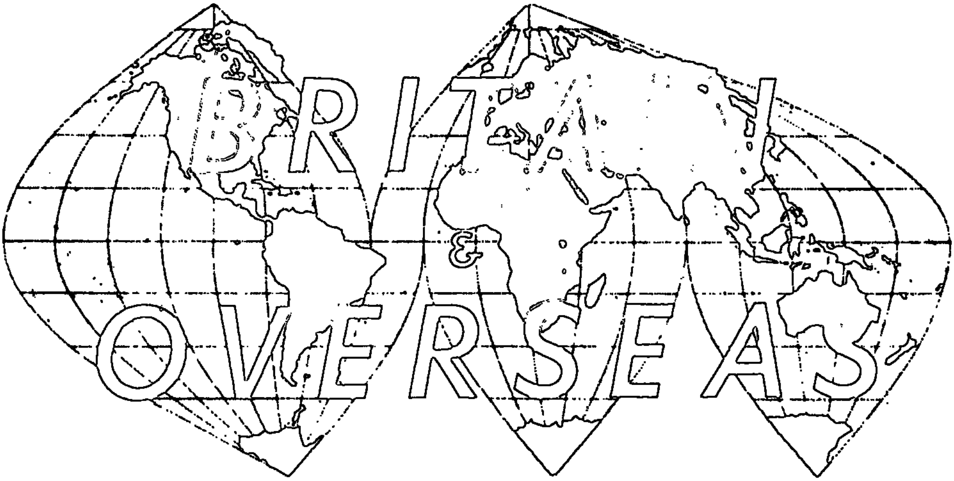

A DIGEST OF NEWS AND VIEWS ON BRITAIN'S ECONOMY
AND OUR ROLE IN OVERSEAS TRADE AND PAYMENTS

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Edward Holloway, Honorary Secretary, Economic Research Council 1955-85

It is with great sadness that I have to inform readers of Britain and Overseas of the sudden death in November of Edward Holloway. For the last 30 years Edward had been responsible for most of the day to day running of the Economic Research Council, including the arrangement of the popular dinners, study lectures and publications as well as building up membership. He was also, of course, Editor of Britain & Overseas.

Edward was a founder member of the Economic Research Council and became Honorary Secretary in 1955. Prior to this, in 1936 he founded the Economic Reform Club and Institute. Among its achievements was the campaign to reduce Bank Rate at the outbreak of war in 1939, thus saving the country millions of pounds in interest. The Club produced a number of useful papers dealing with war-time finance. Its principal objective was to obtain an enquiry into the workings of the monetary system which finally came to fruition with the setting up of the Radcliffe Committee on credit and currency in 1955. In 1959 it joined up with the Economic Research Council.

In 1967, in association with 19 leading industrialists and economists, Edward was responsible for publishing five reports on the theme of national economic recovery. They underlined the need to regulate the money supply and to greatly reduce the volume of government borrowing. These topics were an underlying theme in much of Edward's later work, including the book which he was just about to publish at the time of his death.

Edward's work in the field of British economic and monetary policy was supplemented by an extensive schools lecture programme between 1950 and 1970. In 1963 he went to Rhodesia at the invitation of the Government to carry out a survey of the growth potential of the economy. A full report was subsequently submitted to the Rhodesian Government.

The tireless work which Edward Holloway carried out for the Economic Research Counncil, on an entirely voluntary basis, will be greatly missed. However, the Executive Committee is determined to continue his efforts, including the regular of publication of Britain and Overseas.

Damon de Laszlo
Chairman, Economic Research Council

Recent Events of Interest to Members of the Economic Research Council

UK Monetary Policy

Late in 1985, the Government announced that it was abandoning its target for the £M3 measure of the money supply and replacing it with an (unstated) exchange rate target. £M3 had been growing well above its target range but the Government argued that this did not have inflationary implications since the growth of financial liberalisation and the persistence of high real rates of interest had increased the demand for £M3 as a store of wealth and not as a potential reservoir of purchasing power.

The new emphasis in policy has been widely interpreted, not least in financial markets, as a weakening of anti-inflationary resolve. The signals which are sent out to price setters in the economy by an unspecified exchange rate target are said to be much weaker than those sent out by a monetary growth target. However, the Chancellor has attempted to show how the exchange rate will be used to curb domestically generated inflation. He has warned that an acceleration of pay rises will lead to increases in interest rates in an attempt to produce an offsetting upward pressure on the exchange rate.

However, the immediate prospect is for downward pressure on sterling, no matter how tight the domestic monetary stance, due to continued weakening of oil prices. While an oil-induced decline in sterling need not have *overall* inflationary implications, the Government would have lost its use of the exchange rate to control *domestically* generated inflation. Its only hope would be that pay claims responded quickly to this external deflationary twist so moderating any fall in the exchange rate. This has been a pious hope in the past.

Not surprisingly, therefore, the switch to an exhange rate policy at a time of falling oil prices has made the Government's monetary policy look distinctly ineffectual. A growing body of opinion, which may include the Treasury, has been moved to the opinion that a further prop to sterling is needed in the form of membership of the European Monetary System.

US Monetary Policy

1985 also saw the exchange rate looming larger in US monetary policy formulation. This followed the September meeting of the Group of Five leading industrial nations at which it was agreed to pursue co-ordinated policies to weaken the US dollar. Of course the US Federal Reserve did not shift from its money supply target to an exchange rate target on the British pattern. Moreover, there was no marked relaxation of monetary policy because the Federal Reserve has long held the view that the fundamental contribution which the US could make to weakening the dollar would be to reduce its growing Federal budget deficit. While budgetary policy remained so stimulatory, monetary policy had to be primarily responsible for preventing an inflationary upsurge.

The passage of the Budget Reform Bill (or Gramm – Rudman Bill) into law in December represents an important first step in the containment and eventual elimination of the US budget deficit. It is the Act's objective to eliminate the budget deficit by fiscal year 1991. However, many unanswered questions remain as to how the provisions of this legislation can be implemented and as to whether it is constitutional.

The Federal Reserve seems to share these concerns and is therefore unlikely to tolerate any major reduction in US interest rates. This provides very little comfort for the British Government, which would like to see domestic interest rates lower but not at the expense of reduced differentials against dollar interest rates. Indeed, Britain may be obliged to increase these differentials. The fragility of sterling means that Britain cannot afford to send out potentially confusing interest rate signals to world financial markets. This helps to explain why Britain joined in the rejection, at the January Group of Five meeting, of the multilateral reduction of interest rates proposed by Japan.

Government Economic Policy – A Personal View

D. de Laszlo.

The economic policy of the present Government was formulated in the late seventies to deal with a 20% inflation rate and a 5% unemployment rate. The attack on the inflation problem was wholly necessary and has every appearance of being successful. It must be noted that some of the success in reducing inflation has been due to circumstances outside the Government's control. By the same token the rise in inflation in the seventies was also to some extent due to factors outside Government control. The major problem today however is not inflation. Inflation is no longer inhibiting or disrupting the country's commercial endeavours.

One of the ways that the Government is pushing inflation down is by maintaining a high level of sterling, so reducing the cost of imports and helping the trend of declining commodity prices. To do this, excessively high rates of interest are being maintained. The advertised virtue of high interest rates is that they reduce borrowing demand, which is true but only applicable to the industrial sector. There is little evidence that consumer demand is significantly dampened any more by high interest rates. The long term by-product of the last five years of high interest rates has been a diversion of resources away from industry.

Short term movements in interest rates do not immediately affect industrial investment, which takes a minimum of six months and on average between a year and two years to implement. Industrial investment requires a long term view and one of its criteria is the hurdle rate of return that is needed to make the project viable. By way of example, if a company's overdraft has been typically costing between 14% and 16% for the last one or two years and it would appear by Government pronouncements that this situation is likely to remain for the foreseeable future, then any capital investment that cannot produce a return of, say 10% over the company's borrowing rate is not viable, bearing in mind the investment has to produce a return to pay the interest and re-pay the capital over the life of the investment before any profit can be shown. These are long term trends in management thinking and in small and medium sized companies they are often policies that are adopted according to 'gut feelings' of the owners or directors. In large companies where sophisticated financial techniques are used, the policy is better formulated, a prize example within British industry would be GEC, who have been disinvesting i.e., generating cash as a policy, for a considerable period, to the detriment of the British electrical and electronics industry.

The Government's economic policy at the moment is encouraging business, in simple terms, to reduce its borrowing and investment in plant and machinery as it is less risky and more profitable to pay down an overdraft at 15% than to struggle and take risk to make a minimum of 25% required to pay for a new project. This high interest rate, anti-inflation policy needs to be reviewed in the light of damage it is now doing to the industrial base of the country and the consequent unemployment that is flowing from it. The Government should consider the desirability of continuing with this course of driving inflation further down which if carried to its logical conclusion could produce virtually 0% inflation and maybe 20% unemployment.

The trap in which Government economic policy is now caught includes a strange quirk: the draconian measures needed to turn the direction of inflation downwards are being applied in the face of an expressed desire by the Government to reduce its expenditure, or take, of the national cake. Falling commodity prices, which are desirable in inflationary terms, are reducing the Government's revenue from oil (a commodity) and high interest rates themselves are costing the Government excessive amounts of money in financing the National Debt. Disinflation and high interest rates are making it more difficult for the Government to reduce its expenditure and borrowing. Both these factors are examples of the way in which the economic policies formulated in the seventies are working against the declared objectives of the Government today.

The Government's economic thinking is not helped by the political attitude which produces shouts of 'U Turn' at any change in policy and regards movements in the currency as symbolic of the Government's virility rather than changing conditions around the world.

This country has suffered for many years from 'ya boo' reactions which push out the thought and study required to deal with the complex problems of a modern economy to the detriment of the nation as a whole.

Have We Really Conquered Inflation?

Dr. I.G. Patel, Director of the London School of Economics took inflation as his theme when addressing members of the Economic Research Council in January.

He noted that while the international economy was beset by many problems – high interest rates, unemployment, the debt problem, low growth and inappropriate exchange rates – inflation has come down sharply. Manufacturing output prices in the UK only rose by 40% during 1980-85 compared with a 90% increase between 1975 and 1980. Countries such as Germany, Japan and the US had an even better inflation record than the UK since 1980. The picture in developing countries varied but even these nations such as Argentina and Israel with very high inflation rates had been taking heroic measures against them with some success.

Dr. Patel pointed out that the decline in commodity prices had been a special factor working in favour of lower inflation in the developed economies in recent years. If current inflation rates, which are not low by the standards of the 1950s and 1960s, are to be other than temporary then some underlying behavioural and institutional changes will have to take place. The post 1945 inflation is unique in many ways in that inflation was continually accelerating whereas in previous periods, prices had fallen as well as risen. This suggests that new factors were at work in the inflation of the last three decades which will have to be controlled if the improved inflationary performance is to last.

There is no general agreement on what is a tolerable inflation rate. Most agree that a double digit rate is not tolerable, but what of 5% or 3%? Some such as Sir John Hoskyn of the Institute of Directors took the view that only zero inflation was acceptable so that an increase in money wages leads to a commensurate increase in living standards. However, even supporters of zero inflation had to recognise that changes in *relative* prices had to be accommodated.

Dr. Patel took the view that the achievement of a low and non-accelerating inflation rate was good enough. Inflation should not always receive priority over other objectives of economic policy such as a lower level of unemployment. He did not believe in the concept of an unemployment rate which cannot be reduced without the penalty of accelerating inflation. Just as control of inflation has not helped to reduce unemployment it did not necessarily follow that more direct measures to lower unemployment were doomed to failure if inflation rose a little.

Turning to the causes of inflation, Dr. Patel criticised the monetarist approach for its over-simplicity. The post-war inflation had more deep seated causes, manifesting themselves in both excess demand and cost-push forces. On the demand side there was the increase in defence spending associated with the Cold War, the growth of state welfare expenditure and the spread of consumerism on the US model, together with the post-war investment boom of the 1950s and 1960s. The struggle for shares of national income which supporters of the cost-plus theory of inflation emphasise, had been heightened by the spread of democracy, higher levels of education and high levels of people's awareness of the world in which they live.

Targeting of national income and some agreement on how the benefits of likely growth could be shared would help to resolve these conflicts, but more is required to permanently control inflation. Some curbs on demand were needed but not at the expense of lower productivity growth. Dr. Patel favoured a policy geared towards higher growth, faster productivity growth and a higher savings rate. On the cost-push side he favoured the growth of arbitration and the wider adoption of the Japanese system of bonuses; but emphasised that rigidities were not merely confined to the labour market.

The essence of Dr. Patel's message was that inflation is a societal problem and that if it is to be controlled on a long term basis a variety of responses are required.

Investing in Britain's Future: The Balance Between Capital and Current Expenditure in the Public Sector

This Economic Research Council report by Mr. Andrew Street will shortly be published. It was commissioned by the Council because of a growing concern at the worsening imbalance between capital and current expenditure in the public sector. Between 1973 and 1983 the share of capital expenditure fell from 13.3% to 7.9% of total public expenditure. Central and local government reduced its capital expenditure by 55% in real terms during this period. The whole of the decline was due to less construction expenditure. There is increasing alarm about this trend and an emerging debate about the resulting inadequacy of the nation's infrastructure.

This report argues that the Government's central economic objectives, such as low inflation and a prosperous private sector will actually be assisted by an increase in public sector capital expenditure. Therefore, it is the balance between current expenditure and receipts in the public sector which would be the focus of control. About half the financial deficit of central government is due to the "current account" while the much maligned local authorities have been persistently running a current surplus. The Government's attempts to reduce the Public Sector Borrowing Requirement by cutting capital expenditure, especially that by local authorities, is therefore not tackling the true problem.

The report suggests that the Government should recast that part of its Medium Term Financial Strategy dealing with public expenditure and borrowing. It should attempt to balance current receipts and expenditure. The borrowed funds should not support an increase in the money supply, so divorcing public investment from the system of monetary control.

The amount which ought to be borrowed over the next few years in order to meet capital expenditure needs is considerable. Until a coherent public sector investment appraisal is instituted, a complete picture cannot be painted, but even the incomplete and cursory examination attempted in this report identifies £12,600 million of new investment and £14,700 million of repair and maintenance. In other words, new investment expenditure must rise by 12% each year and repair and maintenance expenditure by 25% – both in real terms – just to meet these identified needs.

The Future Role of Building Societies

A Bill currently before Parliament proposes a radical change in the role of Building Societies. Among the many proposed reforms are freedom to offer insurance broking, unsecured lending, estate agency services, the undertaking of property development and the marketing of securities. Building societies will also be able to offer money transmission (i.e., cheque clearing) facilities in line with those of the clearing banks. The distinction between banks and building societies will therefore become much more blurred.

The following article suggests that building societies are already much closer to banks in their ability to create money than is commonly supposed.

A.S.

Are Building Society Depositors Necessary?

by Deryck Artingstall

Conventional wisdom has it that building societies accept depositors' monies and then re-lend them as mortgages to would-be house purchasers. – Is this really so?

The figures used in the ensuing argument are taken from pages 11 and 12 of the Anglia Building Society Report and Accounts 1985.

These accounts show that the Society advanced £969,183,000 for mortgages. How are these loans funded?

The Society's General Manager, in the course of some correspondence, maintained that the funds were obtainable from a combination of mortgage principal repaid, borrowing from the wholesale finance market and depositors' un-withdrawn balances. Principal repaid was £440,906,000, market borrowing was £121,080,000, which totalled £561,986,000, leaving a balance to be found from depositors of £407,197,000.

Now receipts from depositors were £2,241,287,000 to which was added the interest paid to depositors (derived from interest paid in by mortgage borrowers) – £214,486,000, making £2,455,773,000 as the total in depositors' accounts. But withdrawals by depositors amounted to £1,977,713,000, thus leaving in a balance of £433,486,000. It is from this sum which the Society claim they borrowed the £407,197,-000 needed to make up the total mortgage advances of £969,183,000.

It is with deliberate intention that the phrase 'claim to have borrowed' is used. For building societies (and banks), in relation to depositors' funds, give the verb 'to borrow' a quite different meaning to its accepted dictionary defined meaning. If ordinary mortals borrow a sum of money, then that money is at their disposal to spend in ways of their own choosing. Until the borrowed money is repaid then the lender is denied use of it. When, however, the money is repaid then the lender has use of it again and the borrower does not. But by "borrowing" building societies (and banks) mean that the money figures in ledgers (or computers) are manipulated in such a way as to make their books appear to balance. This accountancy sleight of hand covers up the fact that they have created the money they allege to have borrowed from their depositors. In questioning the claim two facts need to be noted.

First, when a building society lends out money for a mortgage it is for a ten to thirty year period. In real terms, therefore, they only have use of this money again for relending as it is repaid.

The second fact is that no depositor is ever denied the facility to withdraw any, or all, of his/her money for a mortgage length of time. Most depositors' money can be withdrawn on demand or at least with three months notice. Added to this no depositor's account is ever debited by the Society claiming to have borrowed some of that money.

When a society writes a cheque granting a mortage of, say £30,000, and it is paid into the borrower's bank, it becomes a credit of £30,000 from which payment is made to the builder of the house acquired, or to the previous owner. The £30,000 then stands as credit to the seller, to draw on at will. That is to say £30,000 exists as purchasing power in addition to the sums held in the society's depositors' accounts.

Returning to the Anglia's total figures in their 1985 Report, £969 million (in round figures) was advanced in loans. These accounts indicate that just over half this sum was derived from repaid mortgage principal (£441 million and borrowing from the wholesale market (£121 million). The remaining £407 million was supposed to have been borrowed from their depositors. It clearly was not. Because the depositors collectively will not be denied the use of £407 million for any part of the life-time of the mortgages granted. The depositors still have this sum, while the Society has issued and distributed it.

The only logical deduction is that the Society has created £407 million. It follows that depositors are not necessary to this money creating. The criterion of demand is sufficient reason and base for creating the necessary monies, subject, as now, to the ability to repay. But if depositors are not necessary then there is no reason to pay interest in order to attract deposits. Borrowers interest payments can and should be drastically reduced. Reduced indeed down to what can be regarded as a service fee, sufficient only to meet the operating cost of the societies.

It is an interesting point as to whether this argument does not apply to the banks. It is suggested that it does.

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