" by all except a very few. Here there is probably a false analogy between the state and the individual. When a private person borrows, the lender has a claim for repayment which he can, if necessary, enforce by compelling the debtor to sell his goods. If a company borrows, its debenture holders have similar rights, while the ordinary shareholders can wind up the company and sell its assets. The ultimate security which protects the lender against the loss of his wealth is the material assets owned by the borrower. Hence lenders naturally insist, so far as they can, that they lend only for the purchase of durable assets and not for current expenditure. But the position of the government is very different; government debt far exceeds the value of public property, yet we cannot conceive of the state going bankrupt and selling up, say, the Houses of Parliament, Woolwich Arsenal or the Post Office. The real security enjoyed by the holder of government securities is not the property owned by the state, but the power of the state to command the private incomes of its citizens. We can count on the prompt repayment of our War Bonds because the government can always borrow fresh sums as each instalment of debt falls due,

and the government can always borrow because it can always tax the income of its subjects in order to pay interest on its loans.

There is nothing unsound in government borrowing to meet current expenditure. There are disadvantages in it but they are only the disadvantages of borrowing for any purpose, namely those which follow from an increase in the size of the National Debt. A debt which the government owes to its own subjects is, of course, a very different thing from a debt owed to a foreign country. The latter must ultimately be paid for by the export of goods; the former, however, causes only a transfer of the power to purchase goods from one set of people to another inside the country. An increase in the internal National Debt does not mean that we shall have any smaller flow of goods to divide among ourselves; it simply means that we shall share the power to buy these goods in a different way; rather less will be left with those who originally earn it, and rather more will be collected by the government and handed to holders of government securities.

Such transfers have their disadvantages. More interest payments mean more taxes, and taxes are always a nuisance. A Chancellor who has to raise large sums for the service of the National Debt will probably be less sympathetic to claims for other and more desirable forms of social expenditure. The holding of government securities tends to increase more steeply than tax payments in the higher ranges of income so that an increase in debt, unless accompanied by adjustments in the tax structure, will tend to cause a transfer from the relatively poor to the relatively rich and so to aggravate the inequality of incomes.¹ These disadvantages are trifling when set against the benefits of increased employment and increased national income which follow from

¹ It is doubtful, however, whether this objection will hold so long as the present level of surtax continues.

government borrowing whenever national resources are less than fully employed, and they can be greatly mitigated by a reduction in the rate of interest at which the government can borrow.

Another widespread fallacy about government borrowing concerns its method. The government can borrow in several ways. When the Bank of England issues extra notes and credits the government with the proceeds, this is one form of borrowing. The Bank actually "buys" Treasury bills with the notes but this is only an accounting device as the profit on the note issue has, for over a century, returned to the Exchequer. Other forms are the Treasury Deposit Receipts (by which the government borrows from the banks), Treasury Bills, and the various forms of War Bonds, Defence Bonds, etc. The main differences between them is in the date at which they are due for repayment. Treasury bills must be repaid at par, usually at the end of three months, other forms of loan after perhaps five, ten or twenty years, while in the case of consols the date of repayment is indefinite. The right to repayment at par in the near future gives a security a high degree of liquidity, and so it is generally true that short term borrowing pays a lower rate of interest than long term borrowing. Normally the gap between long term and short term rates is not very big, but in the inter-war period the government borrowed largely on long term; this meant that people who set a high value on liquidity had to be persuaded to hold illiquid loans and had to be offered a comparatively high rate of interest as an inducement. Hence there appeared a wide gap between short and long rates, which was a new thing in our financial history; in 1938 the yield of Treasury bills was only about $\frac{1}{2}$ per cent, while that on long term government securities was about $3\frac{1}{4}$ per cent.

The chief reason for this was the fallacy that long term

borrowing is the only "sound" method. Borrowing by Treasury Bills and other "liquid" securities was suspect, while borrowing by the issue of notes was regarded with positive aversion. In recent times the pendulum has swung the other way, and we have Professor Polanyi¹ and others saying that, in time of unemployment, the government ought never to borrow in any way except by the issue of notes. (See p. 97 below.)

In fact, however, the method of government borrowing is a secondary matter. The secondary effects may be important and we shall discuss them further after we have examined the significance of inflation. But the thing of primary importance is the net addition to the total rate of spending caused by government borrowing, and this is the same whatever method is used.

To sum up this section of the argument: Government borrowing does not divert savings from industry, on the contrary, like any other borrowing, it is a net addition to the total rate of spending and, so long as there are idle resources, it will cause an increase in employment and in national income. From this point of view it matters little how the loan is raised or on what it is spent; it is the total amount of borrowing-and-spending which is important. Changes in public borrowing-and-spending can make a tremendous difference to the tempo of economic life, as we have seen in the course of two great wars. The ability of the government to increase or decrease its borrowing-and-spending gives it an instrument of tremendous power for regulating income and employment. The borrowing policy of the state is much more powerful in this direction than the purely monetary policy of the banking system, yet in peacetime this power

¹ M. Polanyi, *Full Employment and Free Trade*, Cambridge University Press, pp. 41 *seq.*

has hardly been used at all because of the mistaken ideas about it which have until recently prevailed. Here is one of the greatest opportunities for a change in public policy in the future.

There is one final influence on the rate of spending, which we must mention here, even though we cannot yet discuss it fully, namely the balance of trade with foreign countries. When we in Britain import from abroad, a part of British national income is spent in foreign countries, and gives employment and incomes to foreign producers. When we export goods or provide services for foreigners, a part of foreign national incomes is spent in Britain and gives employment and incomes to British producers. If the two were always equal, or if there were always the same gap between them, then they would not cause any change in the total rate of spending. But this is not so and changes in foreign trade do in fact cause great changes in employment, especially in a country like Britain, where foreign trade plays such a large part in economic life. An increase in the value of exports or a decrease in that of imports will increase the total rate of spending in the country concerned; a decrease in exports or an increase in imports will reduce the rate of spending. Thus the former will increase employment, the latter decrease it, and like any other changes in the total rate of spending, the initial change will produce secondary results through the "Multiplier Effect". This has sometimes been put forward as an argument for protection, but it is a very weak one, for a protective tariff can only create employment at home by creating unemployment abroad. Countries which have increased their tariffs during a trade depression have always met with retaliation, which has left them little if any better off than before. The dispute between free traders and protectionists requires to be fought out on other grounds which are outside the scope of this book.

CHAPTER EIGHT

THE MEANING OF INFLATION

SO FAR we have been concerned chiefly with the situation in which the total rate of spending is too low to maintain full employment, and so the community is forced to waste some of its resources in idleness. At the present time (1947), however, we are more immediately troubled by the opposite situation, where our resources of labour and capital are employed to the utmost limit, and there is still an unsatisfied desire to spend. This inflationary situation can be explained by following exactly the same line of argument as that which has been used before.

Anything which tends to increase total effective demand has an inflationary tendency; anything which decreases total effective demand has a deflationary tendency. A decrease in the desire to save, a shift in the distribution of income from rich to poor, a fall in the rate of interest, an increase in the pace of invention; more optimistic expectations by private investors, an increase in government borrowing-and-spending, an increase in exports or a decline in imports, all these things will cause an increase in the rate of spending, and all may be described as inflationary tendencies. Each of these has its opposite, which will cause a decrease in the rate of spending, and which we shall, therefore, call a deflationary tendency.

It is not likely that all these influences will be pulling in the same way at once, and normally we shall have some inflationary and some deflationary tendencies at work. If the

inflationary tendencies gain the upper hand, total effective demand will increase and will then exceed the value of current output at the prices previously ruling. Then traders will find their stocks going down, they will try to place new orders and, if there are any idle resources available to meet these, production and incomes will increase. If the deflationary forces predominate then total effective demand will fall below the value of current production, part of that produce will remain unsold, future production will be cut down, and unemployment and loss of income will ensue. This is only another way of saying what we have already said in earlier chapters.

It is obvious that, if we are going to use the words "inflationary" and "deflationary" in this sense, we must not, as is often done in ordinary speech, imply that either is a good or a bad thing in itself. Whether we want more inflationary or more deflationary tendencies will depend entirely on the circumstances of the moment, the crucial test being whether there are idle resources available to meet increased spending. So long as such idle resources exist, inflationary tendencies will increase employment and output, and so will be beneficial. When there are no idle resources, however, increased spending cannot lead to any increase in output, and can only do harm. In 1932, and indeed during all the inter-war period, the inflationary tendencies badly needed stimulating; in 1947, with a large unsatisfied desire to spend and practically no idle resources, it is the deflationary influences which need encouragement.

There has been a lot of discussion recently as to whether we have "inflation" in post-war Britain and, if so, how much, but the issues are obscured by failure to agree upon the meaning of the word. If we want to use the single word

“inflation”, as distinct from “inflationary tendencies”, to describe a particular state of affairs we must define it carefully. We shall use the word here to describe a state in which total effective demand (or the rate at which people would wish to spend in the absence of controls) is greater than the value of current production, and in which production cannot be appreciably increased in order to meet this extra demand.

The result of this situation will be that prices in general will rise unless held in check by legal restrictions, but the result may come about in two different ways. In the first place the increase in effective demand may come from above, e.g. through government borrowing-and-spending in time of war. In this case producers and traders find themselves in a position to charge higher prices for their goods, though as yet nothing has happened to increase their costs. They therefore make an abnormal profit, and hence we shall distinguish this type of inflation by the name “profit inflation”. Alternatively, the increase in effective demand may come from below through an increase in the wages of labour or the earnings of some other factor of production. These increased earnings create additional purchasing power, which raises the price of goods, but in this case the rise in price does not give abnormal profits to the producer, but merely compensates him for the rise in his costs; hence we call this a “cost inflation”. If the producer were not able to raise prices he would, of course, not be able to produce at all in face of increased costs, and so it is true to say that in a cost inflation the rise in costs causes the rise in prices, and the increase in purchasing power merely permits it to take place. In an actual inflation the two elements of cost inflation and profit inflation are frequently combined, but it is important to consider them separately.

As an illustration, let us take a simplified example. Suppose that, in time of war when all our productive resources are employed, the value of net national income at current market prices is £8,000 million a year. The government uses half of this for the war and other necessary public spending, leaving half to be bought by its citizens. To pay for the £4,000 million worth of goods which the government buys it raises £2,000 million in taxes, and borrows £2,000 million. The public thus receives £8,000 million in income, of which £2,000 million goes in taxes. We will assume that people wish to save a further £1,000 million and that the government is the only borrower. Even so, there would still be £5,000 million of spending to buy £4,000 million worth of goods. Clearly this is an impossible situation as spending must always equal incomes, so either the public must somehow be induced to cut down its spending by a further £1,000 million or else the prices of goods must go up, thus giving extra incomes to the sellers by increasing profits and so preserving the balance between spending and income.

Which of these two possibilities will materialise depends on whether we are living in a free or a controlled economy. In an uncontrolled economy, there would be no way of cutting down spending, other than by increasing the amount of taxation. In the absence of this, the public will still try to spend at a greater rate than goods are coming forward to be bought, and prices must go up. This rise in prices will have two results. It will mean that more money will be needed for everyday transactions and so, unless the banking system increases the supply of money, there will be less available as a means of holding wealth, and the rate of interest will rise sharply. A sharp rise in interest rates will give a slight encouragement to saving. Secondly, the rise in prices will

increase traders' profits at the expense of the incomes of other sections of the community; there will be a more unequal distribution of income, and therefore more saving. In this way the increase in saving will proceed until it offsets the "excess" borrowing of the government, and total effective demand will be brought back to the value of current production.

Theoretically, this might be the end of the trouble. The rise in prices would bring about a less even distribution of national income, and cause hardship to wage and salary earners and to people with fixed incomes; the higher prices would continue until there was a fall in effective demand, but once a balance had been reached between saving and voluntary borrowing-and-spending,¹ there is no necessity for the rise to continue.

But in practice, if government borrowing is long continued, the situation is very likely to get out of hand. Wage-earners will have suffered hardships as a result of the initial rise in prices, but the overwhelming demand for goods and so for labour will have put trade unions in an exceptionally strong bargaining position. They will press for higher wages, and strike unless they get them. Employers will have little reason to refuse for a strike means loss of profit, while, in a sellers' market, a rise in wages can always be passed on to the buyer. So wages will go up, costs will rise, and a further rise in prices will take place. In addition to the "profit inflation" with which we started, we now have a "cost inflation". This second rise in prices will cause further demands for higher wages, and these will again raise prices, and so on. This is the famous "vicious spiral"

¹ The initial excess of government borrowing over saving would, of course, have been offset by an *involuntary* repayment of loans by dealers whose stocks were running down.

of inflation about which we heard so much in the war years. Of course, it can only happen if the supply of money is allowed to increase, but, if the government wants to borrow large sums, it is almost bound to provide for an increased quantity of money; the alternative would be a rise in interest rates to a quite inordinate level.

We experienced this type of inflation in Britain during the Napoleonic Wars, when direct controls were non-existent, and during the early stages of the 1914-18 war, when controls were few and weak. If such an inflation goes far enough, it may lead to a complete loss of confidence in the currency, a terrible evil which we in Britain have been fortunate enough to escape. When the public sees prices continuing to rise it comes to expect a further rise. Thus each increase in prices, instead of putting people off from spending, only makes them more eager to spend before prices go up any further. No one will be willing to save for if they hold their savings in money they expect its purchasing power to decline; if they lend their savings they can only expect to be paid back in money of a lower value. The consequent rush to spend can only drive up prices further and faster and this goes on until whole economic life of the nation is disrupted. This is the extreme inflation which occurred in Germany and Russia after the war of 1914-18, and in Hungary, Greece and China after the war of 1939-45. In an uncontrolled economy inflation is a very dangerous thing; even a little of it can do a lot of harm, and it can very easily get completely out of hand.

In a controlled economy, such as we built up in Britain in the recent war and in the later stages of the 1914-18 war, inflation is handled in a different way. To begin with, the government does not bid for what it wants against its citizens in the free market—instead it requisitions the goods and

conscripts the fighters and workers that it wants, and private citizens have to put up with what is left. This does not alter the fact that private citizens still have purchasing power greater than the value of the things left for them to buy, and to check the rise in prices which would result, maximum prices are fixed by law for all important commodities. At the controlled prices, demand will, of course, be greater than supply; so most essential goods have to be rationed to ensure even distribution. For less essential things the public can be left to queue and scramble. To complete the apparatus, Controls are extended to private borrowing and spending and to foreign trade. The object of the whole complicated system is simply to give the government first claim on the national output, and to ensure that the rest is shared in a reasonably fair way without a great rise in prices.

Let us turn back to our numerical example, and suppose for the moment that the Controls apply to all goods and are perfectly efficient. The public will have £6,000 million of income after paying taxes of which it will voluntarily save only £1,000 million, and so it will try to spend £5,000 million on £4,000 million worth of goods. But now this simply cannot be done. The citizen will take his wage packet to the shops, buy his rations, on which he can spend only a fixed amount, and then join in the scramble for unrationed goods. Some of the things he wants cannot be bought, because they are not allowed to be made; others may be of such poor quality that he decides he would rather go without; for others he must join in queues, put his name on waiting lists, or walk from shop to shop making fruitless enquiries. He will go on doing these things until he has bought a certain amount, but eventually his endurance will wear down. The more footsore he grows, the more angry he gets at the rebuffs of traders who no longer want to sell to him, the more

strong will grow the subtle attractions of the national savings poster. Eventually he decides to save more than he had originally intended because it is too much effort to spend. If the amount of goods coming into the market and the prices of all of them are effectively controlled then private citizens as a whole cannot spend more than a limited amount. The greater the eagerness to spend, the greater the scramble for unrationed goods, but sooner or later some people will drop out and decide to save instead of spend. So the difference between total borrowing and the amount which the public had intended to save anyway accumulates as *involuntary* saving. It is not *compulsory* for no single individual has been compelled to save any particular sum, but it is involuntary in the sense that it would not have been done if the free choice of the public as a whole had not been restricted by Controls.

This is substantially what has happened in Britain since 1939. Controls have not been perfect, but they have been very efficient; a small number of goods have been left uncontrolled because they were not sufficiently important to be worth the trouble of controlling and there has been a small black market. Nevertheless the "profit inflation" has been very small. In 1938 profits, including the profits of firms and the personal earnings of doctors, lawyers and other professional people, formed $28\frac{1}{2}$ per cent of net national income. Their share rose to a maximum of 31 per cent in 1940 and 1941, but had fallen to $29\frac{1}{2}$ per cent in 1943 and less than 29 per cent in 1945.¹ "Cost inflation" has not been kept in check so well. Some factors in cost are outside the control of our own government; imports cost us more owing to rising prices in other countries, shipping

¹ Cmd. 6784. The figures are, of course, calculated before payment of Excess Profits Tax.

difficulties, and the fall in the value of the pound at the beginning of the war. Although the prices of most important commodities have been controlled, little has been done to check the rise of money wages. Unions have pressed for a wage increase when the situation seemed to justify it. Employers faced with higher wage bills have had to ask for, and have often received increases in their controlled prices. The "vicious spiral" of cost inflation has, therefore, been present to a quite considerable extent. The price of consumer's goods in general, at factor cost, has gone up by 47 per cent, while their market price, which reflects the influence both of indirect taxes and subsidies, has risen by nearly 60 per cent.

Our present inflation has thus been strictly controlled and instead of a violent rise in prices, we have had a moderate rise and a great deal of involuntary saving. If this saving is really involuntary, we may ask what is the point of the savings drive on which so much energy has been spent. If the public can be convinced that saving is good for them, they will feel less resentment at their inability to spend their incomes, and this will be good for national morale. Further, the greater the anxiety to spend the greater will be the rise in the prices of those goods which are uncontrolled, and the more incentive will be given for black market operators. The encouragement of voluntary saving by propaganda therefore both bolsters up morale and also acts as an insurance against the administrative breakdown of Controls.

The evils of controlled inflation are less than those of uncontrolled inflation, but they are evils none the less. Inability to spend as we like diminishes the desire to earn, and leads to a reduction in output. Restriction of the consumer's choice means that available supplies do not always go to those who would get the most satisfaction from them.

Controlled prices of consumer goods mean that the desires of the consumer cannot have their usual effect in stimulating production, while if less essential goods are uncontrolled the production of these will actually be encouraged at the expense of the controlled ones which are really more important. Controlled prices in the factor market prevent that delicate mechanism from making its proper contribution to efficient production, while the lessening of competition, which is the inevitable consequence of price control, removes another incentive to efficiency. The apparatus of control itself with all its licences, permits, registers and forms causes innumerable small delays in production and distribution. It also employs many people, both in the civil service and on the staffs of traders and manufacturers, who might otherwise be ministering far more directly to the wants of the consumer. If inflation is unavoidable it is better to control it but it is far better not to have inflation at all.

We have taken wartime government borrowing as our example of inflation because government borrowing is the only cause which has ever produced serious inflation in the course of history. From the Spanish vellon inflation of the seventeenth-century, through the French assignats of 1789 to 1797, the British inflation of the wars with France from 1793 to 1815, to the great inflations which resulted from the two most recent wars, government borrowing-and-spending has always been the active cause. When inflation gets completely out of hand, it is necessary to reorganise the currency in order to restore public confidence, but this has always been accompanied by a drastic reduction in government borrowing, and it could not be effective unless this were so.

Theoretically, anything which increased the total rate of

spending might cause inflation, but in practice serious inflation has never occurred except as a result of government borrowing in emergency. Modern economic systems have usually operated well below the point of full employment, and no inflationary tendency, except government borrowing, has ever been sufficiently large or sustained to push the system to full employment and produce much true inflation. Occasionally a boom in private investment or an unusually heavy demand for exports has led to mild inflation, but such inflation has always been held in check, partly because the cause itself was transitory, and partly because the banking system (when not subject to government pressure as in wartime) has usually kept down the quantity of money and so caused a sharp rise in the rate of interest. A *restriction* of the quantity of money has sometimes been the means of curbing a potential inflation; an *increase* in the quantity of money has never been the cause of one. We have seen in theory that though this is possible it is very unlikely, and history records not a single case in which it has happened; during a period of inflation the quantity of money increases, but the increase usually *follows* the rise in prices. The increase in the quantity of money acts like the removal of a brake, and although taking off the brake allows the car to move, it does not cause it to do so.

This study of inflation should throw some light on a number of other questions. First there is the role of saving in economic life. Readers who have been accustomed to regard saving as a virtue, and who have been urged to save for the past seven years, may be somewhat puzzled to find saving appearing as one of our principal scapegoats. The reason is, of course, that the attempt to save is socially wasteful unless it is accompanied by a desire to borrow and spend. In wartime when the government is borrowing and

spending all and more than all that its citizens are willing to save, then saving is a social virtue, and so it is, too, when investment is booming and private persons are willing to do the borrowing-and-spending. When, however, borrowing falls short of the saving which people would wish to do out of full employment income, it is a case of the more thrift, the less employment. It was quite right to encourage saving during the past seven years, but it was dead wrong to do so during the crisis of 1931.

Again, it should now be obvious that there will be a big difference between an economic system normally working at or very near full employment, and one working well below that point, as we have known it in the past. In the past an increase in the rate of spending has had to push income up to the point of full employment before it could produce inflation, and it is very seldom that an inflationary tendency has been strong enough to do this. In the future we must maintain full employment, but then any increase in effective demand, unless offset in another direction, will at once produce inflation. The inflation will not be serious unless the incentive to increased spending is strong, but there is always the risk of some unforeseen circumstance causing serious inflation. Clearly, therefore, we must be much more watchful against inflation in a fully employed economy, especially if we are to work without irksome direct controls.

One of the most serious difficulties will be to adjust our methods of collective bargaining so as to allow the free working of the labour market while avoiding a general rise in money wages which could only lead to "cost inflation". This matter is discussed below.

Another set of problems arises in connection with money and interest rates. When there is unemployment, there is no real cost to the community when someone borrows in

order to acquire capital goods. No one has to do without anything else because of the transaction; indeed just the opposite is the case for there is actually an increase in the production of other things because of it. There seems no reason, therefore, why the borrower should have to pay any interest on his loan, apart, of course, from a risk premium, and indeed the practical necessity for him to do so arises simply from the need to bribe the lender to hold his wealth in a form other than money.

At a time of full employment, however, there is a need for society as a whole to choose; if we are to have more capital goods, someone has to go without something else, i.e. the community as a whole must save *instead* of spending and not merely save more out of a bigger real income. In order that society may add to its stock of capital goods in time of full employment, some individuals must save instead of spending; if, other things being absolutely equal, they would prefer to spend, it will be necessary for them to be paid to alter their decision and it is only right that this payment should be charged up to the borrower. This is the fundamental social justification for the rate of interest in time of full employment, but it also has other functions. It acts as a brake on inflation; if there is an increase in the rate at which people desire to spend then, in order to avoid inflation some people must be induced to borrow less or save more, and a rise in the rate of interest will have some effect in both these directions. Also, if it is necessary to cut down borrowing-and-spending, a rise in the rate of interest will ensure that the projects which are expected to be least profitable drop out first. So long as we have unemployment, or so long as full employment is only maintained by government borrowing undertaken specially for that purpose, it does not matter how low the rate of interest drops; the lower the

better. If full employment is maintained without deliberate government borrowing, however, the rate of interest comes into its own again.

If the government borrows by the issue of banknotes this will tend to depress the rate of interest on all loans, but especially short term loans. If it borrows on short term bills and not on bonds, that will tend to reduce the rate on bonds, and raise that on bills. There are some writers (e.g. Prof. Polanyi) who suggest that when government borrowing is required to expand income and employment, it should take place entirely by the issue of banknotes. This would certainly depress the rate of interest, especially on short term loans to a very low level; it would also mean that an enormous quantity of notes would be in the hands of the public. If the public likes to hold its wealth in banknotes there is no reason at all why it should not, and if the burden of interest on the national debt is reduced, so much the better for the taxpayer. So long as we have a potentially deflationary situation only counteracted by deliberate government borrowing, this argument is sound. But if we have a potentially inflationary situation an increase in the rate of spending would precipitate true inflation. The fact that there is a large amount of money about will not cause anyone to spend more, but it will enable property-holders to spend more easily if they want to. If property-owners held their savings in loans instead of money they would have to sell these in order to spend the proceeds. This selling pressure would cause a fall in security prices and so impose a penalty on the would-be spenders. Money, however, can be spent immediately, which is why people like it. The existence of a very large quantity of money would make it impossible to raise interest rates quickly and so we should be deprived of one of our main checks on inflation in the absence of direct controls.

So long as there is chronic underspending by the general public, this does not matter in the least; and any increase in such spending merely allows the government to decrease its own borrowing-and-spending; the danger only arises when there is a tendency towards over-spending on the part of the public. Clearly then, this policy, very suitable for the one set of circumstances, is very dangerous for the other.

CHAPTER NINE

BOOMS AND SLUMPS

IF WE TURN back to the diagram on p. 10 we see that we were suffering from chronic unemployment over the whole of the inter-war period, but that it was roughly twice as bad in some years as in others. Further, if we looked back over the course of history we should find that similar variations have been going on during the whole period for which we have economic statistics. They can be clearly traced to the end of the eighteenth century and dimly even further back, right to the beginnings of modern industrial society. We have already given an explanation of chronic unemployment, but so far we have seen no reason why there should be these great variations in activity. The study of the "Trade Cycle", as these variations are usually called, involves some of the most advanced methods of technical economics, and we can only give the bare outline of it here. Let us begin by collecting the most important facts which are shown by the statistical study of past cycles.

(1) The fluctuations are surprisingly regular. Years of exceptionally good trade, marked by high prices and a high level of employment and production, occur about once every eight or nine years, and between each there is a year or two of exceptionally bad trade. Occasionally the interval is a little shorter or a little longer than the average, and some booms are higher, some slumps deeper than others, but on the whole it is the regularity which most impresses one, and which justifies the use of the term Trade Cycle.

(2) The cycle is international in character. In its recent

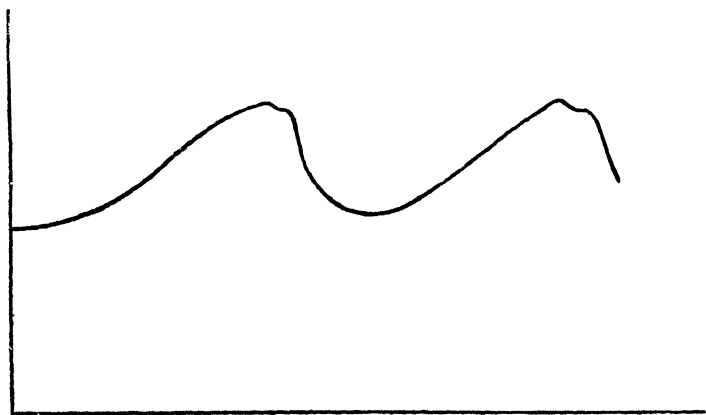
manifestations, it has spread over almost the whole civilised world, and only those countries with rigidly controlled economies have been able to escape it.

(3) The cycle is most marked in the case of capital goods, especially capital goods which are durable. The production of these, and consequently employment in the industries making them, varies much more than does that of most consumer goods.

(4) The cycle is marked by large variations in prices and wages, and there is a tendency for prices to rise faster than wages in a boom and to fall faster in a slump.

(5) The rate of interest usually changes very little in the course of the cycle, though the rate for short-term loans often rises sharply for a short time at the peak of the boom.

(6) The cause of change is not quite a smooth up and down movement; the downswing is usually more rapid than the upswing, and there is a narrow plateau at the top. If we draw a curve of trade activity through the cycle it would tend to run rather like this.



A long steady upward pull, gaining a little in steepness as we approach the top; a slight drop, the narrow plateau and then the precipice. Most of the downward movement usually takes place in the first year or two of depression, to be followed by a year or two of stagnation and several years of steady recovery before the boom is reached. Then comes a slight check and a pause of just a few months before the rapid descent into depression begins again.

These are the most important observed facts about the cycle. We cannot accept any explanation which does not fit them all in; if we find one that does, it will probably not be very far from the truth. We can look for our explanation by the same methods as we have been using; we know that anything which affects total effective demand will cause a variation in income and employment. We know, too, that an initial change in spending will ultimately cause a change in total income considerably greater than itself through the "Multiplier Effect".

The most likely place to look for a change in effective demand is in the volume of private borrowing-and-spending on capital goods. Capital goods are required not for their own sakes, but for the production of other goods; the demand for capital goods therefore depends on the demand for consumers' goods, and from this there follows a very important relationship. Suppose that, at constant prices, and with no change in the productive process, an industry is making additions of £1,000,000 to its capital each year. If these additions are to be justified, consumption of the products of this industry must increase by an amount large enough to keep this equipment fully occupied, say by £10,000,000 a year. If consumption increases by more than this, then the rate of borrowing-and-spending will go up; if consumption increases by less than this, borrowing-and-

spending will go down. If consumption ceases to increase and merely remains constant, no new capital at all will be needed, while if consumption declines, some of the existing capital will be redundant, and replacements will be neglected until the amount of capital in the industry falls to what is required. To put this in a general form, the rate of new investment depends not on the rate of consumption but on the *rate of increase* of consumption.

In order to see the importance of this, we will adopt the device familiar in economic analysis of ignoring for the moment all the complicating factors. We will suppose that there is no increase in capital due to new inventions or an increase in population, and we will ignore changes in prices, in the rate of interest and in expectations as to the future. In these conditions there would be no addition to the capital of the community in the long run, addition made at one time being used up at another. Both borrowing-and-spending, and saving would in the long run be zero. If at one moment people wished to make a net addition to capital that would bring about an increase in voluntary borrowing-and-spending, carrying it to a level higher than that of saving and causing an increase in income; if people failed to make replacements, that would lead to a decline in income.

Now suppose that some net borrowing-and-spending takes place. The Multiplier Effect will come into play, national income and employment will go up and consumption will increase. Thus far the new investment might appear to be justified, but as the rate of saving out of increased incomes goes up consumption will increase less rapidly (see Multiplier diagram, p. 46), and so the hopes of the investors will be disappointed. When we reach a new equilibrium with saving again equal to desired borrowing-and-spending, income and consumption will cease to grow

altogether. This is the peak of the boom. At this point no further new capital will be needed, but new capital will be coming into existence as a result of previous orders, some of it will be redundant and industry will use this up by cutting down on replacements. This will reduce the rate of spending and set up a "Multiplier Effect" in reverse, reducing income and consumption and leading to still further postponement of replacements. But as income goes down people will begin to draw on their property (dis-save) in order to maintain consumption. Thus, as capital wears out, we shall again have reached a point at which industry has just as much capital as it needs to provide for current consumption. This will be the bottom of the depression, but it will not be stable any more than was the boom because, with capital continuing to wear out and no new plant being made, there will soon be too little capital. Thus new orders will be placed, the rate of spending will go up, and the whole process begins all over again. Here, then, we have the germ of the trade cycle; it follows from the simple relationships between capital goods and consumers' goods, and between investment and income. It is something which is part of the essential nature of any system in which capital goods are ordered because the buyers expect to sell consumers' goods. Here, then, is an explanation of why the cycle is so general, and why it has been present ever since the dawn of industrial society. Modern society was born with it, and will continue with it unless an operation is performed to correct it.

We can now go back to the complication we have ignored. First, in the real world the increase of population is continually creating the demand for new capital. This means that there will be in the long run some saving and some borrowing-and-spending, apart from the cyclical fluctuations. It also means that in the downswing the reduction

in capital will overtake the shrinkage in consumption more rapidly than it would do otherwise. The depression will be rather shorter and less deep, the boom rather longer and higher, but the fundamental pattern of the movement remains unchanged. Incidentally the fact that in the most highly industrialised countries, the population has almost ceased to increase is one reason why recent depressions have been worse than those of the nineteenth century.

Another and even more important reason for the growth of the amount of capital in that long run is that new inventions are continually providing new investment opportunities. But the pace of new invention is not perfectly regular, and occasionally some great development will cause a sudden increase in the rate of investment. Moreover, it is easier to take advantage of new inventions when demand is expanding; we might expect, therefore, that during the depression, industry would lag behind in taking advantage of new inventions, and that this lag would be made up in the boom. If this is so, the size of the swing between boom and depression will be rather greater than it would otherwise be.

We have noticed that the cycle is marked by considerable changes in prices and wages, with prices varying by more than wages. This will mean a shift to profit in time of boom and a reduction of profits in time of depression, with probable large changes in company saving as a result. As the size of the national income goes up, profits get a larger share of it and company saving increases. Thus savings overtake the desired level of borrowing sooner. In depression the opposite is the case; companies' earnings go down more than total income, their savings drop sharply and so the shrinkage of total savings overtakes more rapidly the shrinkage of borrowing. This behaviour of prices and wages thus tends to damp down fluctuations.

The rate of interest comes into the picture only at the peak of the boom. If the monetary authorities refuse to permit an increase in the supply of money as prices go up, this will cause a sharp rise in the rate of interest, which will check the development of the boom.

When anything has been repeated regularly a large number of times, as the trade cycle has, people naturally come to expect it. We cannot explain the cycle simply by expectations, because people will not be almost unanimous in expecting a change unless they have some reason to do so. But when we know this reason, as we now do, expectations can be fitted into the picture. After a period of good trade business men will begin to feel that this is too good to last. Knowing that bad trade has followed good in the past, they will expect it to do so in the future. If they expect a period of falling demand and falling prices, they will see little advantage in new investment, especially as the price of capital goods will now be high, and this growing reluctance to borrow and spend will itself help to turn the boom into depression. Similarly, when trade has been bad for some time and prices are low, business men will expect things to look up, and will feel like buying capital goods cheaply now in order to take advantage of the profits which lie ahead. The very fact that they do this will, of course, help to bring about revival. Thus the mere fact that business men expect booms and slumps will help to bring them about.

We can now put all these influences together, and give a fairly good description of what actually happens in a real trade cycle. We begin with the upswing. Trade has been bad and the rate of investment low. The increase in population and the progress of invention have increased the opportunities for employing capital, and the supply of capital goods in existence has lagged behind. Furthermore,

business men expect the situation to improve, and so will take an optimistic view of the opportunities. There will thus be an increase in borrowing-and-spending, which will cause an increase in employment in incomes and in consumption. These signs of improved trade will strengthen the expectations of improvement and so the boom gets under way. As the boom goes on, prices will begin to rise and this will cause unions to press for higher wages, but wages will lag behind prices and there will be a shift to profit. Meanwhile, several things are happening which are sapping the strength of the boom. Industry will be catching up on the new inventions which it has neglected in the depression and as these are exploited the opportunities afforded by new methods will diminish in number. The shift to profit, with its increase in company saving will hasten the pace at which saving overtakes the desire to borrow and spend. As the two come nearer to equilibrium, consumption will increase more slowly, and those who have bought capital goods in anticipation of increased consumption will be disappointed. Rising prices and an increased demand for money may cause the rate of interest to rise. Finally, business men will expect the boom to come to an end, and will grow less willing to spend.

All these things will cause the rate of new borrowing-and-spending to diminish until it is no more than the rate at which people are willing to save out of their increased incomes. At this point, income and consumption will not expand any further; we have reached the peak of the boom.

This failure of consumption to expand will disappoint those who have based their purchases of capital equipment on hopes of increasing demand, and will lead to a further slackening in the rate of investment which will now fall below the rate at which people wish to save. At first the

decline in employment will be slight, for consumption will remain very high—this is the little plateau before the precipice. But now that voluntary borrowing-and-spending has fallen below the rate at which people wish to save, a reduction in income will soon follow. This will cause a reduction in consumption, make some existing capital redundant and cause a catastrophic fall in new investment. The expectations of the pessimists will be confirmed, the prospect of falling prices and bad years ahead will make almost all investment projects seem unattractive and even the lure of new inventions will not be tempting so we rush headlong into the depression, with new investment practically suspended and possibly even replacements neglected, and with prices and incomes tumbling.

But the depression, like the boom, carries within itself the seeds of its own undoing. Prices will fall faster than wages and company profits will be cut. Companies will cut their savings and even draw on reserves to maintain dividends or cover depreciation. People who have lost income will also be drawing upon their property, so we may even have negative saving from the community as a whole with quite a high level of income. The shrinkage in savings will thus overtake the shrinkage in borrowing and the decline in income will be checked. This is the bottom of the depression. Meanwhile the supply of capital will be lagging behind the opportunities which are opening up, and expectations will become more optimistic; in fact we are back precisely at the point from which we started.

Of course no two cycles are exactly the same; some of the influences we have described are stronger at one time, some at another, and sometimes purely chance changes in the rate of spending disturb the regularity of the cycle. Nevertheless the picture we have given in the past few paragraphs does

correspond very closely with what history tells us of past cycles.

From this there follow three conclusions:

(1) The root cause of the trade cycle is to be found in fluctuation in private borrowing-and-spending.

(2) These fluctuations are inherent in the nature of a system of free enterprise, for they follow from the relationship between the demand for capital goods and the demand for consumers' goods, and the essence of free enterprise is that private firms are free to decide on their purchases of capital goods in the light of what they expect to make and sell. A policy which is to secure full employment will, therefore, have to include measures to counteract cyclical fluctuations.

(3) In counteracting these fluctuations the crucial point is the small plateau on the edge of the precipice. It is the fall in consumption due to a slight decline in the rate of borrowing-and-spending at this point which pushes the system over into the abyss. If we could prevent this decline in consumption, or offset it by some other form of spending, we could save ourselves from going over the precipice, and stabilise our economic system at a high level of employment.

CHAPTER TEN

FOREIGN TRADE

SO FAR we have said very little about foreign trade, and have excused ourselves by making the convenient assumption that transactions with foreign countries cancel one another out. It is now time to remedy that omission by studying how changes in foreign trade affect the domestic economy of a nation. This is highly important when talking about Britain, for foreign trade plays a more prominent part in our economic life than in that of any other major country in the world. In the immediate pre-war years, imports formed roughly one fifth and exports one eighth of our national income. The commodities on the import list were mainly food and essential raw materials. Among foodstuffs we imported two thirds of our cereals, nearly half our beef and more than half our pork and bacon, two thirds of our mutton, nine tenths of our butter, two thirds of our cheese, three quarters of our sugar and the whole of our oilseeds, citrus fruits, bananas, dried fruits, tea, coffee and cocoa. The list of essential raw materials wholly or mainly imported includes aluminium (100 per cent), copper (95 per cent), nickel (100 per cent), tin (100 per cent), zinc (100 per cent), timber, cotton (100 per cent), wool (80 per cent), hemp (100 per cent), jute (100 per cent), silk (100 per cent), rubber (100 per cent), petrol (100 per cent). Without such goods a modern industrial state cannot live: indeed they are almost as necessary as food itself.

We in Britain cannot do without imports; we cannot even cut them down much without seriously reducing our

standard of life, and in order to pay for imports we must export a large amount of the manufactures we produce. The terms on which we can exchange manufactured goods for food and raw materials are therefore very important to our standard of living. A rise in the price of food and raw materials in relation to manufactured goods would mean that we should have to export a greater volume of goods in order to buy the same amount of imports, and so would make us appreciably poorer. Another consequence of the great part which foreign trade plays in our life is that our economic system is very sensitive to changes taking place in foreign countries—if our customers are prosperous, they buy more British goods, and incomes and employment in Britain go up; if our customers have a trade depression, they buy less from us, and British employment and incomes go down. Thus prosperity or depression abroad very quickly affect our own economy.

It might seem that this great dependence on foreign trade is a dangerous thing, but the risks are worth taking for the great gain in wealth which comes about through specialisation, and through each country concentrating on those goods in the production of which it enjoys the greatest advantage. There is nothing special about the reasons which give rise to foreign trade; they are just the same as those which cause South Wales to “export” steel sheets to England and “import” motor-cars. The advantages gained from international specialisation are often greater than those of regional specialisation because of the greater diversity between different nations, and international trade is complicated by the use of different currencies and by the fact that it is subject to tariffs and other controls, which no government would now think of imposing on trade between different parts of its own country.

The different factors of production are not spread evenly over the whole world, but are concentrated in certain parts. This is most obvious in the case of climate and natural resources. Gold and iron, coal and copper and oil are found only in a few small corners of the earth; a climate suitable for growing cotton or rubber, oranges or rice exists only in certain areas, and these things can only be grown elsewhere under hothouse conditions created at tremendous cost. Clearly there are many of these goods which a country like Britain must buy from abroad because we have not the soil or climate from which to produce them at a reasonable cost.

But differences between countries are not confined to soil and climate. Some areas are far more densely populated than others, and some countries have accumulated much more capital than others. It is true that people and capital can be moved as climate and mineral deposits cannot, but in practice movement is difficult, especially when it involves crossing frontiers and entering a strange country with a different language and way of life. Instead of moving the factors of production themselves, it is easier to move the goods which they produce; hence nations with a dense population and a large accumulation of capital (such as Britain) specialise on manufactured goods which require a high proportion of these factors; other countries, thinly populated and with comparatively little capital but abundant land (such as Australia and the Argentine), go in for primary products derived from extensive agriculture. The two types of country specialise on different things, and exchange their products.

Another advantage of international specialisation is that it allows an industry to take the fullest advantage of economies of large-scale production. If each country tried to be self-sufficient, some of the national industries would have to be

very small because their home market would be so limited, and no one would take their exports. Hence they would be comparatively inefficient and production could be improved if several countries each specialised on a few commodities, built up big industries turning out these few things, and exchanged part of their product for the goods of other lands.

The actual transactions which make up international trade are, of course, brought about through the working of the market system, and arise because a trader sees the chance of a profit by buying in a market where price is low and shipping his goods for sale to another market where their price is higher. But this is only another instance of the profit of the individual coinciding with the advantage of society, for the price differences which give rise to trade themselves reflect differences in the real effort required to produce the goods. The greater the freedom which traders enjoy, the greater the opportunities for each country to specialise on the goods in which it has the greatest advantage in real effort, and the greater the wealth-producing capacity of the world as a whole. Restrictions on trade are almost bound to damage the wealth of the world as a whole even though they may sometimes be in the short-term interest of the country imposing them.

The fact that different countries use different currencies introduces the complication of a further market (the foreign exchange market) and a further system of prices, the prices of currencies in terms of one another. These prices, or rates of exchange, help, like the prices of goods, to determine the course of foreign trade. Suppose that the sterling-dollar exchange rate is \$5 to £1, and that an English manufacturer is producing articles for sale in America at a total cost of £1 each. It will not be worth his while to do this unless he can get a price of at least \$5 in America, since it

will take \$5 to produce £1 in England. If the value of the pound now dropped from \$5 to \$4, our manufacturer will be able to sell at anything over \$4, since \$4 will now be enough to give him the £1 that he wants. When a currency exchanges for less of a foreign currency than before, we say that the exchange rate has fallen, or that the currency has depreciated. From our example it is clear that the depreciation of a currency will stimulate exports and check imports, while appreciation will check exports and stimulate imports.

The price of one currency in terms of others is determined, just like the price of a commodity, by supply and demand. In the short-run, changes in supply or demand may be met by changes in the stocks held by bankers and exchange dealers, but a change in these stocks will soon lead to a change in price and in the long run the price of a currency, like that of a commodity, must be fixed at a level where supply and demand are equal.

The supply of pounds and the demand for foreign currencies comes from British citizens who wish to make payments abroad. The demand for pounds and the supply of foreign currencies comes from foreigners who wish to make payments in Britain. There are a number of reasons which may lead to the exchange of one currency for another. The most obvious one is payment for goods bought and sold, but payment for services (e.g. shipping, banking, insurance, and services performed for tourists visiting a foreign country) and the payment of interest on investments held by foreigners also give rise to exchange transactions. These are known as invisible imports or exports as the case may be. They are invisible in that they cannot be seen and counted and recorded by the customs officer as are movements of merchandise; from the point of view of the country providing

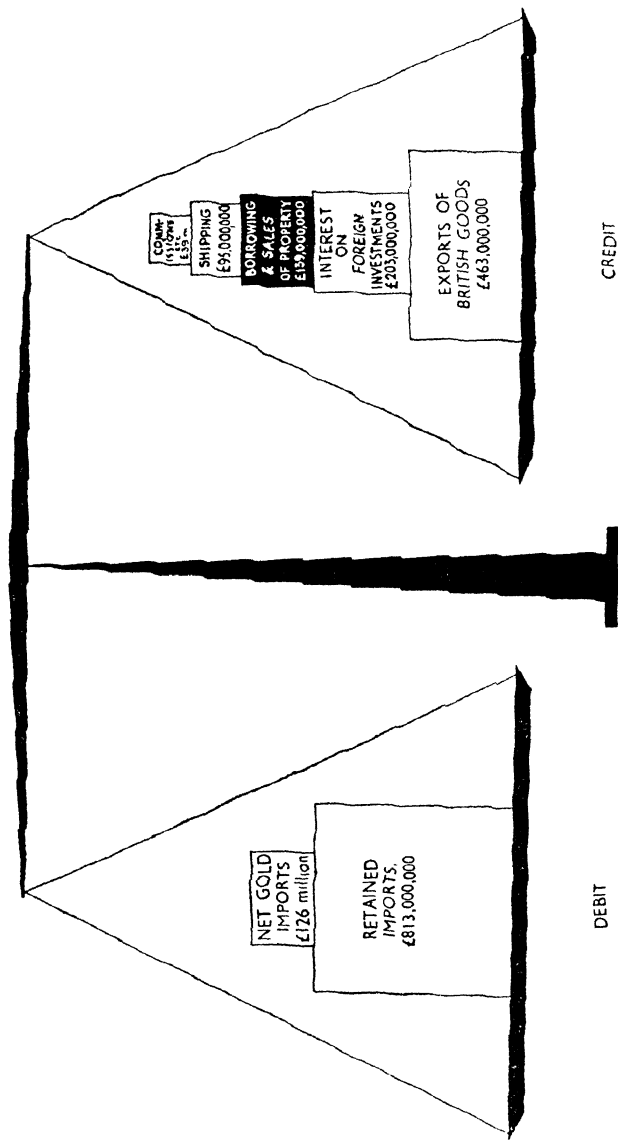
the services or receiving the dividends, they are like exports in that they provide a supply of foreign currency. From the point of view of the country receiving the services or paying the dividends they are like imports, in that they create a demand for foreign currency. Merchandise transactions and "invisible items" are often lumped together under the label, "current account", since they all arise from the production or distribution of current income.

As opposed to transactions on current account, we have transactions on capital account. The purchase or sale of property, making or repayment of loans, the increase or decrease of bankers' stocks of foreign currency (really a form of short-term borrowing or lending) all come under this heading. The man who wants to buy property or subscribe to a loan or build up a bank deposit in a foreign country must first buy the foreign currency in exchange for his own. Hence these transactions, like imports, create a demand for foreign currencies, while their opposites, like exports, provide a supply. Another capital transaction, usually kept separate in published figures, is the import or export of gold. The import of gold, like the import of any other commodity, provides a demand for foreign currency; the export of gold creates a supply.

A nation's balance with the rest of the world, when all these items are considered, has to remain balanced all the time, for the simple reason that payments can only be made abroad if foreigners will sell their own currencies, and they will only sell if they require the proceeds for one or other of these purposes we have mentioned. If a country has a credit balance on current account it must add to its foreign assets either by buying property, making loans, increasing its stock of foreign currency or importing gold. A country which has a debit balance on current account must reduce

Diagram 8.

THE BALANCE OF PAYMENTS OF THE UNITED KINGDOM WITH FOREIGN COUNTRIES
AVERAGE OF 1935-7



its foreign assets either by selling property, accepting repayment of loans, reducing its stock of foreign currencies or exporting gold.

In order to show Britain's foreign trade position more clearly we set out, in the table overleaf and diagram 8, the balance of payments for the average of the years 1935-7. For very many years past British imports of merchandise have been much greater in value than exports, and the gap has been bridged by the invisible items. Until quite recently the invisible items more than made up the deficit, and there was in most years a considerable credit balance on current account. Since 1931 this surplus has disappeared and in the years we have chosen, there was a small deficit. Conditions in many parts of Europe were unsettled, and the inhabitants of these countries were anxious to buy property and build up bank balances in England. This created an extra supply of foreign currency far greater than was needed to meet the small deficit on current account, and the balance was preserved by large imports of gold.

BALANCE OF PAYMENTS OF THE UNITED KINGDOM
WITH FOREIGN COUNTRIES

AVERAGE OF YEARS 1935-7

£ MILLIONS PER YEAR.

DEBIT				CREDIT					
				CURRENT ACCOUNT					
Imports	.	.	.	813	Exports	.	.	.	463
					Net income from foreign investment	.	.	.	203
					Net income from shipping	.			95
					Short interest and commissions	.	.	.	32
					Miscellaneous items	.	.	.	7
					Deficit on Current Acct.	.			13
				813					813

CAPITAL ACCOUNT

Deficit on Current Acct.	.	13	Sales of property and net		
Import of gold	.	126	increase in foreign in-		
			debtedness	.	139
		139			139

Because a country's account with the rest of the world must balance, it does not follow that a similar balance must exist with each country separately. A debit balance with one country can be offset against a credit balance with another. For example, Great Britain has a debit balance with the United States, and a credit balance with Malaya, while Malaya in turn has a credit balance with the United States. We thus have this situation in the financial capitals of the three countries:

NEW YORK

Supply of U.S. Dollars.
Demand for Straits Dollars.

SINGAPORE

Supply of Straits Dollars.
Demand for Pounds.

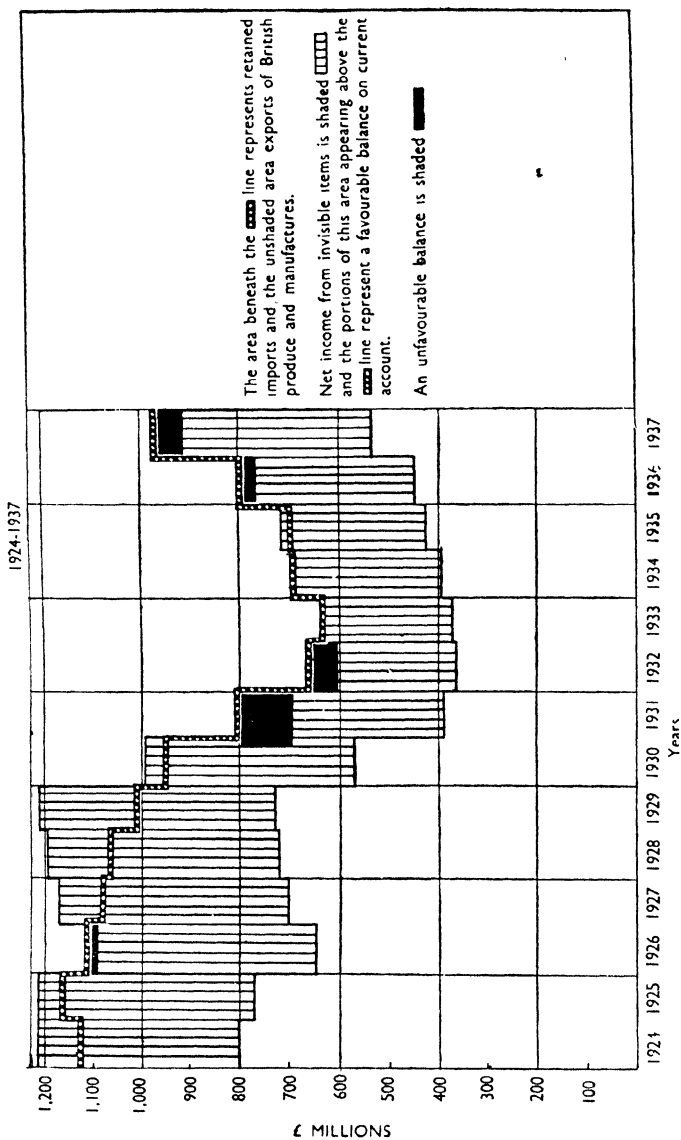
LONDON

Supply of pounds.
Demand for U.S. Dollars.

The exchange operator in London will have customers paying him pounds and demanding to have dollars paid to their American creditors. But he need not buy the dollars directly, and in this situation he will probably find it very slightly cheaper to sell his pounds in return for Straits dollars in Singapore and then sell these for American dollars in New York. By this three cornered operation the British credit with Malaya is offset against the debt to the United States, and the United States debt to Malaya is also settled in the process. This system by which traders buy freely in any market they like, and the resulting debts and credits are offset in the foreign exchange market, is known as

Diagram 9

THE BALANCE OF PAYMENTS ON CURRENT ACCOUNT OF THE UNITED KINGDOM.



multilateral trade. If multilateral trade is to thrive, it is essential that, in the leading foreign exchange markets of the world, it should be possible to exchange any one currency for any other.

The balance of payments with the world as a whole must balance, but what of the mechanism which preserves the balance in face of all the variations to which international trade and finance are subject? In discussing this we must distinguish between the balance of payments on current account and on capital account.

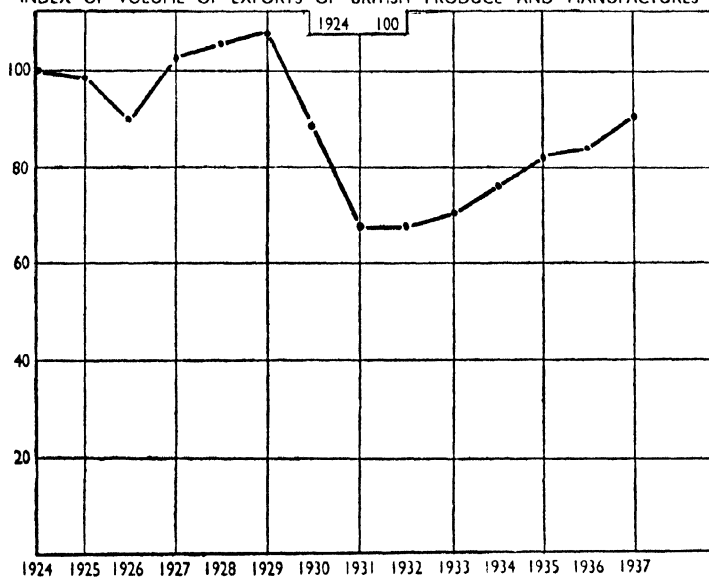
The portion of their incomes which British residents pay to foreigners gives employment not to British but to foreign workers. Similarly, when foreigners make payments to Britain, that gives employment to British workers instead of to those of other countries. Hence a "favourable" balance on current account (i.e. foreigners spending more in Britain than British citizens spend abroad) is a stimulus to employment; the more favourable the balance the greater, other things being equal, will be the rate of domestic spending.

The changes in the balance on current account between 1924 and 1937 are shown in diagram 9. The area beneath the dotted line in each year represents the value of imports, i.e. British spending abroad. The white area shows the value of exports, and to this we add the invisible items, represented by the shaded area, in order to get the total spending by foreigners in Britain. When the shaded area rises above the dotted line, this shows a "favourable" balance on current account, when it falls below, the balance is "unfavourable". The amount of the "unfavourable" balance is shown in black.

Before the war of 1914-18, Britain had a large "favourable" balance. This was maintained, though on a reduced scale, from 1924 to 1930, except in 1926, when exports suffered from a general strike and a prolonged coal strike. But the

Diagram 10

INDEX OF VOLUME OF EXPORTS OF BRITISH PRODUCE AND MANUFACTURES



world economic depression caused a great change, turning a large "favourable" balance in 1929 into an equally large "unfavourable" one in 1931, and the debit balance continued through the nineteen-thirties, except for 1935.

It is apparent from the diagram that the change in the balance of payments was due largely to the falling off of exports during the depression, and to their failure to recover fully. This is brought out more clearly still in Diagram 10, which shows changes in the "volume" of exports, i.e. changes in value corrected for differences in the price level. In the boom of 1929, exports were 8 per cent higher than in 1924, but from 1929 to 1931 they declined by nearly 40 per cent. Recovery was slow and far from complete, for in the boom year of 1937 exports were still 10 per cent less than in 1924, and nearly 18 per cent less than the peak of 1929. It has been estimated that this decline in exports caused a drop in employment in the export industries of 920,000 between 1929 and 1931, and of over 450,000 comparing 1937 with 1924.¹ To this primary unemployment, we should have to add the secondary unemployment resulting from the Multiplier Effect. It is obvious, therefore, that the decline in exports and the failure to find any compensating increase in demand was a very serious cause of unemployment in the nineteen-thirties.

When exports go down, the income of the exporting country goes down too, and this means a reduction in the demand for imports. Of course, this reduction will not be so great as the fall in exports, as only a small part of income is spent on imported goods, but it will go some little way to preserve the balance, and so the burden on the purely financial adjustments will not be so great.

In the case of capital movements, however, this direct

¹ E. A. G. Robinson in *The Economic Journal*, April 1945, p. 73.

effect is not present. If citizens of this country subscribe to a foreign loan, or if foreign holders of bank balances in London decide to withdraw them, there is nothing in these actions which will in itself make any British citizen buy less imported goods. In this case the balance of payments has to be maintained wholly by monetary means.

These means will vary according to whether a currency is on a gold standard or not. The characteristic of a gold standard is that the currency should be convertible at will into a fixed weight of gold. A foreign exchange operator can either buy a foreign currency in the exchange market, or he can buy gold, ship it to the foreign country concerned, and there convert it back into the currency he wants. Naturally he will do whichever is the cheaper. The cost of shipping gold, in the large quantities in which bankers deal, is very small, and so the values of currencies on a gold standard cannot fluctuate by more than a very narrow margin. When Britain and the United States were both on a gold standard, the par value of the pound was 4.867; when the value of the pound fell to only 4.848 British exchange dealers found it cheaper to ship gold instead of buying in the exchange market; when the pound rose to only 4.892 American operators began to ship gold to England.

Gold is thus the balancing item in the account; a country which is a creditor in respect of other items imports gold; a country which is a debtor exports it. But in order to export gold, one must possess a stock, and a country which had a debit balance on other items indefinitely would sooner or later run out of gold and be forced off the gold standard. Hence, if a gold standard is to be maintained, gold movements must be followed by other changes, which will remove the cause of the deficit. These adjustments are summarised in the following table:

ADJUSTMENT OF BALANCE OF PAYMENTS UNDER A GOLD STANDARD.

DEBTOR COUNTRY	CREDITOR COUNTRY
1. Export of Gold.	Import of Gold.
2. Central bank reduces quantity of money.	Central bank increases quantity of money.
3. Rise in interest rates.	Fall in interest rates.
4. Foreign loans encouraged.	Foreign loans repelled.
5. Home investment discouraged.	Home investment encouraged.
6. Income (and power to buy imports) reduced.	Income (and power to buy imports) increased.
7. Costs and prices lowered.	Costs and prices raised.
8. Less imports, more exports.	More imports, less exports.

In theory it might seem that here was a beautiful automatic mechanism, a perfect gyroscope for keeping the balance of payments on an even keel, but there are serious practical difficulties. The first comes as early as stage 2. The central bank of the debtor country must reduce the quantity of money and start the deflationary process on pain of having its gold reserve drained away, but there is no such compulsion on a creditor country. The monetary authority in the creditor country may prefer to "sterilise" its gold, not allowing it to produce any expansion of the currency, and so cutting off the inflationary process before it starts. But even if the creditor country does expand its currency and reduce the rate of interest, this may have very little effect. As we saw in chapter six, a rise in the rate of interest is much more powerful as an instrument of deflation than is a fall as an instrument of inflation. Hence the gold standard, as it has been operated in the past, has a deflationary bias, and leaves the debtor country with more than its share of the burden of adjustment.

Another serious defect is that the gold standard method of adjustment works by reducing income and creating unemployment. In theory this should be only temporary for wages and prices should come down, this should produce an

expansion of exports and divert spending from imports to home products; and this in turn should raise income until resources are fully employed, but at a lower level of prices. In practice, however, it is very difficult to bring about a general reduction in money wages, and so the system tends to get stuck at stage 6 leaving the debtor country faced with a long period of unemployment.

The alternative to the gold standard is a system of free exchanges, by which the value of currencies is not tied to gold, and their price is left to find its own level in the exchange market. Gold in this case has no more significance than any other commodity. The mechanism of adjustment, now much simpler, is summarised thus:

ADJUSTMENT OF THE BALANCE OF PAYMENTS UNDER A SYSTEM OF FREE EXCHANGES

DEBTOR COUNTRY	CREDITOR COUNTRY
1. Fall in exchange value of currency.	Rise in exchange value of currency.
2. Foreign loans attracted.	Foreign loans repelled.
3. Exports stimulated, imports checked.	Imports stimulated, exports checked.

The fall in the value of the currency now operates directly in stimulating exports and checking imports, without the intervening stage of reduced incomes and employment at home. Also when the relative value of the debtor currency falls, that of the creditor currency automatically rises, and this checks exports and stimulates imports in the creditor country. The process of adjustment is thus shared evenly between debtor and creditor instead of pressing almost wholly on the debtor as it tends to do under a gold standard. When a country has a debit balance because its export prices are too high in relation to prices in other countries, there is no doubt that exchange depreciation is a less painful cure than deflation.

Nevertheless, exchange fluctuations can be a great evil, especially when they are complicated by changes in short-term borrowing and lending. In the inter-war period slight changes in political or economic conditions led people with bank balances in one country to transfer them to another. These movements of "hot money" were very large in amount and, if exchanges had been left entirely free, they would have caused violent fluctuations in rates. Unstable exchange rates make it impossible for the trader to face the future with confidence. The manufacturer making for export must estimate how much he can sell in a foreign market several months before his goods actually come up for sale. Unless he knows how his own currency will exchange for a foreign one, he has no idea of the price he will have to charge in an overseas market and hence of the sales he can expect. The importer is in the same boat for, when he looks ahead for his supplies, he has no idea how much the foreign exporter will have to charge in order to cover his own costs. Unstable exchange rates thus add enormously to risk, and are a great discouragement to foreign trade. It was for this reason that the Exchange Equalisation Account was set up in 1932, in order to offset fluctuations by selling pounds when foreigners wanted to transfer balances to this country, and buying them back when balances were moving out.

CHAPTER ELEVEN

BRETTON WOODS

THE EXCHANGE Equalisation Account was an attempt to get the best of both worlds by combining reasonable stability in exchange rates with reasonable stability in home income and employment. A further notable development in the same direction is the International Monetary Fund set up as a result of the Bretton Woods Conference.

The agreement begins by stating that members of the Fund shall fix the value of their currencies in gold, and maintain free convertibility at the fixed value, and for this reason our joining the fund was attacked as a return to the gold standard. But if the Fund is a gold standard, it is a very different gold standard from the one we have just described.

First, although currencies are to be freely convertible at not more than 1 per cent above or below their gold values for current transactions, capital movements are to be controlled. The monetary system of the world is not to be troubled any more with "hot money".

Secondly, the Fund itself provides a source from which members can borrow to meet a short-run deficit. Each member has a quota, which it pays in in gold and in its own domestic currency (chiefly the latter). The Fund thus accumulates a currency pool, and members who require more foreign currency can, up to a prescribed limit, put in more of their own money and take out an equivalent amount of the foreign money they need. The Fund thus adds substantially to the monetary reserves of members, and makes the process of adjustment correspondingly easier.

Thirdly, the value of currencies is not regarded as permanently fixed as by an ordinary gold standard, but provision is made for orderly changes in values when these seem desirable. A government may alter the gold value of its currency by up to 10 per cent of its original par merely by notifying the governing body of the Fund of its intention. Changes greater than this require the consent of the governing body, but the agreement stipulates that such consent shall be given whenever the change is necessary to correct a "fundamental disequilibrium" in the balance of payments, and add that "The Fund shall not reject a requested change necessary to restore equilibrium because of domestic social or political policies of the country applying for a change".

Finally, there is a device which will bring strong pressure to bear on a creditor country as well as a debtor to take its share in redressing the balance of payments. If one country has an export surplus which is not balanced either by invisible items or by foreign lending, other countries will run short of its currency. In order to prevent it from rising above the permitted price in the exchange market, the central banks of all the countries in debt to this particular one will "buy" extra supplies from the Fund. But the Fund has only a limited stock of any currency, and if this state of affairs continued, that stock would soon run out. If this threatens to happen, the governing body can declare the currency to be "scarce" and introduce a rationing scheme. The governing body must prepare a report analysing the cause of scarcity and suggesting remedies, and members are allowed to impose control on dealings in the "scarce" currency. This would mean that the creditor country could no longer export unless it provided the means of payment either by taking imports or making loans. The world would have the benefit of an

expert diagnosis of the malady, and the country concerned would be under strong pressure from its own exporting interests to take the appropriate remedy.

In all these respects the Fund is an immense improvement on the old fashioned gold standard. If the nations co-operate in working it as they did in designing it, then we should have a mechanism which will enable us to steer clear both of the deflationary influence of the gold standard and the anarchy of free exchanges.

There are a good many people, however, who do not wish to see this international co-operation, or who are so pessimistic of our securing it that they would rather scrap the "multilateral" system of trade, and rely instead on the "bilateral" system used so successfully by Germany in the nineteen-thirties. The first step to such a system is the establishment of complete control over all foreign exchange transactions. The second step is to use this control to divert trade from countries with which one has an export surplus towards those from which one has an import surplus. In the buyers' market which existed for most primary commodities in the nineteen-thirties the nation with an import surplus enjoyed a strong bargaining position, especially if the seller relied on this market to dispose of a large proportion of his supplies. A primary producing country having an export surplus with a neighbour and relying on this for the sale of a large part of its output was in a weak bargaining position. Such was the situation of several of the countries of South-Eastern Europe in relation to Germany. The last step in building up a bilateral system is, therefore, to turn to countries in this weak position and offer them long-term contracts to purchase their products at favourable prices *on condition that they purchase one's own exports to a similar value*. This is what Germany did

and, of course, the other countries usually accepted. Having accepted, they sometimes found that German exports of the type and quantity required were not available. In that case there was nothing to be done except either put up with inferior goods or accumulate unspendable and inconvertible balances in Germany. By these methods Germany was able to import on terms very favourable to herself.

In the post-war world Britain will have two big foreign trade problems. We shall have to build up enough exports to make up for our losses in invisible exports and enable us to pay for the imports we need and to discharge the debts we have contracted. We must also find a way of preventing large scale unemployment if trade depression in other countries makes them for a time unable to buy their usual amount of our exports. We have to decide whether to rely on "multi-lateral" trade within the framework of the Bretton Woods agreement, or whether to develop a "bilateral" system based on the Sterling Area.

At present we are committed to the first alternative by our adherence to the Bretton Woods agreement, but it does not follow that the issue is settled for good. The bilateralists put up a stiff fight in Parliament and outside to prevent our joining the Fund. A member is allowed by the rules to resign at any time simply by informing the governing body and settling up its account, so it is always possible that any setback to international co-operation will lead to a renewal of the argument, and even to our resignation. Moreover, the present government (1947) is adopting a policy of concluding bulk-purchase agreements for a number of primary commodities, e.g. cotton and wheat. These do not in themselves form "a bilateral" system, for the essence of such a system is the balancing of the account as a whole with each country, but if they were extended to a wide range of goods they would

certainly tend towards "bilateralism". It is, therefore, as necessary to discuss the merits of the two systems now as it was when our joining the Fund was still in doubt.

The bilateral system has obvious advantages, or it would never have come to enjoy the support which it has. It would be a means of making sure of at least a minimum of imports, whatever might happen to our exports, and out of that minimum we could draw up a scheme of priorities, making sure that those goods which the authorities regard as most important have first claim on our purchasing power. As most of the bilateralists are also "planners" this idea appeals to them. We might be able to concentrate our trade on countries which were pursuing full employment policies similar to our own, and so get a greater stability in exports. Again, in a buyer's market we are in a very strong bargaining position with regard to some of our principal imports. We buy over three-quarters of world exports of pork and bacon, beef and mutton and butter, and the countries producing these are very dependent on our market. If we took advantage of this dependence we might drive a hard bargain.

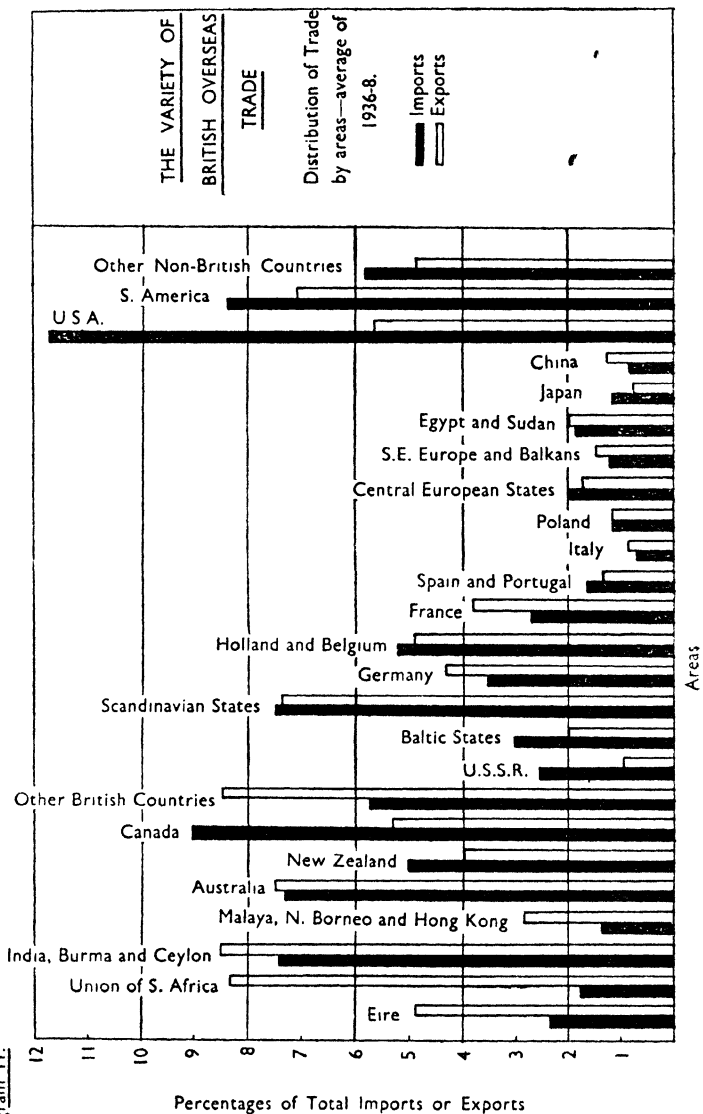
The nature of these arguments reveals the nature of "bilateralism" itself and of its attendant disadvantages. It is essentially a defensive reaction, a system founded upon fear; fear that we shall not be able to export enough to pay our way unless we ram our goods down the throats of anyone weak enough to submit to that treatment; fear that other countries will be misguided enough to wallow in depressions so long and so deep that their inability to buy our goods will create unemployment here and drag us into depression too. Fear is a very bad motive on which to base economic policies; the policies of the inter-war period were largely based on the fear of unemployment, and most of them only succeeded in making unemployment worse.

"Bilateralism" involves a great restriction on trade, and so it limits the power of countries to specialise on the goods they are best fitted to produce, and impoverishes the world as a whole. From this impoverishment it is very unlikely that any one country will emerge in the long-run the richer. Thus, although we might drive a good bargain for the commodities we have just mentioned, there are many others where our bargaining position is weak, and where "bilateralism" would make it weaker.

This especially true of a country like Britain whose trading connections are so extensive. The "Sterling Area" alone is not nearly sufficient to supply our needs, and if we tried to weld that area into an economic bloc we should inevitably suffer discrimination outside. Diagram 11 shows something of the ramifications of our trade in the years 1936-8. Although several countries have been lumped together, no one of the areas shown took so much as 10 per cent of our exports, and only one, the United States, supplied 10 per cent of our imports. In trying to concentrate trade on some of these areas, we should inevitably miss good buying and selling opportunities in others.

The argument in favour of gaining stability by concentrating our trade on countries pursuing a full employment policy like our own is highly unconvincing. It assumes that countries are divided into enlightened sheep with a rational and successful employment policy, and ignorant or perverse goats who will not even try to extricate themselves from the slough of depression. Even if this were so, it would by no means follow that the countries from whom we most need imports would be among the sheep. But in reality all countries want full employment, but none of them are very certain yet how to get it; that will take a lot of thought and experiment in all countries. If, as we believe,

Diagram 11.



we see the way a little more clearly than some of our neighbours, our interest and duty lies in co-operation and leadership, not in subjecting to commercial ostracism any country less successful than ourselves in the pursuit of full employment.

The bilateral policy would involve the violation of our pledges under the Mutual Aid Agreements. It would also involve us in economic and probably political conflict with the United States, and would split the British Empire, for Canada has never been in the Sterling Area and in the case of an economic war between Britain and the U.S.A., Canada could hardly help siding with her near neighbour.

Successful bilateral treaties are based on exploitation of the weak by the strong, on forcing a weak country to take your exports as a condition of selling its own goods, even though its inhabitants could buy what they want more cheaply elsewhere (for if this were not so there would be no need for the treaties). This is a policy of very doubtful wisdom in the long run. The exploited will soon realise their mistake and seek a way out; the market for primary products may not always be a buyers' market, and once the exporters were free of their almost exclusive dependence on our market, our power over them would be gone. Even if it could be practised successfully, this commercial exploitation is repugnant to ordinary morality. It is the policy pursued for the benefit of Nazi Germany by Dr. Schacht, and it would hardly be fitting that we in Britain should imitate his methods.

The British Empire is by far the largest trading group in the world, and as such it is bound to play a leading part in shaping the future organisation of international trade. If the Empire organises itself into an exclusive economic bloc other parts of the world will surely follow suit, and then will

be sown the seeds of world impoverishment and political conflict.

Our decision to join the International Monetary Fund and to co-operate in rebuilding the system of multilateral trade was a right one, both in our own interest and that of the world. It now remains to work with other countries in operating the machine as well as designing it, and to fit in our international obligations with our domestic policy of full employment.

CHAPTER TWELVE

SOCIALISM

WE HAVE now analysed the various causes of unemployment as it has arisen under the system of free enterprise. We have seen that stable employment can only be maintained so long as the total rate of effective demand is equal to the value of current production. Anything which causes a rise in the rate of spending will add to employment; anything which causes a drop, will add to unemployment. The chief sources of fluctuations in employment have been changes in exports and changes in the volume of investment during the trade cycle, and in addition there has been chronic under-employment because of the failure of the rate of spending to keep pace with the rate of output as the latter increases.

The level of employment would be governed by the rate of effective demand in a socialist society as in a capitalist one, but the socialist planning authority would have a comparatively easy task in regulating spending. In a capitalist society total effective demand depends on the balance between what is saved by private persons, companies, and local authorities, and what is voluntarily borrowed and spent by private firms and the government together. In a completely socialist society the government would own all capital and would do all saving, and we should thus be clear of the difficulty that arises because saving and borrowing-and-spending are done by different people.

Government revenue would consist of "profits" (i.e. excess of selling price over costs of production) in government-owned industry, and taxes. Government expenditure

would consist of the ordinary services and transfer payments provided by most modern governments plus capital expenditure in industry. Since private individuals cannot save, the government has only to balance its own budget (i.e. to raise no more in revenue than it spends) in order to maintain the total rate of spending. If the government were to raise more in revenue than it spent, there would be a deflationary influence, if less, an inflationary one. The maintenance of full employment is thus a piece of simple arithmetic for the planning authority, and it is hardly likely that even the most inept bureaucracy would make a serious error here. We could hardly say that the socialists had solved the unemployment problem; rather should we say that the problem simply does not arise in a socialist society, for the root of the problem is the fact that under the system of free enterprise, the saving, and the borrowing-and-spending decisions are taken by different sets of people, whereas in a socialist state both are united in a central planning authority. We need hardly add that this applies only to a completely socialist state, where all saving and investment are "planned". In order to get the advantage you have to go the whole way; a half-socialised economy may be little if any better off than a wholly capitalist one.

We must concede to the socialists that, if they push their ideas to their logical conclusion, they will have no unemployment problem, but it does not follow from this that socialism is a superior form of economic organisation. For socialism, like capitalism, has its own problems peculiar to itself. We showed in chapter two that any system which aims at the greatest happiness of the greatest number must fulfil five tests, of which full employment is only one. What of the other four, freedom of the worker to choose his employment, efficiency in production, fair distribution, and making what the buyer wants.

Freedom of the worker to choose his employment. In theory there is no reason why a socialist state should not give this essential freedom provided that the planners were willing to raise wages in occupations where labour was scarce, lower them in occupations where labour was superabundant, and then wait while these changes produced their effects. In practice, however, it is very doubtful whether a planning authority would exercise this degree of patience, for it is in the nature of the labour market that it only works gradually. It is a big step to change ones job, however much help and encouragement the state may give, and workers will take time to think it over and perhaps linger a little in the hope of getting another job at their old trade before deciding to learn a new one. Thus, when the planning authority cuts down output in one industry in order to expand production elsewhere, there will be temporary unemployment of the type described in pp. 55-6 in the declining industry. Meanwhile the planned expansion in some other industry will be held up for lack of labour. In these circumstances it is highly probable that the planning authority would grow tired of waiting and resort to direction. The traditional attitude of socialist thought, with its emphasis on the duty as well as the right to work, makes this development all the more likely. It would not be surprising, therefore, if freedom remained merely the academic ideal, and coercion became the accomplished fact.

Efficient production. Efficiency depends first and foremost on the use of the socially correct proportions of each of the different factors of productions. This is a matter that cannot be decided for one industry by itself, for it depends on balancing the needs of all the industries competing for limited supplies of labour, land, equipment and materials. Under a system of free enterprise the factor market is the instrument

which balances the needs of one industry against those of another. When any type of labour or material is relatively scarce its price rises, and everyone has an incentive to use it sparingly; when any factor is relatively abundant its price falls and everyone is encouraged to make greater use of it. No alternative to this balancing mechanism has ever been invented, and so far as one can see there is no prospect of such an invention.

The value of the market for distributing the factors of production between different firms and industries is so great that the Russian planners have tried to create a market to replace that which they destroyed, giving each plant a ration of bank credit and instructing the manager to hire the labour and buy the materials he wants. Such a market, however, is very unlikely to work well, for several reasons. The prices at which the managers have to buy are not genuine market prices determined by supply and demand, but are "planned prices", that is prices more or less arbitrarily fixed, and the "ration" of credit is arbitrary, too. Secondly the factor market and the consumer goods market are interlinked. The need of, for example, the motor car industry for men and machines depends on consumers' desire for motor cars in relation to their desire for other things. If consumers want more cars, the industry will need more "factors"; if consumers want more of other things which might be made instead of cars, then the motor industry must use less men and materials, and the factors thus released must be diverted to other uses. A socialist system, as we shall see, measures the desires of the consumer very badly and so it cannot measure the need for factors of production well. Finally, the management of an industry usually has a vested interest both in increasing its size of and in raising its output per man (a most superficial and

misleading test of efficiency). Hence it will be tempted to use political pressure and graft to increase its ration of bank credit and get priorities for anything which is particularly scarce; thus the industry with the most influential contacts will get more than its share of the relatively scarce factors of production.

This last danger is always present in a socialist system, but it is perhaps particularly acute in a partly socialised one, where the prestige of the government depends on the publicly owned industries giving at least a superficially good account of themselves. For example, much public attention has been focused on output per man shift in the coal industry. The National Coal Board has powers to borrow very large sums, while the borrowing of most other industries is still restricted. It is quite possible, therefore, that the Coal Board might embark on unduly lavish purchases of capital equipment which would very considerably raise output per man-shift, and that the socialists might then hold this up to the public as an example of the advances to be made by socialist planning compared with the stagnation of private industry. But, of course, the gain in output per man-shift would be by no means conclusive proof of true efficiency. If it had only been made by using capital equipment which could have been put to better use elsewhere, the result would be less not gain to the country as a whole.¹ Under free enterprise, capital invested in this socially wasteful manner would fail to earn its dividends, and the directors who had made the investment would be very unpopular with their shareholders. Under a publicly owned monopoly, however, there is no such check.

¹ A large amount of new investment in the coal industry is of course, desirable. We refer only to the possibility that it may be pushed to lengths which are excessive in relation to the capital resources available to other industries.

Efficiency also depends on giving maximum incentives to production both to workers and to management. Workers can be paid by piece rates and bonus systems, but what of the socialist management? Under free enterprise the incentive is the prospect of a profit, the penalty for the inefficient is the making of a loss. A socialised firm may be required to keep accounts, and managers rewarded or penalised according to the paper profit or loss which they show, but if the price system is arbitrary, the making of a profit is no longer a test of true efficiency. Similarly the securing of an output target, or of a high rate of output per man are not true tests. They cannot be used for comparing plants making different things and are quite useless, therefore, for comparing one industry with another; hence when a whole industry is concentrated under a single "Board", "Commission" or "Corporation" or "Trust" there is no possible basis for judging the efficiency of the higher direction. Even for testing the efficiency of plant managers within a single industry these quantitative measures are of very limited use, for they can only compare plants operating under similar conditions, and they will always stimulate graft, and encourage the use of processes which give apparent rather than true efficiency. An example published as I write is the Voroshilovgrad mine which used explosives to blast out coal and rock indiscriminately, with the result that coal faces were ruined, 150,000 tons of coal were so mixed with rock as to become useless, and damage valued at 15,000,000 roubles was inflicted. But the undertaking concerned had surpassed its production quota.¹

Moreover, efficiency is a dynamic not a static thing. It is quite possible that a firm may be highly efficient at one moment in its career, but in the course of a few

¹ Quoted from *Pravda* by *The Sunday Times*, 8 September, 1946.

years the management may deteriorate in quality, the undertaking will slip into a routine which goes on regardless of changes round about, new processes and new ideas will be neglected, the tastes of the consumer will no longer be studied so closely, relations with workers will deteriorate. There can be no one closely connected with industry who has not seen this process of fossilisation at work.

The greatest safeguard against stagnation and the greatest stimulus to progress is competition. In a society where competition is keen there is no firm so efficient that it can afford to rest on its oars. Even the industrial giant apparently secure in the possession of a large share of its market must be constantly on the look-out for improvements, or it will find younger and more energetic rivals, in its own country or abroad, underselling it and winning over its customers. Every now and then the process of stagnation goes too far, and then the firm gives itself a thorough overhaul or, if it has no longer strength to put its house in order, goes out of business altogether.

Monopoly, which is the negation of competition, is the enemy of dynamic efficiency, though it may often seem for the moment to increase static efficiency. The amount of monopoly from which British industry has suffered in the recent past is the chief reason for its failure to hold its own in the world, and for this a heavy responsibility rests on the governments which have encouraged and even, at times, compelled producers to form monopolistic organisations. A private monopoly may be expected to have little dynamic efficiency, but even the most powerful private monopoly has to face the possibility of new competition in the future if it allows its costs and prices to rise too much. A state monopoly, however, has not even this spur, for it is protected

by harsh laws from any form of competition.¹ A state monopoly of the type which socialism would create in each industry is likely, therefore, to show even less dynamic efficiency than would a private monopoly. It is improbable that socialism would achieve more than a moderate degree of static efficiency; it is most unlikely that, without the stimulus of competition, it would maintain dynamic efficiency for long.

Fair distribution. The fundamental difficulty about fair distribution, as we have seen in chapter two, is the decision between the two principles of fairness, reward according to merit and reward according to need. A socialist society like any other will have to make this decision, and if it wants efficiency in production it will have to come down on the side of reward according to merit. Financial incentives may be bolstered up by appeals to patriotism and to the spirit of sporting rivalry, but these will be incidental. If the Russian experience is anything to go by, the pursuit of efficiency will lead to piece-rates, steeply graduated bonus systems, high salaries for skilled men, and very high ones for executives of outstanding ability. The whole will add up to a distribution of incomes hardly less unequal than that produced by free enterprise.

It is quite wrong to suppose that socialism will solve the problems of distribution by transferring capital from public to private ownership. The important thing about capital, from the point of view of society, is not who owns it but how it is used and how the wealth which it produces is divided. We have already seen that, in a socialist state, capital will probably be used less efficiently than under free enterprise,

¹ As an example of harshness, c.f. the Civil Aviation Act, 1946, which prescribes a maximum penalty of £5,000 fine and two years' imprisonment, for anyone infringing the rights of the monopoly.

while a socialist manager may be in a very similar position to a capitalist owner. The manager of a Russian factory enjoys power and income comparable to that of the "captain of industry" in a system of free enterprise; the one thing he is denied is the very doubtful blessing of shouldering the risk of loss when things go wrong.

The problem of fair distribution involves much more than a mere conflict between capital and labour. There is a clash of interest between various grades in the same industry—management, executives, clerical staff, foremen, craftsmen and unskilled labourers. Each will have its own, probably rather exaggerated, idea of its importance and of the proper remuneration for its services, and the more there is for one, the less will there be for the others.

Further, all grades within any one industry have a common interest in exploiting the general public as consumers of their product. We have seen more than once in the case of private monopolies employers and workers sinking their differences and raising prices against the consumer to their common benefit. This danger is perhaps greatest in the case of a half-socialised state, where largely autonomous public bodies enjoy a legally protected monopoly in certain industries. If workers in such an industry demand high wages, the "board" could pay them and recoup itself by putting up prices. The same expedient might also serve to cover up mistakes of management, and to allow the "board" to show a paper profit however badly it may be run. In a fully socialised state the central planning authority would be responsible for balancing one set of claims against another, but it would always be under pressure from this side and that for higher "planned" prices and wages.

Making what the buyer wants. The consumer goods market under a system of free enterprise gives each individual

buyer the power to choose between the thousands of possible ways of spending his income, and of buying just that assortment of goods that best suits his own particular taste. The sum total of all our choices then determines how much of each type of goods shall be produced. It is theoretically possible to improvise a consumer goods market in a socialist system, but there are very great practical obstacles, and no socialist state has yet even tried to build a satisfactory consumer goods market.

Many socialist planners are frankly scornful of the idea of consumers' choice, regarding the consumer as not knowing what is good for him, and needing the wisdom of the planner to guide him.

But even the planner who wishes to give the consumer freedom of choice will have a difficult job. In a fully socialised state the planning authority must start with a guess as to how much of each good consumers will want. However careful use is made of past experience, the guess can hardly be exactly right, and, in any case, the desires of consumers are constantly changing. In order that production might be adjusted precisely to meet the ever changing desires of the consumer, it would be necessary that industries which found themselves with an unusually brisk sale should "profiteer" by raising their prices above the planned level. This would mean that less purchasing power would be available for other things, and some of the goods least desired by the public would remain unsold. The price of goods thus hanging fire should be reduced until the supply could be cleared, which would involve their makers in an accounting loss. The next stage would be for the industries showing an abnormal profit to expand their operations, while these showing a paper loss would cut down their production, and this process would have to go on until the supply of each

good was just cleared at a price which would just cover cost. In this way, as in the consumer goods market under free enterprise, production would be shifted continuously from things the consumer liked less to things he liked more.

But is it likely that this will be done in practice? "Profiteering" is so foreign to good socialist doctrine that it is unlikely to be approved by the planning authority. On the other side, there is likely to be strenuous opposition to reducing prices and making a paper loss, with the reduction in the scale of operations which would follow. Probably, therefore, the planning authority will stick to its planned price and output for both industries, and if it does this there is no fear that the full output will not be sold. The commodity which is in relatively short supply will go first, but when consumers find that they are too late for this, they will take the other rather than nothing.

A good example of this is the working of the food points rationing at the time of writing (1947). The goods covered by the scheme have a planned supply and a planned "price" in points, a "price" which is seldom changed, and which is usually very far from that which would be needed to make demand equal to supply. The housewife begins each "ration period" hunting for the goods which give her most satisfaction for her points, but as the end of the month draws near she buys anything she can get rather than lose her points altogether. Thus the Ministry of Food has only to stick to its planned points values and make the total issue of points big enough to buy its planned supplies and it can be sure of selling almost anything it chooses to put on the market. In the same way the planning authority of a socialist state need only stick to its planned money prices and make consumers' incomes equal to the output of consumers' goods. The market will then be cleared and the only sign that

anything is wrong will be that retailers will have more requests for some goods than for others.

The pressure of consumers' demand will be very little felt in a socialist state, and instead there will be another very different pressure—the pressure of each industry to expand. Anyone who has experienced the inter-departmental rivalries which arise in the civil service, in a large private firm or even in a university should have no difficulty in understanding the nature of this pressure. A higher production target will mean more power and importance for the “high command” of the industry; there will be more responsible jobs and better prospects of promotion and high salaries for executives; more workers will be needed, so a strong case can be made to the planning authority for higher wages. In a contracting industry, on the other hand, there will be less scope for the men at the top and less prospects of promotion, while workers will be faced with the possibility of a relative decline in wages and with the need for some of them to leave their jobs and seek other employment. Every industry will therefore seek expansion and resist contraction by all the means in its power, and the resulting balance will be not the balance of consumers' desires, but the balance of political pressure on the planning authority.

Besides these purely economic considerations, there are others on the borderline of politics and economics, which deserve mention. In a partly socialised state, the position of the public bodies operating nationalised industry is difficult. If they are the direct responsibility of a Minister there is a danger of overloading Parliament with detailed questions on their operation, and even of making them the sport of party politics. To avoid this the semi-autonomous board has been set up. Sometimes as with the National Coal Board, the Minister concerned has great power behind the scenes, but

he has no responsibility to Parliament for the ordinary operations of the board. Such public bodies form monopolies far stronger than any private monopoly, with special interests of their own like any other monopoly, and with little to ensure that these special interests are subordinated to the general interest of the public.

In a completely socialised state, the planning authority is responsible for safeguarding the public interest, but that body will feel directly the pressure of each industry, while the unorganised consumer can make his voice heard in only the faintest manner. The weakening or destruction of the market deprives the consumer of a most powerful yet delicate means of influencing the economic system, and he is left only with clumsy and relatively feeble political weapons. The planning authority thus becomes a body of tremendous power and, like the armies of former times, it may prove almost uncontrollable by the elected representatives of the people. This would be a very real danger in Britain, for the British constitution was evolved when the activities of government were limited, and when the duty of the elector was to give an opinion on a few clear cut issues. In a socialist state, the elector would have to give his views not only on the traditional activities of government, but on all the multitudinous works of the planning authority. A cross on a ballot paper would be no means at all of doing this; the elector would have to choose his member more for personal qualities than for programme, and to rely implicitly on his wisdom. The poor harassed member in turn would have to keep watch on the National Coal Board, the Railway Executive, the Banking Corporation, the Electricity Trust, the Pottery Commission, the Toy Combine and so on into hundreds of state monopolies, to see how each affected the interests of his constituents and what public opinion in his

constituency thought about them. The vital function of an M.P. as an interpreter of his constituents' views and interests to the government would become more than any single man could handle, and the whole delicate system would be in danger of breaking down from sheer overstrain.

To sum up, a socialist state will have an easy job in securing full employment provided that it is fully socialised and centrally planned. It is likely, however, to be less efficient, especially in the long run, than private enterprise; it is likely to be much less sensitive to the interest of the consumer; and it would impose a terrible strain on our political institutions. A half-planned, half-socialised economy is not much better off than free enterprise so far as employment is concerned, and has peculiar problems which do not arise in either of the other two worlds.

If there were no possibility of avoiding booms and slumps and chronic unemployment without socialism, then we should have to make the best of the other evils, and the present writer for one should be a socialist. If, however, there is a policy which will secure full employment while preserving the advantages of free enterprise, then socialism loses its principal attraction and its evils heavily outweigh its advantages. The key to such a policy is to be found in the analysis of chapters three to eleven.

CHAPTER THIRTEEN

ANOTHER WAY TO FULL EMPLOYMENT

THERE is another line of policy, based on the arguments in the central chapters of this book, which can give full employment without the disadvantages of socialist planning. It is now time to describe that policy. Our diagnosis is complete, and we need only summarise it before prescribing our remedy.

At the time of writing (1947), we still have a large amount of controlled inflation. Production of peacetime goods is going ahead with increasing speed, but if there were no controls effective demand would far outrun supply. In most occupations, there is an acute shortage of labour, and such unemployment as exists is due to bottlenecks—to the fact that the unemployed and the unfilled jobs are not always in the same place, that production is held up at various points for lack of specialised equipment and materials, and to lack of skilled craftsmen to build new factories and convert war factories to peacetime uses. Clearly this sort of unemployment is only temporary, and has very little to do with the main problem.

This state of controlled inflation may continue for some time. Government expenditure on defence is likely to remain higher than it was before the war; the housing programme will entail very heavy capital expenditure for at least ten years; before the new legislation on health services and education can be fully effective much must be spent on hospitals, health centres and schools; big road-building projects are planned; railways and public utilities need much

new equipment; our basic industries, coal, steel and cotton, are planning to spend large sums to bring their plant up-to-date; and on all sides firms are eagerly awaiting the chance to instal new plant or replace old. Consumers still enjoy high incomes and have been saving up for seven years, and are eager to spend some of the savings which they have accumulated while opportunities of buying have been restricted. Finally, to pay for our pre-war volume of imports and meet our foreign obligations, we must export perhaps as much as 75 per cent more goods than in 1938. In all these directions there is a great store of pent-up demand, and the problem is not to create spending but to hold it back.

So long as this continues, the government should follow a deflationary policy. Public expenditure should be watched carefully and the less urgent projects be cut out or postponed. Taxation must remain high and thrift should still be encouraged, and so long as goods remain in short supply, price control, rationing and the restriction of private capital expenditure will have to be maintained.

But as the conversion of industry from war to peace proceeds, and as the fruits of new investment are gathered, the flow of goods to the market will grow larger. As the more urgent needs for public and private capital are met, as consumers satisfy their keenest wants and run down their past savings, the desire to spend will decline. Thus effective demand and available supplies will come to meet one another and, as the gap between them narrows, the precautions against inflation can be relaxed. Eventually, if past experience is any guide, we shall reach a point at which effective demand is no longer sufficient to absorb all that can be produced by a fully employed community. Then general unemployment and trade fluctuations will recur unless we have a new policy, specially designed to prevent them.

The first step in framing this policy is that the government should assume the responsibility for supervising and when necessary regulating effective demand, and should categorically declare its intention to keep total demand at a level sufficient to maintain full employment. The government must do this for the simple reason that only the government can. The banking system cannot for, as we saw in chapter six, money has far too weak and indirect influence upon effective demand. No private citizen can undertake the task, for even the richest person or company can exert only a minute influence on the total spending of the country. No one but the government has the knowledge, the power or the right to regulate the total production of the country. The government, however, as tax-gatherer, lawgiver, principal spender and, through the Bank of England, controller of the monetary system must, even consciously or unconsciously, wield an enormous power over total demand. In the past, this power has been exercised blindly and often in the wrong direction; now, thanks to recent experience in the measurement of national income, and recent developments in economic theory, the power is informed by knowledge and is capable of becoming the servant of a consistent economic policy. Nor is the idea of government regulation in this sphere so new as it might appear. It has long been recognised that the government has a duty to safeguard its citizens against inflation, so it would be but logical that it should safeguard them also against deflation.

This responsibility was accepted by the Coalition Government in the 1944 White Paper entitled *Employment Policy*.¹ The first sentence of this paper runs, "The government accept as one of their primary aims and responsibilities the maintenance of a high and stable level of employment after

¹ Cmd. 6527, May 1944.

the war", and later we read that "The government are prepared to accept in future the responsibility for taking action at the earliest possible stage to prevent a threatened slump".¹

This White Paper is a landmark in the development of public policy, and deserves more detailed examination. It has several great merits; it gives a very clear analysis of the idea of total demand and of its importance in maintaining expenditure; it recognises the importance of public spending both for current consumption and capital expenditure, as an item in total demand; and it admits to the harm which has resulted in the past from decreasing instead of increasing public expenditure during a trade depression. Further it promises that the work of the Central Statistical Office will be maintained and expanded and that new statistics of great value will be collected. These include "quarterly or monthly statements of present and prospective employment in the main industries and areas in the country, based on returns from employers", "Regular information relating to savings, projected capital expenditure by public authorities and, as far as possible, by private industry", an annual census of production including particulars of output, stocks and work in progress; "monthly figures of production, consumption and stocks and, if possible, orders in hand" based on sample enquiries, and quarterly estimates of foreign capital movements and the balance of payments.²

On the side of diagnosis the White Paper is excellent. Unfortunately it does not follow up in its prescription, the full implications of the diagnosis. It is chiefly concerned with fluctuations in employment, and hardly at all with chronic unemployment. The authors carefully refrain from

¹ Cmd. 6527, para. 41. ² Ibid, para. 83.

committing themselves to any figure for average unemployment over a number of years, but a note in Appendix II implies an average of 8 per cent, or nearly 1,500,000 persons. Even if Lord Beveridge's target figure of 3 per cent of unemployment is on the optimistic side, there can be no doubt that 8 per cent would represent a degree of chronic deficiency in demand which we ought not to tolerate.

The White Paper recognises that the chief causes of fluctuations in demand and employment have been changes in private borrowing-and-spending, and in the foreign balance. But so far as the foreign balance is concerned, all we are told is that "Our aim must therefore be to agree with other countries on international measures which will be to our mutual advantage and will render them partners with us in a common economic policy".

It is proposed to meet fluctuations in private investment partly by the old method of manipulating the rate of interest through changes in the quantity of money and "by encouraging privately owned enterprises to play their own capital expenditure in conformity with a general stabilisation policy".¹ The nature of this encouragement is not stated, but it is hinted that taxation might be adjusted so as to favour capital expenditure undertaken at the onset of a depression.

These measures are not expected to be sufficient, and it is proposed to offset fluctuations in private investment by variations in public investment and in private consumption. For public investment there is to be a five year plan, which is to be speeded up or retarded, so far as technically possible, as occasion demands.

For bringing about the desired changes in private spending on consumption there is an ingenious plan for making social

¹ Ibid., para. 61.

insurance contributions fluctuate with the level of employment. A suggested scale, based on the figures of the Beveridge Report, is:¹

<i>Unemployment Percentage.</i>	<i>Weekly contribution for adult male employee</i>					
	<i>Employee</i>		<i>Employer</i>		<i>Total</i>	
	<i>s.</i>	<i>d.</i>	<i>s.</i>	<i>d.</i>	<i>s.</i>	<i>d.</i>
Less than 5 per cent	5	6	4	6	10	0
Between 5 and 7 per cent	5	0	4	0	9	0
Between 7 and 9 per cent	4	3	3	3	7	6
Between 9 and 11 per cent	3	6	2	6	6	0
Over 11 per cent	3	0	2	0	5	0

This scale, as we have said, contemplates a quite intolerable degree of chronic unemployment, and it also involves a considerable time lag. It is not until much unemployment has actually occurred, and all the resulting administrative processes have been gone through, that there is an addition to spending. The scale thus implies the inevitability of considerable fluctuations and aims only at mitigating them. It is also suggested that taxation might include an element of deferred credits to be unblocked at the onset of a depression, but this is not followed up in any detail.

On the subject of a budget deficit it is implied in the White Paper that, on the average, the budget should not merely be balanced, but should show a surplus, as it is suggested that we should aim at "an effective reduction from year to year of that part of the public debt which is a dead-weight war debt".² Here is our old fallacy of the difference between "productive" and "unproductive" government borrowing raising its head again. A budget surplus applied to debt reduction is simply a reduction of total effective demand, for those from whom it is taken in taxes will be deprived of spending power, while those to

¹ Cmd. 6527, Appendix II. ² Ibid., para. 76.

whom it is paid will not spend it on current products but either keep it as a bank balance or use it to buy some other form of property. A budget surplus is only justifiable at a time like the present, when it is desirable to discourage expenditure on consumption and to spend more on capital goods than the community wishes to save. In these circumstances a budget surplus accumulated without injuring production would be a good antidote to inflation, but to try to accumulate a surplus at a time of unemployment would be utterly wrong. The White Paper remedies are, except for the latter proposal, on the right lines, but they are too little and too slow.

The first step towards implementing the new promise to maintain demand at the full employment level should be a new type of budget, a development of the work of the Central Statistical Office, and of the excellent surveys of the national economy given by Sir Kingsley Wood and Sir John Anderson in their wartime budgets. The Chancellor should present to Parliament not one budget but a set of three inter-related budgets.

The first, a "Master Budget", should be a true national budget, as distinct from a government budget, a statement of what we could be expected to produce given full employment,¹ and of what we may be expected to spend. The main headings of such a budget would run thus:

<i>INCOME</i>	<i>EXPENDITURE</i>
Net National Income at market value.	Public spending, on goods and services.
	Private spending on consumption.
	Private capital expenditure.
	Balance with foreign countries on current account. ²

¹ The percentage which would correspond to our definition of "as many unfilled jobs as unemployed men" would have to be found by experiment, but the provisional target should be put at about 3 per cent.

² This would, of course, be added when we sold more than we bought, and subtracted when we bought more than we sold.

These items will all be estimates, and some of them may turn out fairly wide of the mark, but the new statistics which it is proposed to collect would enable them to be made much more accurately than has hitherto been possible.

If this national budget balanced we could look forward, unless the estimates were badly falsified by events, to a year of steady employment and income. If the expenditure side were the larger, this would be a warning of impending inflation; if the income side were the larger, this would mean that effective demand would be insufficient to sustain this income, and would be a warning of depression. The first and overriding duty of the Chancellor should be to balance this Master Budget. If it happens to balance without any conscious intervention on his part, he can count himself a lucky man. If his estimates show a deficiency either on one side or the other, then he must recommend to Parliament appropriate action to bring about the balance.

The second budget would be the Revenue Budget showing how much the central government was to raise and spend, by what means and for what purposes, and to this might usefully be added a similar statement for other public authorities. The Chancellor must not, as in the past, regard this budget as his principal pre-occupation. Government spending is one element in total effective demand, and the Chancellor must be prepared to alter his own plans to fit in with the Master Budget, just as he will encourage private consumers and private investors to do the same. It is by its own spending, and the manner in which revenue is raised, that the government has the most direct influence on total demand, so obviously the Revenue Budget must be carefully integrated with the Master Budget.

Thirdly, there is the Foreign Payments Budget, which can be made up in the form of the account shown on pages 116-17.

This will give rise to special problems of its own, but first we must consider the balance of the Master Budget.

If this budget shows an excess of estimated demand over potential output, the Chancellor must take steps to reduce demand. He can use his control over the monetary system to raise the rate of interest; he can exhort individuals and companies to increase their saving; if public authorities have been borrowing, he can cut down borrowing and either make a corresponding reduction in expenditure or increase taxation; he can raise social insurance contributions to deprive consumers of purchasing power, or he can do the same thing by repaying some of the public debt out of the proceeds of taxation. He may choose any of these means which he considers appropriate and which are acceptable to Parliament, but by one or other, or by some combination of them, demand must be reduced until it meets potential output and the danger of inflation is averted.

But once the next few years are over, it is more likely that the deficiency will be with demand than with production. We have already discussed at some length the various theoretical possibilities for adding to total effective demand. The Chancellor will consider them all, and will probably divide them into two groups according to their suitability as remedies for chronic unemployment and as antidotes to trade fluctuations.

Remedies for Chronic Unemployment. The first group of remedies will consist in increasing consumption and cutting down saving. Indiscriminate steepening of taxes on high incomes will not seem very promising, as it has already been carried to the point at which it is killing initiative. A far-sighted government may, however, do something to promote greater equality of income, and therefore increased consumption, by other means. Present inequalities in income

are due largely to inequalities of property and inequalities of opportunity. The limitation of the amount a person might inherit and the reduction of interest rates would reduce inequalities derived from property, while each step towards fuller equality of opportunity will tend towards more equal earnings by increasing the number of entrants to occupations where men are scarce and therefore highly paid. These are steps desirable in the interests of social justice, and which would also tend, in the long run, towards expanding consumption. The same may be said of "social security" services. It is likely, however, to take a long time to bring about any great change in private consumption by these means. Meanwhile there are great advantages for the individual in holding a small amount of property, and great advantages for society in adding to its stock of capital. A wise Chancellor is, therefore, likely to rely more on stimulating investment than on curtailing saving.

Private investment can be stimulated in the long run by low interest rates; when there is chronic unemployment, the case for the lowest possible rates is overwhelmingly strong; when demand and employment are well maintained, however, it may not be wise to push rates too low. The encouragement of scientific research and the widest possible diffusion of its results will be a further stimulus to investment, and so too will the mere knowledge that the government is maintaining a high level of demand.

Public investment offers a very wide range of projects ranging from the almost essential to the practically useless. A Chancellor whose Master Budget shows a chronic deficiency of demand will be justified in encouraging public authorities to borrow for projects which come a good way down the scale, and he can do this simply by making it possible for them to borrow at a very low rate of interest. The

spending authority should still, however, weigh as carefully as it can the benefit against the cost. It is silly to undertake public works merely for the sake of giving employment, for this can be done equally well by an ordinary budget deficit. The difference between borrowing for an ordinary deficit and borrowing, say, to build a bridge, is that instead of buying a bridge the public authority buys its ordinary services, and instead of paying taxes the public buys more consumers' goods. The extra demand is there in each case but it takes a different form. If the bridge will save a lot of people a long detour, by all means let it be built. But if the river is well bridged already or if hardly anyone wants to cross it, the probability is that the consumer goods would be more use than the bridge, and the ordinary deficit is the better policy.

The method by which such a deficit is financed will again depend on our policy towards interest rates. If the chronic deficiency in demand is very serious and we want to bring rates down to rock-bottom the deficit can be financed entirely by the issue of banknotes. In this way the pure rate for short-term debts at least could be brought down to little more than the cost of printing and keeping check of a banknote. In time of really chronic deficiency of demand, this would have the virtue of involving very little expense to the taxpayer; of encouraging private investment to the utmost, and also of reducing the share of national income going to property, and so bringing about a more equal distribution of income. This is the process described by Lord Keynes in the famous phrase "the euthanasia of the rentier". If, however, the deficit is only small and occasional, then it would not be wise to reduce interest rates much below their present level. In that case the best means of borrowing will be by Treasury Bills and medium term bonds.

It is doubtful whether we shall have in the future so strong a tendency to chronic unemployment as we had in the inter-war period. The war has brought great changes in the distribution of private incomes after paying tax; heavy taxes on unearned income and inherited wealth should remain permanently, and will tend to increase spending and reduce saving. The knowledge that the government is making a determined effort to ensure economic stability will stimulate private borrowing-and-spending, and there are many public works which are genuinely worth while at a moderate rate of interest apart from their value as creators of employment. These things may quite possibly raise demand to the point at which chronic unemployment ceases to be a serious evil. But this is very uncertain and policy will have to be dictated by experience. The important thing for everyone to realise is that there is nothing reprehensible in a government deliberately incurring a deficit when this is required to stimulate effective demand; in fact if savings are excessive a budget deficit is an excellent way of absorbing them.

Fluctuations in Effective Demand. The only items of spending which are likely in normal times to lead to large fluctuations in employment are the foreign balance and private borrowing-and-spending. The foreign balance is always likely to vary through circumstances beyond the control of our own government. The White Paper expresses the pious hope that business men will co-operate in stabilising private capital investment, but this is unlikely for some time. We have seen the part that expectations play in the internal trade cycle; so long as business men see booms and slumps happening, they will remain boom-and-slump-minded, and it is mere wishful thinking to suppose that a firm which expects a depression will be persuaded to embark on a large-scale programme of capital expenditure at

the beginning of it. Only when the government has actually demonstrated its ability to control slumps by other means will business men cease to expect them and become willing to stabilise their own rate of capital expenditure.

Obviously then the government must have a means of offsetting fluctuations in total demand, from whichever source they arise. In this offsetting process, speed is the essential thing. The initial fall in demand may be small, but the effect is cumulative—the first fall in demand causes a reduction in income, which means less consumption and less inducement to buy capital goods; hence there follows a further loss of income and a further reduction in consumption and so on. The first decline in private investment or the first fall off in exports is the plateau at the edge of the precipice described in chapter nine. If the offsetting action is only quick enough, it need be comparatively small in amount, but it will save us from going over the edge, and a serious drop in employment will be averted. If the offsetting action is not taken in time, serious unemployment will appear very quickly, and then much more drastic action will be needed to prevent a really deep depression.

We have to look not for remedies which will bring a steady long-run increase in demand (these are the ones for chronic unemployment if it exists) but for something which will give a quick increase at just the moment we want it. We need a kind of supercharger, that can be switched on to produce a sudden acceleration in demand and equally quickly switched off again when the highest safe speed is reached.

Public works are not ideally suited for this purpose. Even if there is a five year plan as suggested in the White Paper, it will take some time to speed it up at the onset of a slump. Moreover, the labour required is likely to be of a very

different type from that which will be put out of a job by the first falling off in demand. Only in the capital goods or export industries as the case may be, will there yet be appreciable unemployment, so the programme of expansion may be held up for lack of labour and materials. In time, of course, these difficulties could be sorted out, but when we are trying to ward off a depression, time is the one thing that cannot be spared.

The same difficulty applies to a budget deficit as a means of combating fluctuations; the government may go on spending, reduce taxation and borrow the difference. This policy, as we well know, will lead to an increase in demand, but only when the private citizen starts to spend the income that had previously been taken from him in taxes. With our present methods of budgeting and taxation the delay would be too long.

Government borrowing-and-spending, whether for current expenditure or for public works will not be a safe method of checking a depression in its very first stage because of the need for speed. They will certainly be of little use if we wait until an appreciable amount of unemployment has actually arisen before we start applying them. The statistics of projected capital expenditure, employment prospects and orders in hand, which the White Paper proposes to collect would, however, make it possible to forecast some little time ahead. At first business men will probably be suspicious of making such returns, but as their purpose and their usefulness become apparent, the time and expense involved will appear as essential a part of good business management as the taking out of a fire insurance policy. If plans for the expansion of public works or the remission of taxes could be made on the forecast of unemployment and not on its actual appearance, they would be much more useful. Even

so, however, these forms of stimulating demand are best regarded as a second line of defence in case a slump does get beyond the initial stage.

For our first line of defence, there are various ways of bringing about a fairly rapid increase in consumption. The variable social insurance contribution is one, though the scheme outlined in the White Paper is not likely to be of much use as it stands. Instead of "gearing" contributions to the unemployment figure, it should be possible to vary them when the forecasts which the Cabinet will receive from its statisticians show that unemployment is likely. In this way, by the time that unemployment increased in some trades, there would be fresh spending already available, this would create extra demand for labour in many industries. Thus our basic principle of as many unfilled jobs as idle men would be maintained. Deferred tax credits would have exactly the same effect, and could also be "unblocked" very quickly if need arose.

The first step, when forecasts show the likelihood of a slump should, therefore, be to put extra spending power into the hands of consumers in one or both of these ways. Meanwhile, plans for tax remissions and for the speeding up of public investment can be advanced and whether or not they are put into operation will depend on reports of the first month or two of increased consumers' spending. If the former has been well judged both in amount and timing, employment will remain at a high level and no further action will be necessary. We can maintain these stimulants until other forms of effective demand revive, and then drop them. If the first remedies are too little or too late, the depression will begin to develop on normal lines, and then a big bout of public works or deficit spending will be necessary to arrest it. We cannot hope always to guess right at first,

but as experience in forecasting and gathering statistics grows we can expect to be nearly right more and more often, and fluctuations in employment will become fewer and smaller. As this happens business men will see the value of the policy and will become more willing to give information; they will also cease to expect violent fluctuations, and so their own capital investment will become more regular. Once the first success has been achieved the task will grow progressively easier.

We end the chapter with a brief summary of the policy we have outlined.

(1) The government must give a categorical assurance of its intention to maintain effective demand, and that this will be given priority over all other matters.

(2) The knowledge on which to base this policy must be secured by collecting statistics as suggested in the White Paper on "Employment Policy".

(3) The present revenue budget must be replaced by a threefold budget and the Chancellor must make it clear that his first concern is to balance the Master Budget, which relates potential income to spending.

(4) Whenever the Master Budget shows a lack of balance on the inflationary side, steps must be taken to reduce effective demand.

(5) If the Master Budget shows a chronic deficiency in demand, a long-term spending programme must be put in operation with the object of:

(a) Stimulating consumption and diminishing of saving through low interest rates and greater equality of incomes.

(b) The encouragement of private investment, also by low interest rates.

(c) The undertaking of all practicable and worth-while forms of public works.

(d) If necessary a budget deficit financed at very low rates of interest by the issue of large quantities of new money.

(6) To meet fluctuations in demand we need:

(a) Measures to stimulate consumption through the reduction of social insurance contributions or the unblocking of deferred credits when unemployment is forecast and before it actually occurs.

(b) As a second line of defence, plans for speeding up public works and borrowing to meet ordinary expenditure, which can be put into effect quickly if the first line of defence is pierced.

CHAPTER FOURTEEN

SOME IMPLICATIONS OF THIS POLICY

THE POLICY of maintaining spending power at home whatever happens to our imports and exports may result in unbalancing the last of our three budgets, the Foreign Payments Budget. The first thing needed to meet this is a large reserve of foreign currency. Our quota with the International Monetary Fund gives some reserve; the holdings of gold and foreign currency in the Exchange Equalisation Account provide another; for the present the "line of credit" in the United States gives a third. The government should endeavour to build up the exchange Equalisation Account to a size big enough to meet any temporary deficiencies in the balance of payments which are likely to occur, and backed by these reserves, it can then take appropriate action through the Monetary Fund.

The balance on current account may turn "against" us, i.e., we may sell less goods and services to foreign countries or buy more from them. This may be due to one of several causes:

(a) A depression abroad. In this case, by maintaining our purchases and paying for them out of reserves, we shall be helping the foreign country concerned to maintain demand and restore its own prosperity. We must also keep the world fully informed, through the Fund, of our own methods of combating depression. No country wants a slump for its own sake, and if we can give a lead in showing how slumps can be avoided we need not fear that the lead will not be followed.

(b) The fact that a foreign country is constantly running an export surplus either because of its tariff policies or because its demand for imports is kept below by chronic unemployment. In this case the currency of the offending country would become "scarce" and the machinery described in chapter eleven would operate.

(c) Because prices in Britain were higher than those in other countries also enjoying a high level of income and employment. In this case we must either reduce prices or devalue the pound in terms of foreign currencies. It is almost impossible in a free economy to reduce prices without causing unemployment, and the right policy would be to seek permission of the governing body for devaluation—permission which in these circumstances it would be bound to give.

Other problems will still remain in the secondary causes of unemployment. If we are to get down to a target figure of 3 per cent unemployed we shall need careful matching of industry and employable population in each area, and all possible facilities for changing from one job to another. The government will need power to influence the location of industry. At present it has almost absolute power through the control of building licences and the allocation of materials, but when these emergency measures are abandoned, the rather negative powers given by the Location of Industry Act, 1945, may need to be strengthened.

A different and more dangerous problem will arise over wages. Hitherto the worker has been selling his labour in buyers' market; unemployment has pressed wages downward and the chief function of the trade unions has been to counteract this by exerting an upward pressure at every possible opportunity. Any union which secured a wage increase or successfully resisted a reduction secured a real

benefit for its members, and the cumulative action of all unions was a very important factor in raising the standard of living of the wage-earners as a class. In these circumstances it was natural and right that union leaders should be always on the look-out for chances of pressing for higher wages.

In conditions of full employment when union leaders, often for the first time in their lives, are bargaining in a sellers' market, there will be a great temptation to press the demand for higher wages more vigorously than ever before. The temptation has been apparent during the war, and when full employment is maintained through the period of reconstruction and into normal peacetime conditions it will be stronger still. Yet to yield to it could lead only to a disastrous cost inflation. (See chapter eight, p. 86). Just as the worker would be selling his labour in a sellers' market, so would the employer his goods. The employer would not offer much resistance to claims for higher wages, for there would be enough purchasing power to enable him to pass the extra cost on to the consumer by charging higher prices. Rising prices would lead to further demands for wage increases, which would be followed by a further rise in prices, and so on in the famous "vicious spiral". This is the "cost inflation" which we discussed in chapter eight. This inflation would make any rise in money wages almost wholly illusory. The most that the workers in any one trade could gain would be some small benefit for themselves at the expense of consumers in general, most of whom are their fellow workers in other trades. Even this benefit would be only temporary, for those who had been left behind would strive to catch up and, when we were all getting more money and all paying more for our goods, we should be very much where we were before. So wages and prices would go on

chasing one another, with the weakest always lagging behind and suffering hardship, with increasing difficulties in selling abroad enough to pay for our imports, and with the danger of a complete loss of confidence in the currency always lurking in the background.

The first step to avoiding the danger is to realise its gravity, but it is one thing to realise the presence of danger and another to take effective precautions. One safeguard would, of course, be that the government should keep down purchasing power to a level that would be no more than enough to buy current output at stable prices. But then manufacturers who had paid higher wages would find that they could not sell their goods at a profitable price, and so output and employment would be curtailed until wages came down again. This is no more than a return to the bad old method of keeping down wages through unemployment, and we can dismiss it at once.

Another possible solution is that wages for each occupation should be fixed as part of a national wages plan. Wages are the price of work, and if prices in general are to be controlled then it is only logical to control the price of work. But wage controls are open to just the same objections as any other price controls; they impair the working of the market, on which the efficiency of the system of free enterprise depends.

We need a new criterion by which those engaged in negotiations can judge of the merits of a wage claim. In recent years the two most common arguments from the trade union side have been the cost of living, and the rate of wages in other comparable occupations. Both have an element of wisdom in them, but neither will be enough to meet our new needs. Everyone recognises the need for some minimum standard of real income, which is the justification

for considering wages in relation to the cost of living, but to tie all wages strictly to a cost of living index would be one of the quickest ways to inflation. Similarly we need certain standards of fairness between different occupations, for any rate which seems grossly unfair to those who receive it will be a constant source of unrest. The problem of unfairness between different occupations, however, will be less difficult in conditions of full employment than it has been in the recent past, for the better employment is in general, the less obstacles there are in the way of movement from less attractive to more attractive jobs. It would be very useful, however, if the Trades Union Congress could induce unions to agree on a rough-and-ready standard as between different occupations, for this would enable those which are generally considered to be underpaid to obtain higher wages without giving rise to further claims by the general body of unionists.

But any such understanding would have to be very flexible, for a wage structure is not fair or unfair in an absolute sense, but only in relation to current conditions, and it is only through changes in relative wages that labour can be guided into those occupations in which it is most needed to satisfy the wants of the consumer. When consumers buy more radio sets, the radio industry needs more labour and there is a tendency for wages to rise. In other industries where consumers' purchases have declined, less labour is needed and wages tend to fall. Hence there is an incentive for workers to enter the expanding industry rather than the contracting one, and if possible to transfer from the one to the other. Such an incentive is vital if we are to meet the ever changing needs of consumers, while leaving the worker free to choose his job; if we cut out this incentive the alternatives are either direction of labour or stagnation.

When the demand for a commodity expands, its price will rise and those who produce it will make abnormal profits. Out of these higher profits they can and should pay higher wages. Such an increase in wages would not be inflationary, for it would merely follow a rise in prices that had already taken place through an expansion in demand. Moreover, if total purchasing power is kept constant, an expansion of the demand for one thing will be accompanied by a contraction of the demand for something else, and here there will be a tendency to falling prices and wages. Thus the *general level* of wages and prices will be kept stable, though individual wages and prices fluctuate as the preferences of consumers shift from one thing to another.

For our new criterion in wage negotiations we want a means of separating wage claims which would be a cause, from those which are a consequence, of a rise in prices. Such a criterion is whether a wage claim can fairly be met out of profits. If the union can show that profits have increased either as a result of higher prices following on an increase in demand, or of an increase in the efficiency of labour, then their claim should be met. If employers can show that they cannot reasonably meet a claim without a further increase in prices, then it should be refused unless there is exceptional hardship involved. There will, of course, be a difference of opinion as to what wage can "fairly" be paid out of profits, but that is the proper field of collective bargaining. It is necessary that every union, employers' association, trade board, conciliation board, court of arbitration and Joint Industrial Council should realise the importance of this principle and strive to apply it. The new statistics will make it much easier to form a true picture of the situation, and the government can do much to spread knowledge of the danger involved and the means by which it may be avoided. We

may trust that the common sense and adaptability of our leaders in industrial relations will enable them to reach a satisfactory solution in the end, but it would be rash to expect that there will not be many difficulties and mistakes on the way. The cultivation of a new attitude towards collective bargaining will be one of the biggest practical problems in the working of the economic system in conditions of full employment.

The great merit claimed for the policy outlined in the last chapter is that, while the state controls the total volume of spending, the direction in which that spending flows is left largely for individual citizens to decide. In this way, we can maintain the competitive stimulus to efficiency, and preserve the free market for the job which it does supremely well—measuring the immensely varied wants of the consumer and matching them with the innumerable different materials and types of special skill which we call “factors of production”. It does not follow from this, of course that the state should do nothing in the economic sphere except regulate the amount of spending and employment; even the most thorough-going believers in *laissez-faire* would not suggest that. The true test of whether any piece of state action should be undertaken or not, is simply, “will it contribute to the greater happiness of the greatest number?” Few people want government action for its own sake, so the onus of proof should be upon those who advocate any particular policy. If they can show that it will add to the total of human welfare, well and good; if not, they lose their case.

There are many forms of state influence on economic life that can easily be justified by this test. One is the provision of services which cannot conveniently be supplied by private enterprise—Adam Smith’s lighthouse is one

obvious example; roads, bridges and water supplies, health and educational services are others. Another responsibility of the state is the maintenance of a minimum standard of real income for its citizens, which involves the establishment of trade boards where workers might otherwise be exploited, the administration of social security services, and the provision of public relief.

The state has also an obligation to intervene in cases where there is a divergence between public and private interests. An important example is the location of industry. A business man will erect his factory in the place where he expects his costs to be lowest; this is in his own private interest and, if he counted in his costs all the items which are relevant from the point of view of the community, then his action would also be in the public interest. But there are some items which are costs from the point of view of the community but not from that of the business man. The sprawl of overgrown towns causes inconvenience to all their inhabitants and is a danger to national security; the decay of industry in depressed areas causes great hardship to those who are deprived of the prospect of a job unless they move. These are disadvantages of the drift of industry to greater London and Birmingham, disadvantages which are very real, but which are not represented in the costs which the business man considers in deciding where to set up his factory. Hence the business man will not see the whole picture, and his interest in this matter will not entirely coincide with that of society as a whole. It is quite right, therefore, that the state should influence the location of industry in order to correct this divergence between public and private interest. Another duty of the state—woefully neglected of late—is to preserve competition and check and, when necessary, regulate monopolies. These are only a few examples, but

they are enough to show that there are very many fields of beneficial state activity in a system of free enterprise. Each case must be judged on its merits and always with reference to the greatest happiness of the greatest number.,,

One of the most beneficial results of full employment will be the abolition of "depression-melancholia". This is an insidious disease which takes many queer forms, but all of them involve the perversion of the simple commonsense aims of economic effort, all sap the energies of society and restrict the growth of economic welfare. The policy and thinking of the inter-war period is full of its symptoms.

One is our attitude towards monopolies. Business men faced with chronic bad trade and periodical falls in prices, try to protect themselves by combining to shut out new competitors, form price rings, restrict output, share markets by quota arrangements and promote a live-and-let-live atmosphere which is fatal to efficiency. Instead of frowning on such practices, governments openly encouraged them; the common law on restraint of trade which might have been an effective safeguard has been whittled away by a series of judicial decisions until it is practically useless; a Labour government by the Coal Mines Act of 1930 forced upon the industry a monopolist organisation which is largely responsible for its present state of inefficiency; a "National" government pressed the iron and steel industry to set up a similar organisation, and connived at or openly encouraged the formation of restriction schemes in a variety of other industries. The governments of the inter-war period have a heavy responsibility for the present shortcomings of British industry, but their policy was only reflecting the views of the average citizen.

Another symptom was our policy with regard to foreign trade. We felt that we must create employment at home

regardless of the effect on other countries; and so in a wave of mass hysteria with hardly a thought of what we were doing, we cast aside all the great legacy of economic wisdom since Adam Smith and returned to the seventeenth century, when a "favourable" trade balance was the chief object of policy. In this and most other countries imports were restricted by tariffs and quotas, exports encouraged by exchange depreciation, or by subsidies given by specially created monopolies. Economists pointed out that these were only "beggar-my-neighbour" remedies; any employment which they gave at home could only be by causing corresponding unemployment abroad. Since other countries were sure to take reprisals, even this advantage would be only temporary; each country would end up much where it was before, and the world would be poorer because of a new mass of trade restrictions. But this obvious argument fell on ears quite deafened by "depression-melancholia".

Ever since Henry I gave asylum to Flemish weavers who founded the art of fine textile manufacture in Britain, we have warmly welcomed immigrants, especially those who brought a trade with them, and British industry has benefited enormously as a result. In the nineteen-thirties, however, a craftsman might not come here to work for fear he took an Englishman's job. The only form of immigrant who was welcomed was one who brought enough property to maintain himself, and promised to live in idleness on the products of British workers, to whom his spending would give employment. It was, of course, just the same in the United States and the Dominions. Thus we lost thousands of useful workers and caused terrible suffering to the hunted and oppressed of Europe. The same attitude persists in 1947, in spite of the great shortage of manpower, and the suggestion of employing Polish miners has aroused the

strongest opposition even though British workers in other industries are unemployed, not for lack of demand, but for lack of coal.

If a married woman prefers to go on with her former career after marriage one might think it no one's business but her own. If we had full employment these extra workers would be welcome, but in the inter-war period their employment met with strong opposition; they were "doing a man out of his job". Some trade union practices restricting the rate of output reflect the same spirit, and so does a common view of the shorter working week as a means to employment. To have a shorter working week because workers prefer more leisure to more goods is perfectly rational; to advocate a shorter working week as a means of disguising unemployment is the sort of argument which could only pass with someone whose brain is fuddled with "depression-melancholia".

A few years experience of full employment promises great changes in much of our social and economic thought, changes that will improve international relations, release new creative energies, and add enormously to the power and efficiency of economic society.

CONCLUSION

THE MAIN purpose of this book has been to show that mass unemployment arises because of the failure of effective demand to absorb all that a fully employed industrial society can produce. Effective demand consists of the aggregate spending of the whole community—of individuals, private firms, local authorities, public bodies and the central government. This aggregate spending is made up of spending on goods for current consumption on the one hand, and on newly created capital goods on the other. The former are normally bought out of current income, the latter by borrowing.

In order that some people may borrow and spend it is necessary that others should save. If more is borrowed and spent than the community wishes to save, effective demand is increased. When we have idle resources, this will lead to an increase in employment and national income, and out of a higher national income more will be saved. In time of full employment an increase in effective demand would produce a rise in prices and a more unequal distribution of income, and this too would lead to an increase in saving. Thus borrowing-and-spending creates its own saving. Saving, however, has no similar power of creating its own borrowing-and-spending. An increase in thrift unaccompanied by an increased willingness to borrow and spend would reduce effective demand, and would choke itself off by causing unemployment and lowering income.

Saving is thus a social virtue only so long as it is accompanied by a desire to borrow and spend. At the root of

the unemployment problem is the fact that saving and borrowing-and-spending are done by different groups of people and from different motives, and that in the past we have had no machinery for balancing the two otherwise than through changes in employment and income. Except when swollen by government borrowing to finance a war, borrowing-and-spending has been too little to absorb all that the community would have wished to save out of full employment income, and so we have had chronic unemployment. Further, borrowing-and-spending has fluctuated violently, and these fluctuations have a cumulative effect, producing still greater fluctuations in employment and income.

The implications of this argument will seem revolutionary to a conservative and conservative to a revolutionary. The government must assume responsibility for keeping effective demand at a level sufficient to maintain full employment. Whenever effective demand seems likely to fall below this level, the government must stimulate it by encouraging both private borrowing and private spending out of income. But if this proves insufficient, and it probably will, the government must be willing to borrow itself, either for the creation of new social capital or to meet a deliberately incurred deficit in the Revenue Budget. If, on the other hand, effective demand were to become excessive, and we were threatened with inflation, the government would have to reduce demand by discouraging private spending and itself budgeting for a revenue surplus.

This is the only marked break with tradition which our argument implies. The two great defects of the system of free enterprise have been unemployment and unnecessary inequalities of wealth and, as we have seen, the two are closely connected. By controlling the level of effective demand as we have suggested, the state can maintain a high

and stable level of employment. By maintaining the present high rates of taxation on unearned and inherited wealth, it can largely remove those inequalities which have not the justification of promoting efficiency.

When these two things are done, there will be no advantage in a general transfer of the ownership of capital to the state. On the contrary, there would be great advantages in leaving the ownership of most instruments of production in private hands. By this means the desire for private gain is harnessed to the service of the public, and competition for private profit promotes the efficient use of capital for the public benefit; the sensitive and powerful mechanism of the market records the manifold desires of consumers and distributes the available supplies of materials and labour to the points where each will contribute most to making what the buyer wants; decisions are decentralised, and authority is diffused among as many different people as possible; economic life becomes a school of experience in practical democracy, and economic organisation a safeguard to political liberty.

There will still be room for the state to take part in economic life in many ways, as it has done in the past. A few important examples were mentioned in the last chapter, but there are many others, and experience will reveal still more. The state will, no doubt, take on the production of further goods and services itself when, for some special reason, they can be supplied better publicly than privately. It will continue to guide and regulate private actions when such regulation helps to harmonise them still more closely with the public interest. But there is nothing revolutionary in this. Each case can be considered on its merits, and no change should be made until it was clearly shown to contribute to the greatest happiness of the greatest number. There would be no wholesale destruction of old institutions,

no sudden sweeping away of traditional practices; all that was best in the past would be preserved, and there would be a steady stream of improvements recommended by reason and experience. The British people have always excelled at this type of evolution in the past, and it is to this that we should look in the future.

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