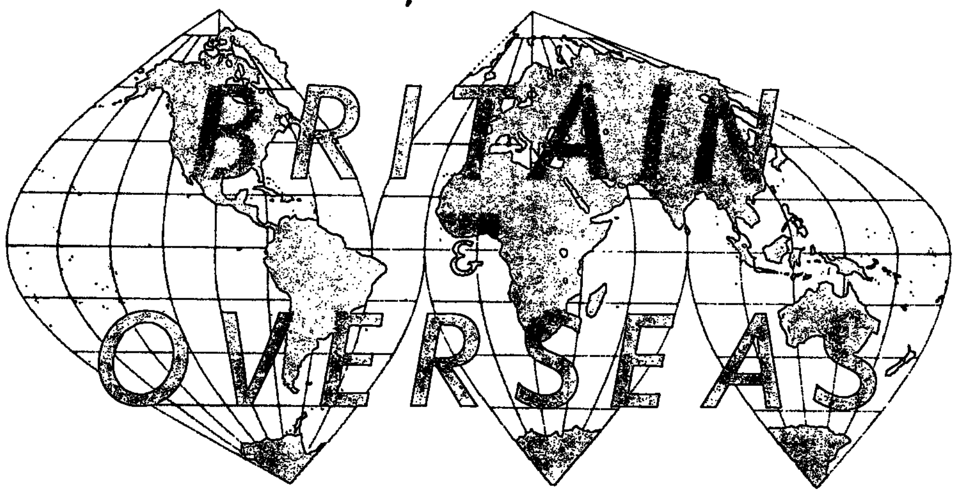

A DIGEST OF NEWS AND VIEWS ON BRITAIN'S ECONOMY AND OUR ROLE IN OVERSEAS TRADE AND PAYMENTS

Autumn 1982 Vol. 12 No. 3

Drowning in a Sea of Unpayable Debt	2
The EFTA Alternative	5
Reform of the EEC	7
The Fallacy of Reflation	8
Conflict of National Laws with International Business	10
Stabilising World Prices	11
Some Illusions about Credit	12
The Commonwealth Option	16
Sir George Bolton	16

Published quarterly
Editor: Edward Holloway

Published by
The Economic Research Council

55 Park Lane, London W1

Subscription rates: U.K. £2 p.a. Australia $5 Canada $6 New Zealand $5 U.S.A. $6.

DROWNING IN A SEA OF UNPAYABLE DEBT!

The current crisis in the international banking system is the subject of deep concern. For if the world banking system were to collapse, it would result in a major international financial calamity. There is real danger that debtor countries such as Mexico, the Soviet bloc countries and many third world countries will finally be forced to default on their loans and the International Monetary Fund, the central banks and the Bank for International Settlements have been active in trying to prevent a major breakdown. The 1970's saw the biggest credit boom the world has ever seen, with commercial bank credit expanding two or three times faster than real economic growth.

This problem dominated both the two-day Commonwealth finance ministers meeting recently held in London and the more important meeting of world finance ministers subsequently held in Toronto. In his opening address to the Commonwealth ministers meeting, the Secretary General, Mr Shridath Ramphal, said "The search for world economic recovery so desperately needed remains stalled, and we drift towards the abyss of economic disaster continuing the pretence that our fate is our own. The world teeters on the brink of a depression that could be wider and deeper than that of the 1930's." He urged that the international bankers should explore the possibility of a world central bank and whether the International Monetary Fund could be transformed into such an institution.

Further Lending

Present efforts to prevent the erosion of confidence which would cause the breakdown of the international financial system, however, only perpetuates the problem, for these consist, in the main, in further lending to enable the debtor countries to pay the interest on their outstanding liabilities: International bank lending grew by over a fifth each year in the last part of the 1970's. Commenting on this situation in an article in THE TIMES in July 1981, Lord Lever wrote – "The money markets of the world have come increasingly to look like a casino in which the major currencies are turned from reliable investment and trading media into little more than gambling counters".

It needs to be recognised that, in the final analysis, payments across frontiers can only be made if goods and services are exchanged. This puts the third world countries in an impossible position when they try to meet their overseas commitments. For unless creditor nations will accept an excess of goods and services as imports, and so enable the debtor to earn foreign currencies with which to pay, they are inevitably placed in a position of unpayable debt.

While the proposed increase in resources available to the I.M.F. will probably, if implemented, stave off an immediate break-down, they will only be a palliative and will not solve the imbalance which exists between debtor and creditor countries. Some more far-reaching reforms are needed if the problem is to be solved in the long term.

It is worth while to look back over the past years for a solution. For our present situation is similar to the problems of the 1930's and there were several post-war plans for better methods of financing international trade. As we said

in an article on the North/South Dilemma in our Spring issue, in the 1940's a number of ideas were put forward on both sides of the Atlantic. They were all based on the fundamental provision put forward by Lord Keynes that equal pressure should be brought to bear, not only on the debtor nation to pay its debts, but also on the creditor nation to accept payment. Keynes put forward a plan which envisaged the setting up of a clearing union where payments between nations could be swopped and the means established to iron out the debtor-creditor relationships.

Bretton Woods

This plan was turned down at the Bretton Woods Conference in 1944 in favour of a plan put forward by Harry Dexter White which culminated in the Bretton Woods Agreement, followed by the Washington Loan Agreement, which was bitterly opposed by many in this country.

Another plan which attempted to solve the problem of international payments was put forward in 1941, entitled 'A Twentieth Century Economic System'. This proposed a system of multi-lateral contra-account, whereby nations would acquire credits in an international clearing union when they exported; it could only clear these credits when it imported, so creating a contra-account. It would not have to import from the country to which it sold, but if it wished to take payment, it could do so only by importing from some other nation to the value of its exports (visible and invisible).

Failure to import would result in a credit held by the international clearing union; credits so created would have an agreed life and would then be cancelled. This plan, very briefly summarised, achieved significant support at the 16th Congress of the Federation of Chambers of Commerce of the British Empire in 1948. In the Report of the Congress the scheme was summarised thus – "The essential feature of this scheme is that nations would recognise that exports could only be paid for by imports: that it was their duty and obligation to maintain their own external payments in the world in balance. To give effect to this concept it would be agreed amongst the nations that if they did not clear their claims on other nations within a period of years e.g. seven years, that claim would automatically lapse under a Statute of Limitations."

Among others who proposed similar schemes was Dr. Herbert Feis, a prominent official in the American Treasury. He contributed an article in an influential American periodical, FOREIGN AFFAIRS in 1943. He also advocated the setting up of an international clearing house where claims between countries could be swopped and if claims remained outstanding over an agreed period of years, they could be cancelled.

Lease-Lend

These ideas have been largely ignored since the end of the 1939-45 war but there have been periods when the general principles have been in operation. When the war broke out in 1939 the U.S.A. operated a policy of "Cash and Carry". This meant that Britain's gold reserves and investments overseas were drained away in an effort to obtain dollars to pay for vital imports. Recognising that this could not continue, the late Franklin Rossevelt introduced Lease-lend and Mutual Aid, which, in his words "cut out the dollar sign and removed the financial nonsense from international trade. This operated to the benefit, not only of Britain, but also the U.S.A. It was a tragic decision when at the end of the war, lease-lend was withdrawn and the dollar sign restored. The resultant chaos in world payments led to the introduction of Marshall Aid in an attempt to restore shattered European economies. The European Payments Union was set up in 1950 to iron out the payments problems of European countries whose trade was being sorely disrupted by constant balance-of-payments difficulties.

The E.P.U.

In the words of the original objectives of the Union, it set out to provide "some cushion to play the part which European gold and foreign-exchange reserves, many of which are now depleted, cannot be expected to play. It will also be necessary to make it possible for countries which improve their position to strengthen their reserves and to encourage them to do so." The EPU provided the cushion by taking some part of the debit and credit arising from trade between members of the Union, and freezing it so that trade could continue to flow, even if trade between the nations was unbalanced. And it worked!

Something along these lines, establishing a system of Mutual Aid by the setting up of a Payments Union or clearing house to provide a cushion between debtor and creditor nations is urgently needed if we are to meet today's challenge. The I.D.A., which allows soft loans is a step in the right direction but cannot meet the needs of the present crisis. Failure to implement proposals along these lines will, in the long term, lead to a break-down in the world trading system.

It should be borne in mind that the high-income industrialised countries urgently need an expansion of world markets. The low-income countries would provide the capacity for that expansion if means were found to enable them to meet their obligations without being drowned in a sea of unpayable debt.

THE WORLD GASPS FOR LIQUIDITY

"Only yesterday, it seems, bankers were flush with deposits and jetting everywhere on earth, eager to lend to bustling, ambitious borrowers. The same bankers today over-extended and frightened, are jetting home with discouraging news of foundering economies and insolvent borrowers pleading for time and more credit. It is as if everyone – rich and poor alike, capitalist and socialist, advanced and developing – were making the rounds of a giant Monopoly game board and the rules changed."

Extract from an article by Norman Gall in 'Forbes', October 11 1982.

THE EFTA ALTERNATIVE

Some while ago President Mitterand of France made the suggestion that Britain should be given special status within the EEC. This was a proposal worthy of careful consideration, for it is becoming increasingly obvious that the demands made on the British economy by the Community are becoming increasingly onerous.

When Britain together with Ireland and Denmark joined the Common Market in 1973, the countries of our former partners in the European Free Trade Association (EFTA) decided to forge a new relationship of their own with the Community. Thus, EFTA countries were given "special status"; they accepted some aspects of the Community arrangements but not others, in particular participation in the Common Agricultural Policy, which has been the source of much aggravation and dissension ever since we joined.

During the Common Market controversy there were many who argued that Britain would be better off by remaining with EFTA and accepting the partial involvement which would have given us the full liberalisation of all traffic in industrial goods which was such a major factor in persuading the British people to accept Common Market membership. Access to the market of 300 million was one of the pro-marketeers main objectives.

EFTA Compares Favourably

It is interesting to note, therefore, that the EFTA countries have shown a resilience which compares favourably with Britain, Denmark and Ireland, all countries suffering from a major depression. Recently the EFTA countries celebrated the tenth anniversary of the free trade agreement and, as the following report published in 'The Courier' for September-October 1982 clearly shows, they have found their agreement with the EEC a highly satisfactory arrangement. The countries concerned are – Austria, the Faroes, Finland (associate member) Iceland, Norway, Portugal, Sweden and Switzerland.

Tenth anniversary of the free trade agreement

On the tenth anniversary of the signing of the free trade agreements linking the Community to the EFTA member countries the Commission expressed its satisfaction with the way the agreements have operated.

Approximately a quarter of the Community's external trade is with the EFTA countries which in turn do about 60% of their trade with the Community. Together the two groups of countries form a market of 300 million consumers.

The Commission believes it is in the mutual interests of all concerned to do everything they can to improve the working of this Western European market to remove the remaining barriers and divisions and to forestall any upsurge of protectionism, and it will for its part have regard to the importance of free trade with the EFTA countries when considering the means of consolidating the Community's internal market.

Flexible Arrangements

Cooperation has now extended to take in many fields not directly within the scope of the free trade agreements such as scientific research, the environment, transport and economic and monetary questions. This has come about in a variety of ways, sometimes by the conclusion of formal agreements, sometimes by flexible arrangements for the exchange of information. The Commission attaches great value to this pragmatic style of cooperation, which enables EFTA countries to work together with the Community in their own way in fields of mutual interest.

The free trade agreements do not apply to trade in agricultural products, although they do contain a clause in which the Community states its readiness to foster the harmonious development of trade in agricultural products so far as its agricultural policies allow.

Agriculture less important

Such trade is governed by a large number of specific agreements or arrangements on various agricultural products, constantly updated to take account of market conditions. Only 16% of Community farm exports go to the EFTA countries, compared with over 26% of its industrial goods, and in the last few years EFTA has tended to become relatively less important as a market for Community agricultural produce.

On a broader front, EFTA countries are not unaffected by the Community's whole external economic posture, indeed its policies towards its other industrailized trading partners and the developing countries in particular are of the greatest concern to them. The Commission believes that it is in the Community's interest not to restrict meetings and exchanges of views to bilateral trade questions alone, and it would like to extend such discussions to take in the whole field of external economic policy, in keeping with the spirit of solidarity and cooperation, the importance of which was stressed by the Council recently.

This seems to indicate that President Mitterand's proposal would be worth close examination; preserving what is mutually advantageous in our relations with the Community at the same time as removing those aspects which generate much heat and hostility with our Common Market friends.

Revamping Relationship

As Gordon Tether wrote in 'The Times' on 25.5.82 – "if President Mitterand's proposal were acted upon Britain would not be down-grading herself to the position of a second-class EEC country. All she would be doing would be revamping her relationship with the Community to put herself in a position to secure the best of both worlds rather than the worst – as is the case at present. Thus we could be rid at a stroke of the enormous burdens that are directly imposed on the British economy by involvement in the Common Agricultural Policy".

REFORM OF THE EEC

Mr. Teddy Taylor asked the Secretary of State for Foreign and Commonwealth Affairs what are his objectives for EEC reform in 1983.

Mr. Pym: Our aims are to work with our partners to develop existing Community policies, to seek new policies which will benefit Britain and the Community, to try and change the CAP and to solve the budget problem.

Mr. Taylor: As we have been trying for 10 years to get a new, permanent, solution to the budget problem as the latest estimate, if there is no reform, is that we may have to pay £1,000 million net next year, will the Government make it clear that, in the absence of a firm agreement on a new fair contribution system, they would be willing to withhold contributions from the EEC?

Mr. Pym: Our objective is a reorganised budget that is fair not only to Britain but to every member of the Community. That is fundamentally necessary to the health of the Community. We shall seek to achieve that in negotiations for 1983 and later, which have not yet begun. I would not expect the Commission to put a proposal before us for a few weeks yet. That proposal will be the beginning of the negotiation that ensues. I shall bear in mind during the negotiations the points that my hon. Friend raises.

Mr. Leighton: In view of the Prime Minister's statement yesterday that the level of employment in this country depends on our share of home and overseas markets, and bearing in mind that our current deficit in manufactured goods with the original EEC Six is running at £5.5 billion compared to a surplus of £6.6 billion with the rest of the world, will the right hon. Gentleman estimate how many jobs have been lost in this country by the trade deficit now inflicted upon us by the Common Market?

Mr. Pym: Not as many as would have been lost if we were not members of the Community.

Sir John Biggs-Davison: Is my right hon. Friend aware of the concern of many people in the country, who are favourably disposed towards the Community, over the degree of European discrimination against Commonwealth persons and products? Will my right hon. Friend see what can be done in the interests of the Community to bring the whole Commonwealth closer to Europe?

Mr. Pym: That is an objective that I certainly have in mind. I am a strong supporter of the Commonwealth and wish to do whatever I can to further its interests within the context of the Community. I shall keep in mind the important point that my hon. Friend has raised.

Hansard. Vol.29 No.168 Col. 361. 20 October 1982.

THE FALLACY OF REFLATION
by Harry Rutherford

Few people would deny that the quantity of money in circulation bears some relation to the level of prices, even though it may not be the only factor which determines them. If an economy were in a state of equilibrium, with prices stable and with consumption and production approximately matching each other, and if an irresponsible Government suddenly caused a large amount of extra money to be created in order to pay for expenditure which it wanted to incur, the result would undoubtedly be an increase in the general level of prices. And if the Government were to do this when demand already exceeded production the inflation would be even worse. Such a creation of new money for Government expenditure could improve the economy only if there was a glut of finished goods, and prices were falling.

So how can an economy which is in equilibrium reach a higher level of production? This is the problem with which Professor Soddy dealt in his book **Wealth, Virtual Wealth and Debt** (George Allen & Unwin, 1926) and later in **Money versus Man** (Elkin, Mathews & Marrot, 1931). His analysis of the problem provides one of the strongest arguments against the creation of money by the banks as interest-bearing debt. Generally money that is borrowed is required either for the sake of production. But the effect of borrowing for consumption is that the borrower, except in an inflationary economy, consumes less than he otherwise would by the amount of interest he has to pay, though he gets what he wants sooner.

Major cause of inflation

The greater proportion of borrowing from the banks is done by companies who wish to increase or improve their production. They reckon to pay the interest on their loan out of the extra profits they hope to make by investing in more working and, if necessary, fixed, capital. But while it takes time – weeks, months or even years – for the increased production to come on the market as finished goods, the money which has been created for the investment becomes income in the hands of individual consumers very soon. The inevitable result of an increase in the money available to be spent without a corresponding increase in the amount of goods available for purchase is a decline in the value of the money. In any one case this is negligible, but in total it is a major cause of inflation.

Professor Soddy pointed out the simple fact, well known to anyone who thinks about the subject, that the only sure way to bring an economy in equilibrium to a state of higher production and consumption is by some people temporarily reducing the amount they consume. The money which these people would have spent on personal consumption is invested and used instead to buy plant and machinery and to increase the value of work in progress. Once this extra volume of work in progress is 'in the pipeline' it cannot be taken out again for consumption without reducing the rate of production. To pay for the increase in the rate of production by bank-created money does not eliminate the need for abstinence from consumption, it merely conceals it. Instead of some people deliberately

consuming less and investing what they save in increased production, everyone is compelled, whether they like it or not to consume less as a result of the general decline in the value of money.

Let us start from an economy in equilibrium, where prices are relatively stable. This is the situation which the present Government hopes to reach by depressing the economy. And let us assume that there is not a glut of finished goods on the market, because production has been reduced to match reduced consumption. The problem then will be how to increase the level of production again to an acceptable volume. Let us then further assume that there is, as there probably will be when the present depression reaches its lowest ebb, enough fixed capital equipment to increase production very considerably without further capital expenditure. What will be required is to increase the level of production and this inevitably means to increase the work-in-progress or unfinished goods 'in the pipeline'.

A fresh injection of Money

Those companies which as a result of the depression have become more liquid will be able to pay for this out of their own stored up resources. But companies which have used up much of their liquidity in the mere task of survival through the depression, will need a fresh injection of money to pay for the necessary increase in working capital. The only way this can be done without sowing the seeds of the next inflation is by some people abstaining from consumption and lending the money they would have used for that purpose. Then, as the increased quantity of goods comes on the market it will be necessary to increase the quantity of money in the hands of the public, which can be done by the creation of new money to pay for current Government expenditure and a corresponding reduction of taxation. If inflation is to be avoided, reflation has to take place by the issue of new money free of interest to consumers when, and only when, the increased goods have come on the market.

The alternative, which is the conventional way of reflation, is for companies, which are not liquid enough to increase their work in progress out of their own resources, to borrow from the banks for that purpose. This increases the money in circulation almost at once as the extra money thus borrowed becomes income in the hands of individuals. But since some production cycles are much larger than others, the extra goods will not come on the market as soon as the extra money. In the case of a single company this would make little difference, but in general reflation there would inevitably be a small decrease in the value of money. At first this would not seem to matter very much, because the rate of production would go on increasing and in an expanding economy people would say that we can live with a mere 3% to 5% inflation. But a time would come when the economy had reached its limit. Then a new infusion of capital expenditure would be required for still further increase and again the new money would reach the market before the extra goods were available. Or else the economy would become overheated and a STOP would be applied, and then later another GO. The result of all that is too well-known to need description.

The only situation in which reflation by the immediate creation of new money could be justified would be if there was a surplus of goods on the market which needed to be mopped up before the increase in the level of production took place. But once this had been done the increase in production must be effected by the borrowing of real already existing money, not by the creation of new money.

CONFLICT OF NATIONAL LAWS WITH INTERNATIONAL BUSINESS

The urgent need for an international agreement

The absence of any means of resolving disagreements between nations concerning the application of one country's domestic law to business activities taking place in another – extraterritoriality – results in insecurity, higher business costs and damaging confrontations between otherwise friendly nations.

Such conflicts have been increasing in frequency and seriousness – the action of the United States and the response by Western governments over the East/West gas pipeline being only the latest example.

This is one conclusion of a study, *Conflicts of National Law with International Business Activity: Issues of Extraterritorialty,* by Dr. A.H. Hermann,*.

Dr. Hermann, a distinguished international lawyer, describes how the problem of extraterritoriality has usually been seen in the context of US antitrust application. He points out the difficult position of subsidiaries of US companies required to operate under the legal jurisdiction of one country but also subject sometimes to conflicting orders from Washington.

So abrasive have these and similar conflicts bcome, that friendly nations have been forced to enact legislation 'blocking' the effects of a foreign country's laws. The UK Protection of Trading Interests Act 1980 was one such response and it has been invoked in the current dispute on the gas pipeline.

Resolving the Problems

The author suggests that a more fruitful approach than those so far tried for resolving the antitrust issues would be to seek a limited international agreement which embodies four basic principles:

- Removing from the criminal courts hearings on allegations of offences involving the extraterritorial application of antitrust laws.
- Eliminating private prosecution of antitrust offences committed abroad by non-residents.
- Creating international machinery for harmonisation of antitrust policies in respect of wholly international industries, such as shipping and air transport.
- In respect of other foreign enterprises restricting measures adopted by antitrust enforcement agencies or courts to "cease and desist orders" regarding behaviour taking place outside the national territory.

****Conflicts of National Law with International Business Activity: Issues of Extraterritoriality, by Dr. A.H. Hermann, British-North American Committee, 1 Gough Square, London, EC4.***

STABLISING WORLD PRICES OF BASIC COMMODITIES

Mr. Leo St. Clare Grondona, whose proposals for stabilising world commodity prices have received widespread attention and support from many leading economists, died in London on October 19. He was 92.

A long-standing member and keen supporter of the Economic Research Council, he was, until quite recently, still at work on a revised edition of his book "A Built-in Basic-Economy Stabiliser"* which the Council published in 1972. Sir Roy Harrod contributed a Prefacing Letter in which he commented on Grondona's work "Its inherent quality of lucidity, precision, practicality, and above all simplicity...." He urged that the Cabinet should give serious attention to the Report, a view that was supported by Professor Lord Kaldor, Lord Roberthall and Donald Tyerman. Subsequently the Grondona plan was considered by a Committee of the House of Lords.

"Gron", as he was known to his many friends was an Australian born of English-Irish parents and after leaving Xavier College, spent three years on a million-acre sheep and cattle station in Queensland – by turn drover stockrider and junior overseer; and occasional tutor to children remote from schools. His *Adventures of a Jackeroo* appeared when he was ninetten. His wounds when with the Australian forces in World War I precluded his resuming work on the land, so he joined the Federal Department of Repatriation and was soon in charge of that Department in NSW. He was with the Australian Delegation to the Imperial Economic Conference in London in 1923 following which he became Director of Information at the Australian section of the British Empire Exhibition. He wrote *The Romantic Story of Australia* (to which his Prime Minister, later Viscount Bruce of Melbourne, contributed a Preface) and followed this with *The Kangaroo Keeps on Talking* (to which the then British Prime Minister – later Earl Baldwin of Bewdley – wrote an Introduction).

His *Empire Stocktaking* (1930) was accorded eulogistic leading articles and reviews; and two years later he produced *Britons in Partnership* of which *The Times* said: 'This is a drastic project for the reclamation of the vast estates of Empire – a door to realities which cannot be read without a glow of exhilaration.'

Late in 1934, he was appointed District Commissioner in the Special Areas in NW England. When the Chief Commissioner, Sir Malcolm Stewart, resigned in 1938, Mr Grondona did likewise and became economics consultant to Intercement, S.A., in Paris. In early 1939 his *National Reserves for Safety and Stabilization* appeared. While this, too, was enthusiastically received by the responsible Press, the imminence of war put paid to its then consideration by HM Government. Its author joined the British Army in 1940. He was commandant of one of the chief prisoner-of-war interrogation centres. Some recollections of his experiences in regard to Marshal Messe (GOC Italian Forces in North Africa) F.M. von Rundsted, F.M. von Thoma and other high-ranking Germans, as published in the *Royal United Services Journal* attracted widespread interest.

On termination of hostilities in Europe, he became commandant of the Political Instructional Centre for German prisoners – several thousand of whom volunteered to attend series of courses conducted on university lines, under Foreign Office auspices, until August 1948.

****A Built-in Basic-Economy Stabiliser by L. St. Clare Grondona published by ERC 1972 price £1.10***

In 1958, he produced *Utilizing World Abundance* – a post-war elaboration of *National Reserves* – which was likewise commended in the Press, as well as by MPs of all Parties in debates in the Commons.

In early 1960, he was invited to Australia to present a thesis on his stabilizing system at the XIIth International Congress of Scientific Management in Melbourne – where twenty-nine nations were represented.

In the event, Mr Grondona had long discussions with Finance Ministers in Rawalpindi, New Delhi, Kuala Lumpur, Singapore, Canberra, Wellington (NZ) and Ottawa; and he addressed many groups of Parliamentarians in those capitals. Great interest was evinced in his proposal in all these countries, but none was in a position to implement it; because his system can be effective only if administered by a great commodity-*importing* nation – as distinct from countries that are primarily *exporters* of basic commodities.

When re-visiting his native land, he travelled widely as a guest of the several States, and later produced *Australia in the 1960s* to which the then Australian Prime Minister, Sir Robert Menzies, wrote an appreciative Preface.

It may be apposite to conclude these notes with a quotation from a sentence from *The Times Review of Industry* in its comments on that book: 'Mr Grondona's writings about Australia and the Commonwealth over the past thirty years have won for him an enduring place in the respect and affection of his fellow countrymen.'

SOME ILLUSIONS ABOUT CREDIT
Contributed by Professor D.A. Bell

The E.R.C. publication "Government Debt and Credit Creation" will have performed a useful service if it stimulates examination of the factors involved, but unfortunately the Treasury reply (Britain and Overseas, Summer 1982 issue) is concerned with detailed mechanisms and does not discuss the fundamental factors on which there are widespread misunderstandings.

Illusion number 1 – that there has been a great deal of credit creation in recent years

Table 19 of the E.R.C. publication gave annual figures, 1945 to 1980 showing a large increase in face value of all measures of money, from currency to M3. But these face values must be corrected for inflation if they are to have any real meaning. Different deflators are appropriate for different categories of expenditure, but the single one which is most readily available is the Retail Price Index. This has been re-set to 100 periodically and whenever this was done it was usual to make some adjustment to the relative weights of the items on which the index was based. Therefore an index prepared by joining end-to-end all the successive series of R.P.I. is only an approximation to the R.P.I. but it is an adequate index of the progress of inflation. To avoid any confusion with the exact R.P.I., this synthetic long-term index is here called "purchasing power index" (P.P.I.). It has the value 100 in January 1956 and annual averages are given for later years. The following

table shows that when the values are divided by the P.P.I., M1 actually shows a small **decrease** (this represents an increase in velocity of circulation) while M3 increases by 27% in 20 years, equivalent to 1.2% p.a. compound growth. M1 and M3 are in millions of pounds.

Year	P.P.I.	M1	M1/P.P.I.	M3	M3/P.P.I.
1960	111	6603	5949	10238	9923
1965	132	7783	5896	13051	9887
1970	165	9635	5839	17666	10706
1975	304	17483	5750	37595	12366
1980	594	31214	5255	69575	11712

Illusion number 2 – that the burden of national debt is increasing

It is said that since the national debt has always increased and shows signs of continuing to increase without limit, the time will come when posterity will find it an intolerable burden. Ability to pay will depend on G.D.P. and three things are covered by taking the national debt as a percentage of G.D.P. (or G.N.P. – the difference depends on balance of payments and is small): (a) inflation becomes irrelevant because it enters equally into both debt and G.D.P.; (b) the money base can be expected to grow as G.D.P. grows, just as a large firm needs more capital than a small firm; and (c) the relative ability to service the debt is shown directly. The ratio of total public sector debt (central government plus local government debts) to G.D.P. for the U.K. has for recent years been published annually in Financial Statistics (February 1982 issue, Table S.11); and for U.S.A., the ratio of debt to G.N.P. is included in the Statistical Abstract of the United States (1980 edition, Table 480 on p. 287). Some sample percentages are as follows

Year	(Debt/G.D.P.), %, U.K.	(Debt/G.N.P.), %, U.S.A.
1980	57.5	
1978		53.4
1975	69.8	52.5
1971	84.6	
1970		72.1

If we go back to the 1950's, the figures appear to be over 100%. The ratio is not published as such for Japan, but from individual statistics in the Economic Statistics Annual published by the Bank of Japan the ratio seem to have been little more than 10% up to 1974 but then rose steadily and was probably about 40% in 1980, during which time G.N.P. less than doubled (in current currency terms).

The analogy between a nation and an individual firm was mentioned in (b) above and as a matter of interest figures were found for a few firms in different types of industry. The balance-sheet total of liabilities was taken as analagous to total public sector debt and the annual turnover as analogous to G.D.P., with the following results.

Type of industry	Liabilities, £m	Turnover, £m	Ratio, %
Engineering	68	130	52
Food	250	743	34
Multiple retail (furnishings etc.)	778	1760	44
Pharmaceutical	442	711	62

Illusion number 3 – that credit can be "created" from nothing

Critics of the banking system have alleged that banks create credit by a stroke of the pen, while banks protest that they only lend their customers' money. The truth is in between, but quantitatively nearer to the banks' side of the argument. For while it is true that every loan creates a deposit which can be used to create a further loan and so **ad infinitum**, the practical factor is that the banks have to retain some of each deposit to meet day-to-day demands so that each loan in the chain is smaller than the last. The result is that the banking system creates credit to the extent of three or four times the initial deposit, not unlimited credit.

But can the Government create credit without borrowing? This is what the Prime Minister has called "printing money". For the issue of credit gives the recipient a call on goods and services. Unless someone else is willing to release his call on them, by lending money, the total call on goods and services has been increased and this is in principle inflationary. "In principle" because this assumes that the total supply of goods and services is constant. This point leads to difficult arguments whether the issue of more credit would lead to an equal or greater increase in the supply of home-produced marketable goods and services or would increase inflation and/or produce a balance-of-payments problem. ("Public works" do not normally produce marketable goods). But apart from the question of maintaining a balance between deflation and inflation, which will arise if the velocity of circulation of money does not increase in pace with the growth of G.N.P., credit must not be issued without a countervailing loan to the authority issuing the credit.

Illusion number 4 – that interest rates have recently been high

The question how far real interest rate can fall is relevant to the lending of money which was mentioned in the previous section, 'Real' interest rate is the difference between nominal rate and inflation: it has on occasion been negative, and hence the interest in 'granny bonds' and index-linked treasury stock. This relationship between inflation and nominal rate of interest is not effective in international lending, because in the short term exchange rates are not controlled solely or necessarily by inflation. Nor is it much use to those whose nominal incomes/profits do not increase automatically with inflation. But it is a paramount consideration for long-term investors such as pension funds. It is now over 20 years since Bank Rate rose to the then unprecedented value of 7%. It was suggested that the trend for industry to become more capital intensive would increase the demand for investment and so force up interest rates. However, this is by now belied by continuing low interest rates in Switzerland. It seems that lenders everywhere are satisfied with a long-term real interest rate of 3%–4% as recompense for the deferment of consumption.

COMMENTS ON QUESTIONS RAISED BY PROFESSOR BELL by MCM

The fact that credit creation (increase in money stock) is about the same as the increase in retail prices. This is self-evident – almost by definition – since the increase in money stock leads to an increase in prices of about the same amount generally. For example, for the 1970s:

	Increase % pa Consumer prices	Money stock
Chile	144.4	157.8
Argentina	121.7	120.6
Uruguay	62.6	62.1
Ghana	39.2	35.3
United Kingdom	13.2	12.8
United States	7.2	6.3

Credit can be created from nothing.

'The result is that the banking system creates credit to the extent of three or four times the initial deposit, not unlimited credit.' This of course is true, otherwise there would be absolutely no limit on the increase and the rate of inflation would become infinite.

Interest rates have recently been high.

(a) They have been higher recently than in the mid 1970s – as is shown by a chart from the Bank's latest Bulletin.

(b) 'It seems that lenders everywhere are satisfied with a long-term real interest rate of 3–4% as recompense for the deferment of consumption'.

Certainly; to quote from a booklet I wrote in 1972, referring to the 1950s and 1960s and covering some 20 countries... 'The **level** of bond yield has been closely related to the **rate** of inflation over the period; the level has fairly consistently maintained a margin of 3% over the annual rate of increase in prices for each economy. Such a level, at 3% can be regarded as the 'true' gross rate of long-term interest...'.

(c) From our point of view, the important thing is that the Government has been affected by higher payment of interest. Following are the percentages of the Debt interest paid (our booklet page 36) as a % of gross national product – the corresponding table to that relating national debt to gnp:

Debt interest as a % of gross national product

1980	3.33	1964	2.79	1968	2.83	1972	2.49	1976	2.97
1981	3.25	1965	2.88	1969	2.72	1973	2.47	1977	3.23
1982	3.03	1966	2.70	1970	2.51	1974	2.64	1978	3.39
1983	3.02	1967	2.73	1971	2.39	1975	2.61	1979	3.57
								1980	3.84

While the % fell to the nid-70s – a counterpart of the fall in national debt from the war-laden earlier years – the late 70s saw an increase. That is what the booklet is talking about.

THE COMMONWEALTH OPTION
Reviewed by Jim Bourlet

The debate on Britain's membership of the EEC displays a certain odd rythm. First a lull with little discussion, then a crisis over some major decision or crazy policy, then an exchange of arguments in which every pro market point is answered and the opponents of membership win the intellectual contest, then a loud propaganda trumpeting of the discredited pro market points unaccompanied for lack of media amplification and government support by the opposing case, then an uneasy public aquiescence in the continued E.E.C. imposition (or indeed membership itself) and then back to the lull awaiting the next cycle. It seems remarkable therefore that contestants should still be found to engage in this rather disheartening exercise but in 'The Commonwealth Option' Bryan Gould has set out clearly and concisely the sufficient intellectual answer to the pro-market claim that the Commonwealth can now, – should now, be relegated to a mere tiny role in Britain's economic affairs.

The Commonwealth Option carefully unveils the muddles, confusions and misrepresentations that have been chorused at us about Commonwealth trade, shows how the economy of modern Britain has indelible roots in our economic relationship with the Commonwealth, and points to the damage already done to the economies of this country and many other Commonwealth countries by our E.E.C. adventure. It shows a sad litany of foolhardy economic decisions. Finally, the options before us are given and the 'Commonwealth Option' advocated.

I find that Pro-marketeers cannot seriously, and generally do not bother to argue with this sort of documentation and careful analysis. They are now mostly enjoying remunerative association or employment with the EEC, (One commented to me recently "You had all the arguments and we got all the jobs") and they can cynically dismiss a well argued case with the thought that it does'nt matter because the British public will accept propaganda half truths and is too lazy to work out or investigate the reality – after all, we did in 1975.

That is why I would like to see this pamphlet read very widely.

The Commonwealth Option by Brian Gould, published by Commonwealth Policy Group Ltd. 52 Fulham High Street, London. (50p plus postage).

SIR GEORGE BOLTON

With the death of Sir George Bolton KCMG., BRITAIN & OVERSEAS has lost a valued contributor whose wide-ranging articles on the international economic scene have been greatly appreciated. He had a unique knowledge of international finance dating back to the 1930's when he played a major part in developing the successful technique for managing sterling in the foreign exchange market, following the breakdown of the gold standard.

As readers of BRITAIN & OVERSEAS know, Sir George was outspoken and very critical of the gradual dilution of the sterling area which he had done so much to create. He was also very critical of the decision for Britain to join the European Community which he regarded as a great mistake.